SOUTH-WESTERN
CENGAGE Learning

CHAPTER 8

DISCUSSION QUESTIONS

1. The accounting for payroll-related liabilities is more complicated than for other current liabilities because employers are required to withhold various taxes and other amounts from employees' salaries and remit these amounts to the proper authorities. The accounting for all these withholdings requires recognizing several liability and expense accounts.

2. If the payroll period does not coincide with the last day of a company's reporting year, the company must prepare an adjusting entry for salaries and wages expense and for the salaries and wages payable for the amount earned after the end of the last payroll period up to the close of the reporting year. In other words, if employees were paid through Friday, December 26, but work on Monday, Tuesday, and Wednesday (December 29 through 31) without being paid until Friday, January 2, then the wage and salary expense and the wage and salary liability must be included in an adjusting entry on December 31 in order to have these amounts reflected in the company's financial statements for the calendar year ended December 31.

3. Certain fringe benefits that accrue over an employee's term of employment allowing the employee to take time off with pay are called compensated absences; included are vacation pay, sick pay, early retirement benefits, and compensated time off (i.e., instead of overtime pay, the employee is allowed to take additional vacation).

4. Such a bonus plan increases the manager's incentive to manipulate reported earnings.

5. Expenses are recognized when incurred. The event that creates a severance benefit is the termination of employees. Although this item relates to future payouts, it is estimated and recognized as an expense in the current period.

6. In a defined contribution plan, the amount of money set aside to pay benefits is fixed, and the benefits that will be paid are uncertain. They depend on the earnings of the contributions, the age of retirement, and so forth. With a defined benefit plan, the pension benefits that will be paid are fixed, meaning retired workers will get a pension benefit that is based on factors such as the number of years worked.

7. Many plans associated with post-retirement benefits other than pensions are informal. As such, some companies do not view them as legally binding obligations. In addition, these plans are often not backed by an asset fund. In contrast, U.S. companies are required by law to maintain a pension fund to back up promises to make defined benefit pension payments.

8. A year-end adjusting entry is often necessary in connection with property taxes owed to city or county governments because the property tax assessment year of the governmental unit frequently does not coincide with the paying company's financial reporting year. When the assessment year and the reporting year do not coincide, the company being assessed must report a property tax liability on its end-of-year balance sheet for taxes owed for the first portion of the assessment year that need not be paid until some date after the close of the financial reporting year.

9. The primary objective of determining pretax accounting income is to provide investors and creditors with a relevant measure of operating results and management's performance. This measure should not be affected by the tax regulations that are not controllable by management. Therefore, the pretax accounting income is reported in the financial statements, and income tax expense is based on this pretax accounting income. The objectives of determining taxable income, on the other hand, include social equity, ease of administration, political considerations, and ensuring that individuals and corporations are taxed when they have the ability to pay.

10. A company reports the amount owed to the government for income taxes for a given year by preparing an adjusting entry at year-

end. The adjusting entry is composed of a debit to *Income Tax Expense* and a credit to *Income Taxes Payable* in the amount of the company's reported income before income taxes times the company's effective tax rate. The income tax expense is subtracted from income before income taxes on the statement of comprehensive income to arrive at net income. The income taxes payable account is shown on the year-end balance sheet as a current liability.

11. With a contingent liability, there is a *potential* liability to pay cash, perform a service, or ship a product; with an actual liability, there is a *definite* obligation to pay cash, perform a service, or ship a product. Actual liabilities are recognized on the balance sheet; contingent liabilities may be included with liabilities on the balance sheet, described in the notes, or not mentioned at all, depending on their likelihood of occurrence.

12. According to IAS 38, expenditure on research (or on the research phase of an internal project) shall be recognized as an

expense when it is incurred. As for expenditure on development (or from the development phase of an internal project) shall be

capitalized if, and only if, an entity can

meet all of the following criteria, or else it shall be recognized as an expense:

(a) the technical feasibility of completing the intangible asset so that it will be available for use or sale.

(b) its intention to complete the intangible asset and use or sell it.

(c) its ability to use or sell the intangible asset.

(d) how the intangible asset will generate probable future economic benefits. Among other things, the entity

can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself

or, if it is to be used internally, the usefulness of the intangible asset.

(e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.

(f) its ability to measure reliably the expenditure attributable to the intangible asset during its development.

13. With respect to advertising, the general presumption is that advertising expenditures are to be expensed because of the uncertainty around any future benefit. However, for some types of targeting advertising, where the advertising is directed at customers who have purchased in the past, the advertising cost should be initially capitalized as an asset because the future benefit is both probable and estimable.

14. Other revenues and expenses are those items incurred or earned from activities outside of, or peripheral to, the normal operations of a firm. For general industry, examples of items included would be dividend income, interest revenue, and interest expense.

