RIGOS CMA REVIEW

PART 1 – CHAPTER 1

EXTERNAL FINANCIAL REPORTING DECISIONS

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PART 1 - CHAPTER 1

EXTERNAL FINANCIAL REPORTING

I. OBJECTIVES OF EXTERNAL FINANCIAL REPORTING

The intention of the Financial Accounting Standards Board (FASB) is to create a coherent system of interrelated accounting objectives and fundamentals that can lead to consistent standards and principles. This is to be implemented through a series of Statements of Financial Accounting Concepts. These are pronouncements which are intended by the FASB to set forth objectives and fundamentals that will be used as a basis for future development of financial accounting and reporting standards.

A. Information on Resources and Obligations

The FASB's SFAC No. 1 (superseded by SFAC No. 8) establishes the objectives of general purpose external financial reporting. The following objectives were established:

1. **Investment Decisions:** Financial reporting should provide information that is useful to existing and potential investors, lenders, and creditors, and other users in making rational investment, credit and similar decisions.

2. **Cash Receipts:** Financial reporting should provide information to help present and potential investors and creditors and other users in assessing the amounts, timing, and uncertainty of prospective cash receipts from dividends or interest and the proceeds from the sale, redemption, or maturity of securities and loans.

3. **Resources:** Financial reporting should provide information about the economic resources of an enterprise (assets), the claims to those resources (obligations of the enterprise to transfer resources to other entities and owner's equity), and the effects of transactions, events, and circumstances that change resources and claims to those resources.

It is assumed that users of financial statements will read them with reasonable diligence and have some understanding of basic business reports. An expert knowledge level is not assumed.

B. Basic Concepts And Accounting Principles Underlying Financial Accounting

1. **Accounting Entity:** Accounting information pertains to entities, which are circumscribed areas of interest. In financial accounting, the entity is the specific business enterprise. The enterprise is identified in its financial statements.

2. **Going Concern:** An accounting entity is viewed as theoretically continuing in operation in the absence of evidence to the contrary.

3. **Time Periods:** The financial accounting process provides information about the economic activities of an enterprise for specified time periods that are shorter than the life of the enterprise. Normally, the time periods are of equal length to facilitate comparisons. The time period is identified in the financial statements.

4. **Measurement:** Financial accounting measures monetary attributes of economic resources and obligations and changes in them. The unit of measure is identified in the financial statements. Transactions are recorded using historical cost information.

5. Approximation: Financial accounting measurements that involve allocations among relatively short periods of time and among complex and joint activities are necessarily made on the basis of estimates.

6. Judgments: Financial accounting necessarily involves informed judgment. This precludes reducing all of the financial accounting process to a set of inflexible rules.

7. General-Purpose Financial Information: Financial accounting presents general-purpose financial information that is designed to serve the common needs of owners, creditors, managers, and other users, with primary emphasis on the needs of present and potential owners and creditors.

8. Substance Over Form: Financial accounting emphasizes the economic substance of events, even though the legal form may differ from the economic substance and suggest different treatment.

9. Conservatism: Historically, managers, investors, and accountants have generally preferred that possible errors in measurement be in the direction of understatement rather than overstatement of net income and net assets. These rules may result in stated net income and net assets at amounts lower than would otherwise result from applying the pervasive measurement principles.

C. Recognition and Measurement In Financial Statements of Business Enterprises

1. Recognition Criteria: Guidance for recognizing revenues and gains is based on their being:

a. Realized or Realizable: Revenues and gains are generally not recognized (recorded) as components of earnings until realized or realizable. There are exceptions to this general rule such as in the long-term construction contract area where a portion of the revenue may be recognized (recorded) each year through the life of the contract despite the actual sale taking place later (using the percentage of completion contract accounting method).

b. Earned: Revenues are not recognized until earned. Revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues. For gains, being earned is generally less significant than being realized or realizable.

2. Expenses: Guidance for expenses and losses is intended to recognize:

a. Consumption of Benefit: Expenses are generally recognized when an entity's economic benefits are consumed in revenue-earning activities or otherwise.

b. Loss or Lack of Benefit: Expenses or losses are recognized if it becomes evident that previously recognized future economic benefits of assets have been reduced or eliminated, or that liabilities have been incurred or increased, without associated economic benefits.

3. Financial Statements: A full set of financial statements for a period should show:

a. Financial position at the end of the period.

b. Earnings for the period.

c. Comprehensive income for the period.

d. Cash flows during the period.

e. Investments by and distributions to owners during the period.

4. Not Transaction Value: A statement of financial position does not purport to show the market or sale value of a business enterprise.

5. Comprehensive Income: The concept of earnings set forth in the Statement is similar to net income for a period in present practice; however, it excludes certain accounting adjustments of earlier periods that are recognized in the current period - cumulative effect of a change in accounting principles is an example.

a. Broad Measure: Comprehensive income is a broad measure of the effects of transactions and other events on an entity, comprising all recognized changes in equity (net assets) of the entity during a period from transactions and other events and circumstances except those resulting from investments by owners and distributions to owners.

b. Differences: Earnings and comprehensive income are not the same because certain gains and losses are included in comprehensive income but are excluded from earnings.

c. ASC Topic 220 Requirement: Accounting Standards Codification (ASC) Topic 220 requires that all component items of comprehensive income be reported in a financial statement that is displayed "with the same prominence" as other financial statements. No specific format is prescribed. However, total comprehensive income for the period must be displayed. The Statement requires that a company (1) classify items of other comprehensive income by their nature in a financial statement, and (2) display the accumulated balance of other comprehensive income (i.e. the items that bypass the income statement) separately from retained earnings and additional paid-in capital in the equity section of the balance sheet.

