

## Case 12-2

### To Recognize or Not to Recognize, That Is the Question

Shakespeare Inc. (Shakespeare or the “Company”) is a privately held book printing and publishing company with a December 31 year-end. The summary balance sheet as of December 31, 2011, included:

|                          |                     |
|--------------------------|---------------------|
| Current assets           | \$ 6,500,000        |
| Noncurrent assets        | <u>28,250,000</u>   |
| Total assets             | <u>\$34,750,000</u> |
|                          |                     |
| Current liabilities      | \$ 4,500,000        |
| Noncurrent liabilities   | <u>13,750,000</u>   |
| Total liabilities        | <u>\$18,250,000</u> |
|                          |                     |
| Total shareholder equity | <u>\$16,500,000</u> |

The summary results of operations for the year ended December 31, 2011, included revenue of \$10.7 million and net income of \$1.2 million.

Shakespeare is planning to issue its financial statements on March 20, 2012. On March 18, 2012, Shakespeare’s management will evaluate new information about one of its accruals and two subsequent events to determine if this information or events represent items that should be recognized or disclosed in the December 31, 2011, financial statements.

#### ***Medical Benefits Payable***

For the past several years, Shakespeare has self-insured medical benefits (health and dental) for its employees. The Company records the costs of medical care in the period in which covered events occur and includes its best estimate of the costs that have been incurred but not yet reported (IBNR) in its estimate of the medical benefits payable. Shakespeare looks to the *FASB Accounting Standards Codification*, which defines IBNR in the Master Glossary as “[l]osses incurred by the insured entity that have not yet been reported to the insurance entity.” Shakespeare’s management estimates its liability with the assistance of third-party experts using actuarial techniques, assumptions, and observations that are based on past experience of claims paid through the balance sheet date. The Company monitors the continued reasonableness of the assumptions and methods used to estimate the IBNR liability each reporting period. Management’s process for estimating its medical benefits payable is disclosed in its “Significant Accounting Policies” footnote. Management has a history of accurately estimating the IBNR liability using these techniques as validated by the actual claims received. Historically, all claims are received by Shakespeare within two months of the medical services being provided to its employees.

Using this process, management estimated an IBNR liability of \$1.25 million as of December 31, 2011. As of management’s review on March 18, 2012, Shakespeare had

received claims totaling \$0.75 million for medical care costs incurred before December 31, 2011.

### ***Line of Credit Modification***

As of December 31, 2011, Shakespeare had a line of credit with a bank of \$8 million (with a \$10 million maximum amount available) due in approximately three years from the balance sheet date. Interest accrues on amounts drawn under the line at the London Interbank Offered Rate (LIBOR) (subject to a 3.5 percent floor) plus 7.5 percent per year. Shakespeare is also required to pay a commitment fee equal to 2 percent per year on the portion of the line of credit that was not drawn upon.

On March 1, 2012, the Company completed its modification of the terms of the line of credit with the bank to finance the acquisition of a competitor printing and publishing company (see further facts of acquisition below). The key modified terms are as follows:

- The maximum amount available under the line of credit was increased from \$10 million to \$20 million.
- The term was extended another three years past the original due date (i.e., now due in approximately six years from the balance sheet date).
- The interest rate on amounts drawn was reduced to LIBOR plus 3 percent (still subject to a 3.5 percent floor).
- The commitment fee on undrawn amounts reduced to 0.5 percent.

### ***Acquisition of a New Publishing Company***

Using the funds from the modified line of credit, Shakespeare's management drew \$10 million from the additional capacity on March 10, 2012, to acquire a competitor publishing company in the northeast United States, Hamlet. On the basis of its initial assessment from the Company's due diligence (that started shortly before the balance sheet date), management's best estimate of the allocation of the \$10 million purchase is as follows: \$2 million of current assets and \$8 million noncurrent assets (comprising \$5 million of identifiable noncurrent assets, \$2 million of intangible assets, and \$1 million of goodwill). Hamlet's prior-year audited financial statements included revenue of \$3.2 million and Earnings Before Income Taxes, Depreciation, and Amortization (EBITDA) of \$1.1 million. The estimated purchase price allocation has not been finalized and is expected to be after the financial statements are issued.

### **Required:**

1. Should the information pertaining to actual claims incurred as of the balance sheet date that became available after the balance sheet date be considered in determining management's best estimate of the medical benefits payable? If so, how does this information impact the amount recognized or disclosed?
2. How, if at all, is the modification to the line of credit recognized or disclosed in the financial statements?

3. How, if at all, is the acquisition of Hamlet recognized or disclosed in the financial statements?
4. What should Shakespeare disclose about the date through which the financial statements were evaluated for subsequent events? How would this disclosure change if Shakespeare were an SEC filer?
5. Shakespeare is contemplating adopting IFRSs in the coming year. What guidance in IFRSs addresses events that occur after the balance sheet date but before the financial statements are issued? What does this guidance state about the recognition, measurement, or disclosure of such events?