15. Investors and creditors are generally interested in being able to assess a company's profitability, liquidity, and solvency. The earnings per share number provides a quick summary of a company's profitability that is normalized (for the number of shares of stock outstanding), thus allowing for comparison among firms. A company may have very high earnings, but if it has twice as many shares of stock outstanding as another company, its earnings per share may not be as high as the other company's and, thus, not deemed as profitable by investors.

PRACTICE EXERCISES

PE 8–1 (LO1) Salaries Expense Calculation

Income tax withholding payable	$ 2,750
Labor insurance withholding payable	1,045
Health insurance withholding payable	810
Salaries payable	50,395
Total salaries expense	$55,000

PE 8–2 (LO1) Salaries Expense Journal Entry

Salaries Expense	55,000	
Income Tax Withholding Payable		2,750
Labor Insurance Withholding Payable		1,045
Health Insurance Withholding Payable		810
Salaries Payable		50,395

PE 8–3 (LO1) Insurance Expense Calculation

Labor insurance payable	$3,658
Health insurance payable	2,755
Total insurance expense	$6,413

PE 8–4 (LO1) Insurance Expense Journal Entry

Insurance Expense	6,413	
Labor insurance payable		3,658
Health insurance payable		2,755

PE 8–5 (LO1) Salaries and Insurance Payments

Income Tax Withholding Payable	2,750	
Labor Insurance Withholding Payable	1,045	
Health Insurance Withholding Payable	810	
Cash		4,605
Labor insurance payable	3,658	
Health insurance payable	2,755	
Cash		6,413
Salaries Payable	50,395	
Cash		50,395

PE 8–6 (LO1) Accruing Compensated Absences

Salaries Expense	1,350	
Sick Leaves Payable		1,350

3 months in the quarter × $450 = $1,350

PE 8–7 (LO1) Using Compensated Absences

Sick Leaves Payable	900	
Cash		900

PE 8–8 (LO1) Post-employment Benefits

Salaries Expense	2,400,000	
Benefits Payable ($12,000 × 200)		2,400,000

PE 8–9 (LO1) Defined Contribution Plan

Pension Expense	250,000	
Cash		250,000

PE 8–10 (LO1) Defined Benefit Plan

Pension Expense	200,000	
Cash		160,000
Pension Liability Payable		40,000

PE 8–11 (LO1) Defined Benefit Plan

Pension Expense	80,000	
Cash		80,000

PE 8–12 (LO2) Sales Tax

Cash	552.5	
Sales Revenue		520
Sales Tax Payable ($520 × 6.25%)		32.5

PE 8–13 (LO2) Property Taxes

1. September 24

Prepaid Property Taxes	10,800	
Cash		10,800

2. December 31

Property Tax Expense	2,700	
Prepaid Property Taxes		2,700

$10,800/12 months = $900 per month; 3 months × $900 per month = $2,700

PE 8–14 (LO2) Income Tax Expense

The correct answer is D.

PE 8–15 (LO3) Provisions and Contingent Liabilities

The correct answer is E. "Probable" means the future event is likely to occur, and the amount can be measured reliably so that the entity can make an appropriate journal entry. According to IAS 37 paragraph 14, an entity must recognize a provision if, and only if (1) a present obligation (legal or constructive) has arisen as a result of a past event (the obligating event), (2) payment is probable ('more likely than not'), and (3) the amount can be estimated reliably.

PE 8–16 (LO4) Capitalize versus Expense

The correct answer is B.

PE 8–17 (LO5) Statement of Comprehensive Income Classification

Gross sales	$230,000	
Less: Sales returns	(5,000)	
Less: Sales discounts	(8,000)	
Net sales		$217,000
Cost of goods sold		95,000
Gross margin		$122,000
Operating expenses:		
Salaries expense	$ 11,000	
Advertising expense	3,500	
Rent expense	4,400	
Total operating expenses		18,900
Operating income		$103,100
Other revenues and expenses:		
Dividend revenue	$ 2,000	
Gain on sale of equipment	1,500	
Interest expense	(5,000)	
Net other revenues and expenses		(1,500)
Income from operations before income taxes		$101,600
Income taxes on operations (20%)		20,320
Net income		$ 81,280

Other comprehensive income	0
Comprehensive income	$ 81,280

PE 8–18 (LO5) Earnings per Share

1. Basic EPS: $1,360,000/650,000 shares = $2.09 per share

2. Diluted EPS: $1,360,000/(650,000 shares + 80,000 potential shares) = $1.86 per share

EXERCISES

E 8–1 (LO1) Bonus Computation and Journal Entry

1. The bonuses are calculated as follows:

	Chris	George
Net income	$745,000	$745,000
Bonus threshold	325,000	325,000
Income subject to bonus	$420,000	$420,000
Bonus package	× 0.05	× 0.04
Bonus (before any tax considerations)	$ 21,000	$ 16,800

2.

Salaries Expense ($21,000 + $16,800)	37,800	
Various Taxes Payable ($8,400 + $6,720)		15,120
Bonus Payable ($12,600 + $10,080)		22,680
To record bonuses earned by the president and vice president.		
Various Taxes Payable	15,120	
Bonus Payable	22,680	
Cash		37,800
To record the payment of bonuses.		