D. <u>Elements of Financial Statements</u>

1. Purpose: Statement of Financial Accounting Concepts No. 6 defines 10 elements of financial statements: 7 elements of financial statements of both business enterprises and not-for-profit organizations -- assets, liabilities, equity (business enterprises) or net assets (not-for-profit organizations), revenues, expenses, gains and losses -- and 3 elements of financial statements of business enterprises only -- investments by owners, distributions to owners, and comprehensive income.

2. Definitions of Elements

a. Assets: Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.

b. Liabilities: Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.

c. Equity or Net Assets: Equity or net assets is the residual interest in the assets of an entity that remains after deducting its liabilities.

d. Characteristics of Investments by and Distributions to Owners: Investments by owners and distributions to owners are transactions between an enterprise and its owners as outsiders.

e. Comprehensive Income of Business Enterprises: Comprehensive income is the change in equity of a business enterprise during a period from transactions and other events from non-owner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners. The financial capital concept is the traditional view and emphasizes capital maintenance with measurement through financial statements. Comprehensive income as defined is a return on financial capital.

f. Revenues: Revenues are inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.

g. Expenses: Expenses are outflows or the using up of assets or incurring of liabilities (or a combination of both). These are incurred in delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations.

h. Gains and Losses: Gains are increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from major revenues or investment by owners. Losses are decreases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from major expenses or distributions to owners.

Example: According to the FASB conceptual framework, an entity's revenue may result from

- **a.** A decrease in an asset from primary operations.
- **b.** An increase in an asset from incidental transactions.
- **c.** An increase in a liability from incidental transactions.
- **d.** A decrease in a liability from primary operations.

Answer: SFAC No. 6 defines revenues as inflows or other enhancements of assets of an entity or settlement of its liabilities from delivering or producing goods, rendering services, or other activities that constitute the entity's major or central operations. Item /d/ is the correct answer because this is an example of a deferred revenue that is being recognized in the current period as revenue. Item /a/ involves a decrease in assets, not an increase. Items /b/ and /c/ both relate to incidental transactions.

3. Accrual Accounting and Related Concepts: Items that qualify under the definitions of elements of financial statements and that meet criteria for recognition and measurement are accounted for and included in financial statements by the use of accrual accounting procedures.

a. Accrual Accounting: Accrual accounting attempts to record the financial effects on an entity of transactions and other events and circumstances that have significant consequences for the entity in the periods in which those transactions, events and circumstances occur rather than only in the periods in which cash is received or paid by the entity. Accrual accounting attempts to recognize non-cash events and liability-imposing circumstances as they occur and involves not only accruals but also deferrals, including allocations and amortizations.

b. Realization and Recognition: Realization in the most precise sense means the process of converting noncash resources and rights into money and is most frequently used in accounting and financial reporting to refer to sales of assets for cash or claims to cash. The term realized, therefore, identifies revenues or gains on assets exchanged or sold or liabilities reduced. Recognition is the process of formally recording or incorporating an item in the financial statements of an entity.

c. Recognition, Matching and Allocation: Matching of costs and revenues is simultaneous or combined recognition of the revenues and expenses that result directly and jointly from the same transactions. Many expenses, however, are not related directly to particular revenues but can be related to a period on the basis of transactions or events occurring in that period or by allocation. Some costs that cannot be directly related to particular revenues are incurred to obtain benefits that are exhausted in the period in which the costs are incurred, such as building rents.

E. Using Cash Flow Information and Present Value in Accounting Measurements

In SFAC No. 7, the FASB focused on cash flows and present values as the objective valuation measurements for initial recognition of certain transactions. The term "best estimate" is used to describe the target for estimated cash flows that are most likely to occur. An appropriate interest rate is then determined to discount the expected cash flows to present value.

1. Elements of Economic Value: The elements of value listed in SFAC No. 7 are as follows.

- An estimate of the future cash flow, or in more complex cases, series of future cash flows at different times.
- Expectations about possible variations in the amount or timing of those cash flows.
- The time value of money, represented by the risk-free rate of interest.
- The price for bearing the uncertainty inherent in the asset or liability.
- Other factors including illiquidity and market imperfections.

2. Practical Principles: The practical principles of present value are stated as:

- Don't leave anything out.
- Use consistent assumptions and don't count the same thing twice.
- Keep your finger off the scale.
- Aim for the average of a range, rather than a single most-likely minimum or maximum amount.
- Don't make up what you don't know.

3. Example: You have estimated possible cash flows of $500,000 in five years, or $1,000,000 in ten years, or $5,000,000 in 25 years. What is the expected present value based on a 5% discount rate?

