1. Zero Mostel Company began operations on January 2, 2003. It employs 9 individuals who work 8-hour days and are paid hourly. Each employee earns 10 paid vacation days and 6 paid sick days annually. Vacation days may be taken after January 15 of the year following the year in which they are earned. Sick days may be taken as soon as they are earned; unused sick days accumulate. Additional information is as follows.

Actual Hourly Vacation Days Used Sick Days Used

Wage Rate by Each Employee by Each Employee

2003 2004 2003 2004 2003 2004

$10 $11 0 9 4 5

Zero Mostel Company has chosen to accrue the cost of compensated absences at rates of pay in effect during

the period when earned and to accrue sick pay when earned.

**Instructions**

**(a)** Prepare journal entries to record transactions related to compensated absences during 2003 and 2004.

**(b)** Compute the amounts of any liability for compensated absences that should be reported on the balance sheet at December 31, 2003 and 2004.

1. Soundgarden Company sold 200 copymaking machines in 2004 for $4,000 a piece, together with a one-year warranty. Maintenance on each machine during the warranty period averages $330.

**Instructions**

**(a)** Prepare entries to record the sale of the machines and the related warranty costs, assuming that the accrual method is used. Actual warranty costs incurred in 2004 were $17,000.

**(b)** On the basis of the data above, prepare the appropriate entries, assuming that the cash basis method is used.

1. Presented below are three independent situations. Answer the question at the end of each situation.

**1.** During 2004, Salt-n-Pepa Inc. became involved in a tax dispute with the IRS. Salt-n-Pepa’s attorneys have indicated that they believe it is probable that Salt-n-Pepa will lose this dispute. They also believe that Salt-n-Pepa will have to pay the IRS between $900,000 and $1,400,000. After the 2004 financial statements were issued, the case was settled with the IRS for $1,200,000. What amount, if any, should be reported as a liability for this contingency as of December 31, 2004?

**2.** On October 1, 2004, Alan Jackson Chemical was identified as a potentially responsible party by the Environmental Protection Agency. Jackson’s management along with its counsel have concluded that it is probable that Jackson will be responsible for damages, and a reasonable estimate of these damages is $5,000,000. Jackson’s insurance policy of $9,000,000 has a deductible clause of $500,000. How should Alan Jackson Chemical report this information in its financial statements at December 31, 2004?

**3.** Melissa Etheridge Inc. had a manufacturing plant in Bosnia, which was destroyed in the civil war. It is not certain who will compensate Etheridge for this destruction, but Etheridge has been assured by governmental officials that it will receive a definite amount for this plant. The amount of the compensation will be less than the fair value of the plant, but more than its book value. How should the contingency be reported in the financial statements of Etheridge Inc.?