E 8–2 (LO1) Computing Pension Expense and Payments

Dec. 31	Pension Expense	250,000	
	Pension Liability Payable		250,000
Jan. 5	Pension Liability Payable	250,000	
	Cash		250,000

E 8–3 (LO2) Accounting for Property Taxes

1.	Aug. 1	Prepaid Property Tax	27,550	
		Cash		27,550
		Paid property taxes for the period July 1, 2017, through June 30, 2018.		
2.	Dec. 31	Property Tax Expense	13,775	
		Prepaid Property Tax		13,775
		To record (accrue) property tax expense for the period July 1, 2017 through December 31, 2017.		

E 8-4(LO1) Journalize Sales and Related Taxes

Kelly Inc.

Apr. 10	Cash	37,450	
	Sales Revenue		35,000
	Sales Taxes Payable		2,450

Jordon Inc.

Apr. 15	Cash	21,600	
	Sales Revenue ($21,600 ÷ 1.08)		20,000
	Sales Taxes Payable ($20,000 X .08)		1,600

E 8–5 (LO3) Provisions and Contingent Liabilities

The objective of this exercise is to illustrate the difficulty involved in applying the contingency standards. While the accounting standard uses terms such as *probable* and *possible*, matching these terms with probabilities is difficult. Studies show that there is little consensus on the probabilities associated with the terms *probable*, *possible*, and *remote*. While there are no exact answers to the scenarios given, students should recognize the judgment involved in making the classification decision. The following are provided as possible (or probable) answers.

a. A 40% probability of occurrence would most likely fall between remote and probable. If Rayn Company determined this contingency was reasonably possible, then note disclosure would be appropriate.

b. If the probability of incurring fines levied by the government is less than 10%, most would classify this event as remote and provide no information (or only a brief mention, with no details) in the notes to the financial statements.

c. A probability of 90% is likely to be interpreted as probable. If management determines the likelihood of losing the gender discrimination lawsuit as being probable, the liability (and associated loss) would be formally recognized in the accounting records.

E 8–6 (LO3) Warranty

1.

Apr. 30	Product Warranty Expense	77,000	
	Product Warranty Provision		77,000

2.

Sep.	Product Warranty Provision	45,000	
	Supplies (Cash or Wages Payable)*		45,000

*Depends on what resources Quick Manufacturing Co. uses for repair.

E 8–7 (LO3) Computing Warranty Expense

1.

Jan. 31	Product Warranty Expense	50,000	
	Product Warranty Provision		50,000

2.

Feb. 5	Product Warranty Provision	7,000	
	Supplies		4,250
	Wages Payable		2,750

E 8–8 (LO4) Classifying Expenditures as Assets or Expenses

1. This amount should be expensed. Although the company expects the ad to increase sales over the next 18 months, the product is new and the advertis-

ing is not directed at specific past customers. Significant uncertainty exists regarding the actual amount of increased sales in the future.

2. The entire amount should be expensed. Although the company feels that the research costs will be beneficial in the future, significant uncertainty still exists. It may take years before any actual sales are generated from the research, or there may be no sales at all.
3. The cost of this targeted advertising should be capitalized and then recognized as an expense over the expected beneficial life of the advertising campaign.

4. This one is easy—the cost of the warehouse should be capitalized.

E 8–9 (LO5) Preparing an Statement of Comprehensive Income

Ragnarok Company
Statement of Comprehensive Income
For the Year Ended December 31, 2018

Revenues:			
Gross sales revenue		$39,850	
Less: Sales returns		1,200	
Net sales revenue			$38,650
Cost of goods sold			21,500
Gross margin			$17,150
Operating expenses:			
Selling expenses		$ 970	
General and administrative expenses:			
Office supplies expense	$200		
Insurance expense	540		
Total general and administrative expenses		740	
Total operating expenses			1,710
Operating income			$15,440
Other revenues and expenses:			
Revenue from investments		$ 250	
Interest expense		(410)	
Net other revenues and expenses			(160)
Income from operations before income taxes			$15,280
Income taxes on operations (30%)			4,584
Net income $10,696			
Other comprehensive income			0
Comprehensive income			$ 10,696
Earnings per share:			
Net income ($10,696/900)			$ 11.88

E 8–10 (LO5) Unifying Concepts: The Statement of Comprehensive Income

Fairchild Corporation
Statement of Comprehensive Income
For the Year Ended December 31, 2018