	Years	**Amount**	**PV**
Best case	5	$ 500,000	$ 391,763
Most likely	10	1,000,000	613,913
Worst case	25	5,000,000	1,476,514
Total			$2,482,190
Expected value (divided by 3)			$ 827,397

4. Probabilities: The above calculation of expected value would change if management determined probabilities of each outcome. For instance, the probabilities might be 30% for the best case scenario, 50% for the most likely scenario, and 20% for the worst case scenario. The probabilities would be multiplied by the PV amounts and then added together to calculate the expected value.

	Years	**Amount**	**PV**	**Probability**	**Value**
Best case	5	$ 500,000	$ 391,763	30%	$117,529
Most likely	10	1,000,000	613,913	50%	306,957
Worst case	25	5,000,000	1,476,514	20%	295,303
					$719,789
Expected value			$719,789		

F. Special Topics

1. Leases (ASC Topic 840): A lease is a contractual joint obligation arrangement between a lessor and a lessee. The lessor gives the lessee the right to use or occupy the property named in the lease (either real or personal) for agreed purposes in return for payment of rents. The form of the transaction is that at all times during the lease, the lessor has title to the property.

a. Lessee's Perspective

1) Operating Lease: If a lease does not meet the tests of a capital lease (see next section), it is an operating lease. When the lessee pays, debit Rent Expense, credit Cash. No asset or liability is recorded on the lessee's books, but footnote disclosures are required. The footnotes to the financial statements must provide information about any noncancellable operating leases with terms longer than one year. Operating leases are considered a form of off-balance sheet financing since the company has the use of the asset, but does not record an asset or liability on its balance sheet.

2) Capital Lease Requirements: If any one of the four tests stated below are met, the lease must be recorded as a capital lease. The lessee will record an asset and corresponding liability on their books. The common goal in each criteria is that the lease is in substance a financing arrangement, because the risks and benefits of ownership have effectively been transferred from one party to the other.

a) Title Test: Title passes to the lessee at the end of the lease term.

b) Bargain Purchase Test: The lease contains a bargain purchase option. A bargain purchase option provides that the lessee may buy the asset at a price that is sufficiently below the market price expected at the exercise date that exercise of the option is reasonably assured.

c) Economic Life Test: The lease term is 75% or more of the economic life of the asset. The lease term is the time stated in the lease plus the term provided in any bargain renewal option.

d) Fair Market Value Test: The present value of the minimum lease payments is 90% or more of the fair market value of the asset at the inception of the lease.

Example: On December 30, 20x1, XYZ Corp. signed a 10-year lease agreement for use of a new machine. Terms are ten annual payments of $30,000 each, with the first payment to be made on 12/31/x1. The useful life of the machine is estimated to be 12 years. There is no bargain purchase offer, and the machine reverts to the owner upon expiration of the lease. XYZ's incremental borrowing rate is 12%, while the lessor's implicit interest rate, known to XYZ, is 10%. Present value factors of an annuity of 1 in advance for ten periods are 6.759 at 10% and 6.328 at 12%

1. This is a capital lease as the lease term exceeds 75% of the useful life of the asset (10/12).

2. The total lease liability to be recorded upon the inception of the lease is computed as follows:

* XYZ has both interest rates. The implicit rate is lower than the incremental rate; therefore, the implicit rate (10%) is used. $30,000 X 6.759 = $202,770

Leased Equipment	202,770	
Lease Liability		202,770

3) Lease Advantages for the Lessee: There are several advantages to leasing assets for the lessee. Advantages to leasing include: 1) a reduced initial cash outlay (as compared to a purchase), 2) possible easier credit terms, 3) avoidance of financial restrictions such as limiting additional borrowing, 4) possible maintenance support from the lessor, 5) deductibility of payments (operating lease), and 6) balance sheet appearance (for operating leases, the asset and liability are not on the balance sheet so the debt to equity ratio would not be affected).

b. Lessor's Perspective

1) Operating Lease: Rent payments received on the leased asset are recorded as rental revenues. The leased asset remains on the lessor's books. Such assets are classified separately as "assets leased to others" and are depreciated over their economic life. Other leasehold costs (such as repairs, insurance, and taxes) incurred by the lessor are expensed in the period benefited.

2) Capital Lease (Defined): The effect of deciding that a lease is in substance a financing of an asset by the lessor is the mirror image of the lessee's accounting: The lessor will remove the leased asset from its books, recording a receivable due from the lessee. Any discount or unearned interest is also recorded and amortized over the lease term. To determine the classification on the lessor's books, the same four tests that the lessee uses are applied, plus the following two additional test:

- Collectability of the receivable is reasonably assured. This test is relevant because, if the lease is a capital lease, the lessor will record a gross receivable for the amounts due from the lessee.
- No important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor under the lease. One example of such uncertainties might be a guarantee of performance of the leased asset. The rationale is to assure that the lessor has, in substance, passed the risks and benefits of ownership to the lessee.

3) Lease Advantages to Lessor: A capital lease is an indirect method of making a sale. Leasing is also an alternative means of receiving profits by entering transactions that allow the lessor to transfer an asset (other than a sales transaction). The lessor will also depreciate the asset if it is an operating lease.