Revenues:			
Gross sales revenue		$395,472	
Less: Sales returns	$ 4,280		
Less: Sales discounts	3,644	7,924	
Net sales revenue			$387,548
Cost of goods sold:			
Inventory, January 1, 2018		$ 79,400	
Purchases	$230,560		
Less: Purchases discounts	3,050		
Net purchases		227,510	
Cost of goods available for sale		$306,910	
Less: Inventory, December 31, 2018		44,300	
Total cost of goods sold			262,610
Gross margin			$124,938
Operating expenses:			
Selling expenses:			
Sales salaries expense	$ 40,088		
Advertising expense	6,922		
Delivery expense	2,198		
Insurance expense	1,160		
Store supplies expense	800		
Miscellaneous expenses	460		
Total selling expenses		$ 51,628	
General and administrative expenses:			
Office salaries expense	$ 12,064		
Utilities expense	3,980		
Payroll tax expense	3,600		
Miscellaneous expenses	620		
Insurance expense	600		
Office supplies expense	400		
Total general and administrative expenses		21,264	
Total operating expenses			72,892
Operating income			$ 52,046
Other revenues and expenses:			
Interest revenue		$ 2,400	
Interest expense		(1,170)	1,230
Income before income taxes			$ 53,276
Income taxes			26,000

Net income	$ 27,276
Other comprehensive income	0
Comprehensive income	$ 27,276
Earnings per share ($27,276 ÷ 10,000 shares)	$ 2.73

PROBLEMS

P 8–1 (LO1) Payroll Accounting

1.	Salaries Expense	159,000	
	Income Tax Withholding Payable		6,720
	Labor Insurance Withholding Payable		3,021
	Health Insurance Withholding Payable		3,462
	Salaries Payable		145,797
	To record salaries for the month of December.		
2.	Salaries Payable	145,797	
	Cash		145,797
	Paid salaries for the month of December.		

P 8–2 (LO1,LO6) Payroll Accounting

1. (1) $64,000*5%=$3,200
5% of the salary is withheld for income tax.

(2) $57,000*(8.5%+1%)*20%=$1,083
The insurance rate for accident is 8.5% of the salary and the employment insurance rate is 1% of the salary, and the employee is responsible for the payments of 20% of insurance.

(3) $90,000*4.91%*30%=$1,326
The National Health Insurance premium rate is 4.91% of the salary, and the employee is responsible for the payments of 30%.

2.	Salaries Expense	211,000	
	Income Tax Withholding Payable		10,550
	Labor Insurance Withholding Payable		4,009
	Health Insurance Withholding Payable		3,109
	Cash (or Salaries Payable)		193,332

3. In addition to income and insurance, employers often withhold amounts for union dues, charitable contributions, employee savings plans, and retirement benefits.

P 8–3 (LO1) Determining Payroll Costs

1.

	Commission Rate	Gross Sales	Commission
Jordan	3.0%	NT$140,000	NT$4,200
Alisa	4.5	200,000	9,000
Kasey	1.5	110,000	1,650
Trevor	5.0	180,000	9,000
Chad	2.5	90,000	2,250
Total commissions			NT$26,100

Payroll expense is computed as follows:

Base salaries	NT$ 125,000
Commissions	26,100
Payroll expense	NT$ 151,100

2.

Salary and commission	NT$151,100
Income tax withheld(5%)	(7,555)
Labor and health Insurance withheld	(5,137)
Cash paid to employees	NT$138,408

3. The advantage to taxpayers of having no taxes withheld is that taxpayers would get to keep their money longer before sending it in to the government. The taxpayers could earn interest on this money in the interim. The disadvantage to the taxpayers is that many would not have the discipline to set aside money to pay their taxes due at the end of the year. They would then be forced to seek out loans, probably at a premium interest rate, with which to pay their taxes. The advantage to the government of having taxes withheld is that the inflow of tax revenue is steady and more reliable. It is difficult to think of any reason why the government would not want taxes withheld.

P8-4 (LO1) Recording Accrual of Compensated Absences

a.

Jan. 31	Salaries Expense	324	
	Sick Days Payable-John(8*$15*1.5)		180
	Sick Days Payable-Susan(8*$12*1.5)		144
Feb. 28	Salaries Expense	324	
	Sick Days Payable-John		180
	Sick Days Payable-Susan		144

b.

Mar. 31	Salaries Expense	324	
	Sick Days Payable-John		180
	Sick Days Payable-Susan		144
	Sick Days Payable-John	360	
	Various Taxes Payable(360*25%)		90
	Cash		270
	Sick Days Payable-Susan(8*$12*1)	96	
	Various Taxes Payable(96*25%)		24
	Cash		72

P8-5 (LO4) Preparing Entry for Research and Development Costs

Research and Development Expense ($260,000 + $450,000)	710,000	
Development Costs	250,000	
Cash		960,000

P 8-6 (LO5) Unifying Concepts: The Statement of Comprehensive Income

Moriancumer, Inc.
Statement of Comprehensive Income
For the Year Ended December 31, 2018