4) Types of Lessor Capital Leases:

a) Sales Type Lease: If, at the inception of the lease, a manufacturer's or dealer's profit exists, the lease is called a "sales type" lease. A dealer's profit is defined as any excess of the present value of the minimum lease payments (the fair value of the asset at the inception of the lease) over the cost of the leased asset. Dealer's profit is recognized currently at the inception of the lease.

b) Direct Financing Lease: If there is no dealer's profit, but the lease is a capital lease, it is called a direct financing lease. The lessor records "lease receivable" for the gross payments receivable, together with the contra account, "unearned interest revenue." The leased asset is credited to remove it from the records. No dealer's profit exists, so this is the complete entry.

c) Initial Direct Costs: Initial direct costs are defined as those costs incurred in negotiating and processing successful completed leases. Examples include commissions, legal fees, and credit investigation costs. For operating leases, initial direct costs are capitalized separately and amortized over the lease term in proportion to the recognition of rental income. For sales type leases, expense initial direct costs as incurred. For direct financing leases, initial direct costs are capitalized separately and considered part of the net investment in the lease.

c. Sale and Leaseback: The owner of property sells it to a buyer and, as part of the same transaction, simultaneously leases it back. It is used as a financing device to get money to build or remodel and at the same time secure the right to use the asset.

1) Classification of the Lease: Classification of the lease as an operating or capital lease follows the same rules as stated above.

2) Treatment of Any Gain Realized on the Sale: If the lease part of the sale and leaseback is a capital lease, defer and amortize any gain over the lease term in proportion to the amortization of the leased assets. If the lease is an operating lease, defer recognition of the gain and recognize it in proportion to the rental payments. When the fair value of the asset is less than its book value, any loss should be recognized immediately.

2. Income Tax Accounting: Most of the special problems which arise in accounting for income taxes are because accounting income and taxable income are calculated under two different sets of rules. The calculation of accounting income is governed by generally accepted accounting principles (GAAP). The calculation of taxable income is governed by governmental tax regulations and rules. The difference between the timing of revenues and expenses for financial accounting and tax purposes leads to deferred taxes, which could be either an asset or liability.

a. FASB Statements on Accounting for Income Taxes: ASC Topic 740 shifted GAAP to the liability method from the deferred method of accounting for income taxes. The liability method differs from the deferred method of APB Opinion 11 in its orientation toward measuring the tax effects of temporary differences. Temporary differences are defined as differences between recorded carrying amounts and the corresponding tax bases of assets and liabilities that will result in taxable or deductible amounts in future years if the assets are recovered and the liabilities are settled at their reported amounts.

b. Overview of ASC Topic 740

1) Objectives of Accounting for Income Taxes:

a) Current Taxes: Recognize the amount of taxes payable or refundable for the current year.

b) Future Tax Consequences: Recognize deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an enterprise's financial statements or tax returns.

2) Basic Principles of Accounting for Income Taxes:

a) Current Liability/Asset: A current tax liability or asset is recognized for the estimated taxes payable or refundable on tax returns for the current year.

b) Deferred Liability/Asset: A deferred tax liability or asset is recognized for the estimated future tax effects attributable to temporary differences and carry-forwards.

c) Based on Enacted Tax Law: The measurement of current and deferred tax liabilities and assets is based on provisions of the enacted tax law; the effects of future changes in tax laws or rates are not anticipated. (Liability amounts are not adjusted in advance of enactment of tax changes.)

d) Reduction for Benefits Not Expected To Be Realized: The measurement of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that, based on available evidence, are not expected to be realized.

3) Temporary Differences: The tax consequences of most events recognized in the financial statements for a year are included in determining income taxes currently payable. However, tax laws often differ from the recognition and measurement requirements of GAAP, and differences can arise between:

a) Taxable Income/Financial Income: The amount of taxable income and pre-tax financial income for a year and,

b) Tax Basis/Book Value: The tax basis of assets or liabilities and their reported amounts in financial statements.

Temporary differences ordinarily become taxable or deductible when the related asset is recovered or the related liability is settled. A deferred tax liability or asset represents the increase or decrease in taxes payable or refundable in future years as a result of temporary differences and carry-forwards at the end of the current year.

4) Deferred Tax Liabilities: A deferred tax liability is recognized for temporary differences if it will result in taxable amounts in future years. For example, a temporary difference is created between the reported amount and the tax basis of an installment sale receivable if, for tax purposes, some or all of the gain on the installment sale will be included in the determination of taxable income in future years (postponed from current income to future income). Because amounts received upon recovery of that receivable will be taxable, a deferred tax liability is recognized in the current year for the related taxes payable in future years.

5) Deferred Tax Assets: A deferred tax asset is recognized for temporary differences that will result in deductible amounts in future years and for carryforwards. For example, a temporary difference is created between the reported amount and the tax basis of a liability for estimated expenses if, for tax purposes, those estimated expenses are not deductible until a future year. Settlement of that liability will result in tax deductions in future years and a deferred tax asset is recognized in the current year for the reduction in taxes payable in future years.

3. Debt Extinguishment - Calculation and Presentation of Gain or Loss: If bonds are paid off before maturity, it is considered an early extinguishment of debt, and the gain or loss is equal to the reacquisition price minus the carrying value of the bonds at the date of the redemption.

Example: Assume that $1,000,000 of bonds with unamortized bond issue costs of $19,500 and unamortized bond premium of $27,743 are reacquired at 99. The journal entry is as follows:

Bonds payable	$1,000,000	
Premium on bonds payable	27,743	
Cash		$990,000
Gain on early extinguishment of debt		18,243
Unamortized bond issue costs		19,500
To record redemption of bonds.		