Gross sales revenue		$4,650,000	
Less: Sales returns		8,000	
Net sales revenue			$4,642,000
Cost of goods sold			3,205,000
Gross margin			$1,437,000
Operating expenses:			
Selling expenses:			
Sales salaries expense	$450,000		
Advertising and promotion expense	215,000		
Insurance expense	800		
Rent expense	16,000		
Miscellaneous expenses	6,300		
Payroll tax expense	5,200		
Automobile expense	4,000		
Delivery expense	3,100		
Entertainment expense	1,500	$ 701,900	
General and administrative expenses:			
Administrative salaries expense	$200,000		

Office supplies expense	7,200		
Miscellaneous expenses	5,400		
Utilities expense	1,300		
Insurance expense	800	214,700	
Total operating expenses			916,600
Operating income			$ 520,400
Other revenues and expenses:			
Interest revenue		$ 3,000	
Interest expense		(39,900)	(36,900)
Income before income taxes			$ 483,500
Income taxes			96,500
Net income			$ 387,000
Other comprehensive income			0
Comprehensive income			$ 387,000
Earnings per share			$ 10.46

P 8–7 (LO5) Statement of Comprehensive Income Analysis

	2019	2018	2017
Gross sales revenue	$56,000	(9) *$51,400*	$47,600
Sales discounts	0	300	200
Sales returns	0	100	400
Net sales revenue	56,000	(10) *51,000*	(1) *47,000*
Beginning inventory	(15) *7,200*	8,700	(2) *12,000*
Purchases	33,400	(11) *29,500*	25,000
Purchases discounts	700	400	800
Freight-in	(16) *600*	0	700
Cost of goods available for sale	40,500	37,800	(3) *36,900*
Ending inventory	6,900	(12) *7,200*	(4) *8,700*
Cost of goods sold	(17) *33,600*	(13) *30,600*	(5) *28,200*
Gross margin (40%)	(18) *22,400*	20,400	(6) *18,800*
Selling expenses	4,500	(14) *3,300*	(7) *4,100*
General and administrative expenses	(19) *3,600*	3,100	2,800
Income before income taxes	14,300	14,000	11,900
Income taxes	4,250	4,200	(8) *3,500*
Net income	(20) *10,050*	9,800	8,400

Calculations (to be made in the following order):

(1) $47,600 – $200 – $400 = $47,000
(8) $11,900 – $8,400 = $3,500
(6) 0.40 × $47,000 = $18,800
(7) $18,800 – $2,800 – $11,900 = $4,100
(5) $47,000 – $18,800 = $28,200
(4) From beginning inventory, period 2018 = $8,700
(3) $28,200 + $8,700 = $36,900
(2) $36,900 – $25,000 + $800 – $700 = $12,000
(10) $20,400 ÷ 0.40 = $51,000
(9) $51,000 + $100 + $300 = $51,400
(11) $37,800 – $8,700 + $400 = $29,500
(13) $51,000 – $20,400 = $30,600
(12) $37,800 – $30,600 = $7,200
(14) $20,400 – $3,100 – $14,000 = $3,300
(15) From ending inventory, period 2018 = $7,200
(16) $40,500 – $7,200 – $33,400 + $700 = = $600
(17) $40,500 – $6,900 = $33,600
(18) $56,000 – $33,600 = $22,400
(19) $22,400 – $4,500 – $14,300 = $3,600
(20) $14,300 – $4,250 = $10,050

ANALYTICAL ASSIGNMENTS

AA 8–1 *You Decide:* Should start-up costs be capitalized or expensed?

Judgment Call

Issues to be discussed with this question are:

1. According to IAS 38 paragraph 69(a), expenditure on start-up activities (ie start-up costs) is recognized as an expense when it is incurred, unless this expenditure is included in the cost of an item of property, plant and equipment in accordance with IAS 16. Start-up costs may consist of establishment costs such as legal and secretarial costs incurred in establishing a legal entity, expenditure to open a new facility or business (ie pre-opening costs) or expenditures for starting new operations or launching new products or processes (ie pre-operating costs).
2. It is not necessary that the tax accounting match the financial accounting for many start-up costs.
3. If start-up costs are capitalized, then they must be expensed against the future revenues those costs will generate.

AA 8–2 Hutchison Whampoa

International

1.

Income Tax Expense	165	
Deferred Income Taxes Payable		165
To recognize deferred income tax liability on $1,000 of income earned by foreign subsidiary ($1,000 × 0.165).		

The income tax liability is deferred because it won't have to be paid until the income is transferred to the parent company in Hong Kong. This transfer may not take place for many years. In fact, as far as the Hong Kong government is concerned, there is no tax liability until the transfer takes place.

Interestingly, this is not how Hutchison Whampoa would actually account for these income taxes. According to Hong Kong accounting rules, no deferred income tax liability is required to be recognized if there is no reasonable probability that the income will be transferred and the tax paid in the foreseeable future. In its annual report, Hutchison reports that "it is not anticipated that these amounts will be remitted in the near future." Thus, since Hutchison does not expect to have to pay the $165 in taxes in the foreseeable future, it would not have to report the deferred tax liability. On the other hand, if Hutchison were using U.S. accounting rules, it would have to report the deferred tax liability whether it anticipated paying the taxes in the foreseeable future or not.