Carrying value of the bonds equals the face amount of the bond payable plus any unamortized premium (minus any unamortized discount) minus any unamortized bond issue costs.

4. Long-Term Investments:

a. Accounting For Long-Term Investments: An investment in the common stock of another company can be accounted for in one of two general ways. The two methods are the fair-value accounting method (available-for-sale or trading securities) and the equity method. The use of fair value versus the equity method is largely dependent on the percentage of voting stock the investor has obtained.

1) Fair Value: If the investor acquires less than 20% of the outstanding stock of a company, the appropriate fair-value method should be used depending on the intent of the investor in holding the stock. The 20% figure is a guide used to gauge whether the investor has gained significant influence over the operating and financial policies of the investee. With less than a 20% interest, it is presumed that the investor does not possess such influence.

2) Equity: An investor that acquires 20% or more of the outstanding stock of a company is presumed to be able to significantly influence that company's operating and financial policies. One such policy would be the determination of dividends to be paid. If the investor has the ability to determine when it will receive dividends from the investee, then it would be able to manipulate its own income by using that influence.

a) Balance Sheet Value: The equity method is used to circumvent this possible manipulation and to present the status of the investment at a more meaningful value on the balance sheet. The use of the equity method is required if more than 20% interest is acquired. Just like the cost method, the equity method records the original investment at cost. However, the investor adjusts the carrying value of the investment for the changes in the net assets of the investee that occur when income is earned or dividends are paid by the investee. This adjustment is based on the investor's percentage ownership in the investee.

b) Lack Significant Control: The equity method should be used if 20% or more ownership exists because significant influence is presumed. However, there are situations where 20% or more ownership exists, but the investor lacks significant influence over the investee. In these cases, either a fair-value method (or, less likely, the cost method) would then be used. An example of this type of situation would be where the majority ownership of the investee is concentrated among a small group of shareholders who operate the investee without regard to the views of the investor. Another reason could be that the investor tries and fails to obtain representation on the investee's board of directors.

c) Other Equity Method Adjustments: There are two other adjustments which should be made by the investor under the equity method. First, any "differential" (difference between investment cost and the investor's percentage of the net assets of the investee) should be amortized by adjusting the investment account and income from investment. Second, unconfirmed (or unrealized) intercompany profits or losses from the transfer of assets between investor and investee (explained in later sections) should be adjusted for using the equity method.

b. Piecemeal Acquisitions: An initial investment of less than 20% ownership should be accounted for by the cost method, but what happens when more shares of stock are acquired and the ownership interest accumulates to over 20%? In this case, the equity method should then be followed and the periods during which the cost method was used should be retroactively restated to show the use of the equity method for all periods. The restatement will only reflect the undistributed net income of the investee because the distributed portion would have previously been taken into income as dividends under the cost method.

c. Financial Statement Presentation: The cost and equity methods are methods of valuation. They determine at what value the investment account is carried at on the investor's books. Another separate consideration involved is what method of presentation in the financial statements is appropriate. The two different methods of presentation are consolidated financial statements or investment account presentation only.

1) 50% or Less Control: For investments of 50% or less, the presentation of the investment will consist only of showing an asset on the investor's books entitled "Investment in (company name)," regardless of whether the cost or equity method of valuation is used.

2) More than 50% Interest: For investments of more than 50%, consolidated financial statements should be presented. With more than a 50% interest, the investor has control over the resources of the investee. Thus, consolidated statements are prepared to present the two companies as one economic entity. The assets, liabilities, revenues, and expenses of the subsidiary are combined with those of the parent and the parent's investment account in the subsidiary is eliminated.

3) Exceptions: There are some situations where over 50% ownership is present, yet consolidated statements shouldn't be prepared. This would include where future control is in doubt due to the threat of expropriation of the investee's assets by an unstable foreign government, bankruptcy, or reorganization. ASC Topic 810 requires financial statements be prepared for subsidiaries involved in incompatible operations.

II. INCOME STATEMENT

A. Overview

The income statement's function is to report the results of operations for a given period of time. Presented in the statement are: Revenues and expenses from ongoing business activities and gains and losses in the ordinary course of business. After continuing operations, the **DEC** effects of **d**iscontinued operations, **e**xtraordinary items, and **c**hanges in accounting principles are presented separately, net of tax. This is the "all-inclusive" concept. A sample income statement is presented on page 36.

B. Revenue Recognition

1. Definition of Terms:

a. Revenues: Statement of Financial Accounting Concepts No. 6 defines revenues as "Inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) during a period derived from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations."

b. Gains: SFAC No. 6 defines gains as "Increases in equity (net assets) derived from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period except those that result from revenues or investments by owners."

c. Realization: Revenue is generally recognized when both the following conditions are met:

1) The earning process is complete or virtually complete.

2) An exchange has taken place.

Comprehensive, Multiple-step Income Statement

Elbank Inc
Comparative Income Statement
For the years ended 12/31/x0 and x1
(000 omitted)

	20x1	**20x0**
Net Sales	$8,000	$7,200
Cost of Goods Sold	4,400	4,000
Gross Margin	$3,600	$3,200
General Selling and Administrative Expenses	1,400	1,250
Other Operating Expenses	750	700
Income from Operations	$1,450	$1,250
Other Revenues and Gains:		
Interest Income	120	100
Gain on Sale of Delivery Truck	10	-0-
	$1,580	$1,350
Other Expenses and Losses:		
Interest Expense	40	30
Loss on sale of Computer Systems	-0-	5
Income From Continuing Operations before Income Taxes	$1,540	$1,315
Income Taxes	500	400
Income from Continuing Operations	$1,040	$ 915
Discontinued Operations:		
Income From Operations of Discontinued Strikeout Division, net of applicable income taxes of $40	-	60
Loss on Disposal of Strikeout Division, Net of applicable income taxes of $67	-	(100)
Income Before Extraordinary Item and Cumulative Effect of Accounting Change	$1,040	$875
Extraordinary Loss on Early Extinguishment of Bonds, Net of Applicable Income Taxes of $50	(75)	
Cumulative effect of Change in Depreciation Methods, Net of Applicable Income Taxes of $23	-	(35)
Net Income	$965	$840

	20x1	20x0
Earnings Per Common Share (500,000 shares):		
Income from Continuing Operations	2.08	1.83
Income from Discontinued Strikeout Division		0.12
Loss on Disposal of Strikeout Division		(0.20)
Income Before Extraordinary Item and Cumulative Effect of Change in Depreciation Methods	2.08	1.75
Extraordinary Loss	(0.15)	
Cumulative Effect of Change in Accounting Principle	-	(0.07)
Net Income	1.93	1.68

2. Contract Accounting: There are two acceptable methods:

a. Percentage-of-Completion: Revenue is recognized each year based on (a) the percentage of costs incurred (see formula below) or (b) engineer's estimates of the percentage of work completed. Method (a) is preferable if estimates of costs are reliable.

1) Formula:

$$\frac{\text{Costs to Date}}{\text{Costs to Date} + \text{Costs Estimated to Complete}} \times \text{Contact Price} - \text{Revenue Previously Recognized} = \text{Current Revenue to Recognize}$$

$$\frac{\text{Costs to Date}}{\text{Costs to Date} + \text{Costs Estimated to Complete}} \times \text{Total Profit} - \text{Profit Previously Recognized} = \text{Current Profit to Recognize}$$

2) Key Points:

a) Make sure to include cumulative costs to date in the numerator and denominator.

b) Subtract previous years' revenue (profit) recognized, if calculation is being made for the second or later year. The result will be revenue (profit) for the current year.

c) This process must be applied to each contract each year.

b. Completed Contract: All costs are deferred and matched against revenue in the year of completion. There is usually a very poor matching year-by-year (as compared with percentage of completion). However, the completed contract method is preferable when cost estimates are not reliable.

c. Treatment of Losses: Under either method, if a loss is calculated, it should be recognized in full. Conservatism provides all probable losses must be immediately recognized.

d. Balance Sheet Presentation: Excess of costs and profits over billings are classified as a current asset. Excess of billings over costs and profits are classified as a current liability.

e. <u>Contract Accounting – An Illustrative Problem</u>

Facts: Total Contract Price $18,000
Estimated Costs 16,000

3-year Contract. The contract calls for the customer to retain 20% of contract billings until the last payment is submitted.

Year	Actual Costs	Estimated Additional Costs to Complete	Billings	Collections
1	$4,000	$12,000	$3,600	$2,880
2	10,080	3,520	9,900	7,920
3	3,970		4,500	7,200

Required: Prepare journal entries for the above contract assuming

1. Percentage of completion
2. Completed contract

Solution 1: Percentage of Completion

	Year 1		Year 2		Year 3	
Construction in Progress	4,000		10,080		3,970	
Cash, Payables, etc.		4,000		10,080		3,970
To record cost of construction						
Accounts Receivable		3,600	9,900		4,500	
Billings on Construction in Progress		3,600		9,900		4,500
To record progress billings						
Cash	2,880		7,920		7,200	
Accounts Receivable		2,880		7,920		7,200
To record collections						
Construction in Progress		500		180		370
Construction Expenses	4,000		10,080		3,970	
Contract Revenue		4,500		9,900		3,600
To recognize revenue and profit (loss)						
Closing Entries:						
Contract Revenue	4,500		9,900		3,600	
Billings on Construction in Progress					18,000	
Construction Expenses		4,000		10,080		3,970
Income Summary		500	180		370	
Construction in Progress						18,000
To close accounts to Income Summary						

Schedules

Revenue to be Recognized

Year 1

Costs Incurred to Date / Total Costs (estimated)	4,000 / 4,000 + 12,000	=	4,000 / 16,000	=	25%

.25 x 18,000 = 4,500 Revenue to be recognized

.25 x 2,000 [18,000 - 16,000] = 500 Gross Profit to be recognized

Year 2

Costs Incurred to Date / Total Costs (estimated)	4,000 + 10,080 / 14,080 + 3,520	=	14,080 / 17,600	=	80%

.80 X 18,000 =	14,400	.80 X 400 [18,000 - 17,600] =	320
Less: Prior Year's Revenue recognized	4,500	Less: Prior Year's Gross Profit recognized	500
Revenue to be recognized	9,900	Gross Profit to be recognized	(180)

Year 3

Costs Incurred to Date / Total Costs (actual)	4,000 + 10,080 + 3,970 / 18,050	=	18,050 / 18,050	=	100%