2. EPS = Net Income/Shares Outstanding

   HK$4.14 = HK$17.664 billion/Shares Outstanding

   Shares Outstanding = 4.267 billion

3. The costs Hutchison Whampoa incurs in order to sign up new subscribers to its cellular phone service network are assumed to benefit future periods, not just the period when the subscriber is initially signed up. Since Hutchison reports that the costs are expensed over the following 12 to 24 months, it seems that Hutchison has found through experience that, if it can sign up a subscriber, the subscriber is likely to stay with the service an average of 12 to 24 months (or maybe more). Thus, it makes sense to assign the costs of signing up the subscriber to the subsequent periods.

AA 8–3 Twisting the Contingency Rules to Save the Environment

Ethics

Frank is clearly unaware of the accounting rules governing the financial statement reporting of contingent liabilities. From your examination of Allied's financial statement disclosure, it appears that Allied Industrial has followed the accounting rules exactly—the contingent liability for the $140 million cleanup cost is deemed to be possible but not probable and is therefore disclosed in the notes but is not recognized in the balance sheet. Allied is adhering exactly to the accounting rule for contingencies established by the FASB.

Of course, it may be that Allied has intentionally understated the probability that the contingent liability will materialize. However, even if this is true, the contingent liability is still completely described in the notes to Allied's financial statements that are available to any member of the public. This can hardly be used as evidence of a cover-up.

You have a responsibility to explain the accounting rules to Frank. You should convince Frank not to misrepresent Allied's disclosure as evidence of a cover-up. Using this deceptive technique could eventually backfire if Allied is then able to tell the public that your group has maliciously and knowingly twisted its financial statement disclosures. The last thing you want is for the public to start to view Allied Industrial sympathetically as an oppressed organization. A better strategy may be to use the financial statement disclosure in a fair manner. Acknowledge that while Allied Industrial is not currently obligated to pay the $140 million in toxic waste cleanup costs, the fact that Allied is involved in litigation with 13 other sites may demonstrate a pattern of environmental irresponsibility. In this way Frank can still use the information, but he shouldn't misrepresent it.

EXPANDED MATERIAL

PRACTICE EXERCISES

PE 8–19 (LO6) Insurance Payment Calculation

Payment by the Mei-Hui
NT$55,000 × (8.5% + 1%) × 0.2 =NT$1,045

Payment by the employer
NT$55,000 × (8.5% + 1%) × 0.7= NT$3,658
NT$55,000 × 0.09% × 100% = NT$50
Total:NT$3,708

PE 8–20 (LO6) Insurance Payment Calculation

Payment by the Mei-Hui
NT$55,000 × 4.91% × 0.3 × 1 =NT$810

Payment by the employer
NT$55,000 × 4.91% × 0.6 × (1 + 0.7) =NT$2,755

PE 8–21 (LO6) Salaries Expense Journal Entry

Salaries Expense	55,000	
Income Tax Withholding Payable		2,750
Labor Insurance Withholding Payable		1,045
Health Insurance Withholding Payable		810
Salaries Payable		50,395

PE 8–22 (LO6) Insurance Expense Journal Entry

Insurance Expense	6,463	
Labor Insurance Payable		3,708
Health Insurance Payable		2,755

PE 8–23 (LO6) Salaries and Insurance Payments

Salaries Payable	50,395	
Cash		50,395

PE 8–23 (LO6) (Continued)

Income Tax Withholding Payable	2,750	
Labor Insurance Withholding Payable	1,045	
Health Insurance Withholding Payable	810	
Labor Insurance Payable	3,708	
Health Insurance Payable	2,755	
Cash		11,068

EXERCISES

E 8–11 (LO6) Payroll Accounting

Salaries Expense	77,000(1)	
Income Tax Withholding Payable		3,850(2)
Labor Insurance Withholding Payable		1,463(3)
Health Insurance Withholding Payable		1,134(4)
Cash (or Salaries Payable)		70,553
To record payroll for 2018.		

(1) NT$35,000 + NT$42,000 = NT$77,000
(2) 5% of the salary is withheld for income tax. (5%* NT$77,000)
(3) The insurance rate for accident is 8.5% of the salary and the employment insurance rate is 1% of the salary, and the employee is responsible for the payments of 20% of insurance. (9.5%* NT$77,000*0.2)
(4) The National Health Insurance premium rate is 4.91% of the salary, and the employee is responsible for the payments of 30%. (NT$77,000*4.91%*0.3*1)

PROBLEMS

P 8–8 (LO6) Payroll Accounting

Salaries Expense	142,000(1)	
Income Tax Withholding Payable		7,100(2)
Labor Insurance Withholding Payable		2,698(3)
Health Insurance Withholding Payable		2,975(4)
Cash (or Salaries Payable)	129,227	
To record payroll for 2018.		