1.00 X 18,000 =	18,000	1.00 X (50) [18,000 - 18,050] =	(50)
Less: Prior Years' Revenue recognized	14,400	Less: Prior Year's Gross Profit recognized	320
Revenue to be recognized	3,600	Gross Profit to be recognized	(370)

Accumulated Profit (Loss) on Contract

	Year 1	Year 2	Year 3	Total
Revenue Recognized	4,500	9,900	3,600	18,000
Current Costs	4,000	10,080	3,970	18,050
Annual Profit (Loss)	500	(180)	(370)	(50)
Cumulative Profit (Loss)	500	320	(50)	

Solution 2: Completed Contract

	Year 1 Dr	Year 1 Cr	Year 2 Dr	Year 2 Cr	Year 3 Dr	Year 3 Cr
Construction in Progress	4,000		10,080		3,970	
Cash, Payables, etc.		4,000		10,080		3,970
To record cost of construction						
Accounts Receivable	3,600		9,900		4,500	
Progress Billings		3,600		9,900		4,500
To record progress billings						
Cash	2,880		7,920		7,200	
Accounts Receivable		2,880		7,920		7,200
To record collections						

Closing Entries:

Construction Expenses	18,050	
Progress Billings	18,000	
Construction in Progress		18,050
Contract Revenue		18,000
Contract Revenue	18,000	
Income Summary	50	
Construction Expenses		18,050

3. Installment Sales: Payments received are treated as partly a return of costs and partly profit, so that a portion of the profit is deferred and recognized as collections are made.

a. When Acceptable: The installment sales method is generally not acceptable for accounting, because under accrual accounting profit should be recognized when earned, at the point of sale. The method is acceptable for accounting only when collection of the sale price is not reasonably assured, as evidenced by an extended collection period or there is difficulty in estimating the degree of collectability. However, the installment method is widely used for tax purposes.

Consider the following key points:

1) Separate Accounts Receivable by Year: Keep each year's accounts receivable separate.

2) Gross Profit Percentage: Calculate a gross profit percentage (gross profit/sales) for each year.

3) Unrealized Gross Profit: Unrealized gross profit (to defer) equals gross profit percentage multiplied by the accounts receivable balance for that year.

4) Realized Gross Profit: Realized gross profit (to be recognized in year) equals gross profit percentage multiplied by cash collections by year.

5) Defaults: Loss will equal installment accounts receivable less related deferred gross profit. If merchandise is repossessed, record the merchandise in an inventory account at fair market value, and reduce the loss by this amount.

6) Interest Income: Interest on installment receivable is reported as income in the period earned, separate from the realized gross profit.

b. Cost Recovery: Under the cost recovery method, equal amounts of revenue and expense are recognized as collections are made until all costs have been recovered, postponing any recognition of profit until that time.

c. Installment Sales – An Illustrative Problem

Facts:	20x7	20x8
Sales (on Installment)	$100,000	$125,000
Cost of Sales	75,000	95,000
Gross Profit	$25,000	$30,000
Gross Profit Percentage	25%	24%
Cash Receipts:		
20x7	$30,000	$50,000
20x8		$50,000

Required: Prepare journal entries to record the above installment sales transactions during 20x7 and 20x8.

Solution:	20x7 Dr	20x7 Cr	20x8 Dr	20x8 Cr
Installment Accounts Receivable	$100,000		$125,000	
Installment Sales		100,000		125,000
Cash	30,000		100,000	
Installment Accounts Receivable (20x7)		30,000		50,000
Installment Accounts Receivable (20x8)				50,000
Cost of Sales	75,000		95,000	
Inventory		75,000		95,000
Installment Sales	100,000		125,000	
Cost of Sales		75,000		95,000
Deferred Gross Profit		25,000		30,000
Deferred Gross Profit (20x7)	7,500		12,500	
Deferred Gross Profit (20x8)			12,000	
Realized Gross Profit		7,500		24,500
Closing Entry:				
Realized Gross Profit	7,500		24,500	
Income Summary		7,500		24,500

Schedules

Gross Profit to be Recognized

	20x7
Cash Collected	$30,000
Gross Profit Percentage	x 25%
Gross Profit to Recognize	$ 7,500

20x8

	Accounts Receivable Year 20x7	20x8
Cash Collected	$50,000	$50,000
Gross Profit Percentage	x 25%	x 24%
Gross Profit to Recognize	$12,500	$12,000

4. At Completion of Production: In a very few instances, revenue is recognized at the completion of production. The only situation in which this method may be applied is if it is guaranteed that the entire production will be sold at a locked-in minimum price. The reasoning behind this is that the earnings process is virtually complete at the end of production. A common example of this circumstance is a government subsidy of farm goods, ensuring the farmer can sell all that is produced at a certain price.

5. Other Revenue Topics:

a. When Right of Return Exists (ASC Topic 605): Revenue from a sales transaction where the buyer has the right to return the products should be recognized at the time of sale only if all of the following conditions are met:

- The seller's price to the buyer is substantially fixed or determinable at the date of sale.
- The buyer has paid the seller or is so obligated and such obligation is not contingent on resale of the product.
- The buyer's obligation would not be changed if there were theft or physical destruction of the product.
- The buyer acquiring the product for resale has economic substance apart from that provided by the seller.
- The seller does not have significant obligations for the future performance to directly bring about resale of the product by the buyer.
- The amount of future returns can be reasonably estimated.