(1) NT$60,000 + NT$42,000 + NT$40,000 = NT$142,000
(2) 5% of the salary is withheld for income tax. (5%* NT$142,000)
(3) The insurance rate for accident is 8.5% of the salary and the employment insurance rate is 1% of the salary, and the employee is responsible for the payments of 20% of insurance. (9.5%* NT142,000*0.2)
(4) The National Health Insurance premium rate is 4.91% of the salary, and the employee is responsible for the payments of 30%. (4.91%*0.3*(NT$60,000*2 + NT$42,000*1 + NT$40,000*1))

Insurance Expense	16,697	
Labor Insurance Payable		9,585(5)
Health Insurance Payable		7,112(6)

(5) The insurance rate for accident is 8.5% of the salary and the employment insurance rate is 1% of the salary, and the employer is responsible for the payments of 70% of insurance. The occupational injury payment is 0.1% (9.5%* NT142,000*0.7 + 0.1%*NT$142,000)
(6) The National Health Insurance premium rate is 4.91% of the salary, and the employer is responsible for the payments of 60%. (NT$142,000*4.91%*0.6*(1 + 0.7))

SOLUTIONS TO "STOP & THINK"

Stop & Think (p. 327): Why might a company hesitate to assess the likelihood of losing an ongoing lawsuit as being probable? If you were the attorney for the plaintiff, how could you use the resulting information from the financial statements?

If a company were to consider the likelihood of losing a lawsuit as probable, then the proper accounting treatment would be to recognize the loss on the statement of comprehensive income and to record a liability on the balance sheet. If you were the attorney for the plaintiff in that case, you might use that information to plan your courtroom strategy. After all, if the company thinks it's going to lose, that would give you a distinct advantage.

Stop & Think (p. 331): Would you expect that a rule requiring all firms to expense R&D outlays would cause R&D expenditures to decrease? Why or why not?

Here are arguments on both sides of the issue:

Economic Consequences

While IFRS stipulates that firms capitalize R&D costs incurred after technological feasibility has been established, the U.S. GAAP requires that firms expense all the R&D outlays. From the perspective of a U.S. firm, it will be affected in the following ways:

1. Reported R&D expenses are higher.
2. Reported net income is lower. When a firm's income is lower, banks are less willing to loan money, and investors are less willing to invest.
3. Shortage of financing causes U.S. firms to cut back their research activities.
4. A slowdown in U.S. research activity puts U.S. firms behind foreign firms in terms of technical advancement.

Efficient Market

Bankers and investors, with millions of dollars on the line, do not blindly read financial statements. They are aware of the conservative R&D accounting rule set by the FASB, and they adjust their valuation and forecasting models accordingly when they use the financial statements of companies that perform R&D. Bankers and investors are interested in the economic performance of companies, not in accounting performance. The claim that bankers and investors will reduce financing to firms that report low net income as a result of expensing R&D implies that bankers and investors are completely trusting of whatever numbers the accountants choose to report. This is absurd.

SOUTH-WESTERN
CENGAGE Learning

Comprehensive Problem Chapters 6–8

1. Journal entries:

Jan.	1	Rent Expense	1,400	
		Cash		1,400
		Paid monthly rent on computer equipment.		
	5	Accounts Receivable	27,300	
		Sales		27,300
		Recorded sales for the week.		
	5	Wages Payable	2,800	
		Taxes Payable	3,400	
		Cash		6,200
		Paid wages and taxes from December.		
	5	Cash	19,000	
		Accounts Receivable		19,000
		Collections from customers.		
	8	Office Supplies	300	
		Cash		300
		Purchased office supplies.		
	10	Purchases	10,150	
		Accounts Payable		10,150
		Purchased inventory on account.		
	11	Accounts Payable	16,900	
		Cash		16,900
		Paid accounts payable.		
	12	Cash	22,000	
		Accounts Receivable		22,000
		Collections from customers.		
	12	Accounts Receivable	25,200	
		Sales		25,200
		Recorded sales for the week.		
	15	Rent Expense	2,200	
		Cash		2,200
		Paid monthly rent on office and warehouse.		
	15	Purchases	19,500	
		Accounts Payable		19,500
		Purchased inventory on account.		
	18	Sales Returns	210	
		Cash		210
		Product returned and customer sent a refund.		

Comp. Prob. 6–8 (Continued)

Jan.	19	Cash	30,000	
		Accounts Receivable		30,000
		Collections from customers.		
	19	Accounts Receivable	29,400	
		Sales		29,400
		Recorded sales for the week.		
	20	Salaries and Wages Expense	4,800	
		Income Tax Withholding Payable		310
		Insurance Withholding Payable		780
		Cash		3,710
		To record salaries for the first part of January.		
		Insurance Expense	367	
		Insurance Payable		367
		To record insurance contributed by employer.		
	22	Allowance for Bad Debts	630	
		Accounts Receivable		630
		Wrote off an account as uncollectible.		
	23	Income Tax Withholding Payable	310	
		Cash		310
		Paid tax withholdings to government.		
	24	Purchases	27,000	
		Accounts Payable		27,000
		Purchased inventory on account.		
	25	Office Supplies	480	
		Cash		480
		Purchased office supplies.		
	25	Accounts Payable	43,000	
		Cash		43,000
		Paid accounts payable.		
	26	Cash	30,500	
		Accounts Receivable		30,500
		Collections from customers.		

Comp. Prob. 6–8 (Continued)

Jan.	26	Accounts Receivable	29,700	
		Sales		29,700
		Recorded sales for the week.		
	29	Sales Returns	1,470	
		Cash		1,470
		Products returned and customers sent a refund.		
	30	Purchases	20,300	
		Accounts Payable		20,300
		Purchased inventory on account.		
	31	Cash	29,900	
		Accounts Receivable		29,900
		Collections from customers.		
	31	Accounts Receivable	15,400	
		Sales		15,400
		Recorded sales for the partial week.		
	31	Salaries and Wages Expense	5,000	
		Insurance Withholding Payable		230
		Income Tax Withholding Payable		810
		Wages Payable		3,960
		To record salaries for the last part of January.		
		Insurance Expense	382	
		Insurance Payable		382
		To record insurance contributed by employer.		

2. Adjusting entries:

Bad Debt Expense	261	
Allowance for Bad Debts		261
To record bad debt expense for the period [$21,770 × 2% = $435 (rounded); $435 desired ending balance – $174 existing balance = $261 bad debt expense].		
Supplies Expense	680	
Office Supplies		680
To record supplies used for the period ($1,680 – $1,000 = $680).		

Comp. Prob. 6–8 (Continued)

Cost of Goods Sold	84,550	
Inventory		7,600
Purchases		76,950
To adjust inventory to its year-end balance ($24,050) and close purchases.		

Ending inventory based on a physical count, 165 units. Using a FIFO assumption, those 165 units came from the most recent purchases. That would consist of the following:

Purchase Date	Amount	Unit Cost	Total Value
Jan. 30	140	$145	$20,300
Jan. 24	25	150	3,750
Total	165		$24,050

3. Trial balance:

Fray Enterprises
Trial Balance
January 31, 2018

	Debits	Credits
Cash	$ 64,420	
Accounts Receivable	21,770	
Allowance for Bad Debts		$ 435
Inventory	24,050	
Prepaid Rent	1,100	
Office Supplies	1,000	
Accounts Payable		36,150
Wages Payable		3,960
Taxes Payable		810
Insurance Payable		1,759
Common Stock (10,000 shares)		30,000
Retained Earnings		13,546
Sales		127,000
Sales Returns	1,680	
Cost of Goods Sold	84,550	
Rent Expense	3,600	
Salaries and Wages Expense	9,800	
Supplies Expense	680	
Insurance Expense	749	
Bad Debt Expense	261	
Total	$213,660	$213,660

Comp. Prob. 6–8 (Continued)

4. Income statement and balance sheet:

Fray Enterprises
Statement of Comprehensive Income
For the Month Ended January 31, 2018

Sales	$127,000	
Less sales returns	1,680	
Net sales		$125,320
Less cost of goods sold		84,550
Gross margin		$ 40,770
Less expenses:		
Salaries and wages expense	$ 9,800	
Rent expense	3,600	
Supplies expense	680	
Insurance expense	749	
Bad debt expense	261	15,090
Operating income		25,680
Income taxes		0
Net income		$ 25,680
Other comprehensive income		0
Total comprehensive income		$25,680
Earnings per share ($25,680/10,000 shares)		$ 2.57

Fray Enterprises
Balance Sheet
January 31, 2018

Assets:		
Cash		$ 64,420
Accounts receivable	$21,770	
Allowance for bad debts	435	21,335
Inventory		24,050
Prepaid rent		1,100
Office supplies		1,000
Total assets		$111,905
Liabilities and Equity		
Liabilities:		
Accounts payable	$36,150	
Wages payable	3,960	
Taxes payable	810	
Insurance Payable	1,759	
Total liabilities		$ 42,679
Equity:		
Common stock	$30,000	

Retained earnings	39,226*	
Total equity		69,226
Total liabilities and equity		$111,905

*$13,546 + $25,680

Comp. Prob. 6–8 (Concluded)

5. Days' sales in inventory = $84,550/[($24,050 + $31,650)/2] = 3.0359
= 365 days/3.0359
= 120 days

Days' sales in receivables = $127,000/[($21,335 + $25,996)/2] = 5.3665
= 365 days/5.3665
= 68 days

Days' purchases in payables = $76,950/[($36,150 + $19,100)/2] = 2.7855
= 365 days/2.7855
= 131 days

Based on this analysis, Fray's operating cycle is approximately 188 days in length. That is, the time between when the company receives inventory and when it receives the cash from the sale of that inventory is 188 days. Since the company pays for its inventory in 131 days, the company must finance the difference, 57 days, using other means.