If sales revenue and cost of sales are not recognized at the time of sale because these conditions do not all exist, then both accounts should be recognized when either the return privilege expires or when all these conditions are met, whichever occurs first.

b. Franchise Fee Revenues: The initial franchise fee should be recorded as revenue when the franchiser makes substantial performance, and collection of the fee is reasonably assured. Substantial performance exists when (1) there is no obligation to refund any consideration and (2) all required initial services are performed. Installment methods should not be used to account for franchise fee revenue, unless such revenue is collectible over an extended period, and no reasonable basis exists for estimating collectability (unusual).

(1) Materiality: If an initial fee is substantial in comparison to the continuing franchise fee, and services are to be performed in the future, a portion of the initial fee should be deferred and amortized over the life of the franchise.

(2) Other Options: If the franchise agreement contains other options for which there is reasonable expectation for exercise, then that portion of the initial franchise fee attributable to such option should be deferred. Continuing franchise fees received over the life of the franchise should be reported as revenue as earned.

c. Real Estate Sales (ASC Topics 360, 605, and 976):

1) Non-Retail: Full profit recognition when (1) profit is determinable (collectability reasonably assured) and (2) seller is not obligated to perform significant activities after the sale. If the above criteria are not met, use installment method, or cost recovery method, or deposit method, depending on the circumstances.

2) Retail Land Sales: Full profit is recognized with (1) expiration of refund period, (2) sufficient cumulative payments, (3) collectability of receivable, (4) nonsubordination of receivables, and (5) development is practical. If the above criteria are not met, use percentage-of-completion method, or installment method, depending on the circumstances.

D. <u>Expenses</u>

1. Definition of Terms:

a. Expenses: Expenses are defined by SFAC No. 6 as “Outflows or other using up of assets or incurring of liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity’s ongoing major or central operations.”

b. Losses: Losses are defined in SFAC No. 6 as “Decreases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period except those that result from expenses or distributions to owners.”

c. Matching Principle: The matching principle is the theory of “let the expense follow the revenue.” The three methods of recognizing expenses include the following:

1) Associating Cause and Effect: Some costs are recognized as expenses on the basis of a presumed direct association with specific revenue. Examples of expenses that are recognized by associating cause and effect are sales commissions and costs of products sold or services provided.

2) Systematic and Rational Allocation: In the absence of a direct means of associating cause and effect, some costs are associated with specific accounting periods as expenses on the basis of an attempt to allocate costs in a systematic and rational manner among the periods in which benefits are provided. Examples of items that are recognized in a systematic and rational manner are depreciation of fixed assets, amortization of intangible assets, and allocation of rent and insurance.

a) Depreciation: Depreciation is a process of cost allocation, not valuation. The cost of an asset (less any residual value) is allocated in a systematic and rational manner over the period benefited by the use of the asset. In estimating the period of allocation, both physical and economic factors must be considered. Depreciation schedules must be revised if an asset’s usefulness becomes impaired. Land is not depreciated, but land improvements with a limited life are. Remember to appropriately allocate depreciation expense for partial periods within a given year.

(1) Straight-line Method: Depreciation is considered a function of time.

$$\frac{\text{Cost} - \text{Estimated Residual Value}}{\text{Estimated Useful Life (in Years)}} = \text{Annual Depreciation Expense}$$

(2) Activity Method (Units-of-Production Method): Depreciation is considered a function of usage.

$$\frac{\text{Cost} - \text{Estimated Residual Value}}{\text{Estimated Useful Life (per unit of activity)}} = \text{Depreciation Expense per Unit of Activity}$$

(3) Sum-of-the-Years' Digits Method: This is an accelerated depreciation method.

$$\frac{\text{Years of Life Remaining at the Beginning of Period}}{\text{Sum of the Years' Digits}} \times \text{Cost Less Estimated Residual Value} = \text{Depreciation for That Period}$$

$$\text{Sum of Years' Digits} = \frac{n(n+1)}{2} \quad (n = \text{Years of Useful Life})$$

Example: On January 2, 20x5, Mogul Company acquired equipment to be used in its manufacturing operations. The equipment has an estimated useful life of 10 years and an estimated salvage value of $5,000. The depreciation applicable to this equipment was $24,000 for 20x7, computed under the sum-of-the-years' digits method. What was the acquisition cost of the equipment?

a. $165,000 **b.** $170,000 **c.** $240,000 **d.** $245,000

Answer: The depreciation fraction for the third year of a ten-year life is 8/55. Therefore, $24,000 -:- 8/55 is equal to the amount of the original cost less the salvage value.

$24,000 -:- 8/55= $165,000
$165,000 + $5,000 salvage value = $170,000 original cost.
Choice /b/ is the correct answer.

(4) Declining-Balance Method (200%, 175%, 150%, 125%): This is also an accelerated method. Remember to ignore salvage value in the calculation of the first year's depreciation, but to consider the salvage value at the end of the asset's useful life.

Double Declining Balance = Book Value at Beginning of Period x (SL% x 2.00)
= Depreciation for that Period

Example: On July 1, 20x0, Mundo Corporation purchased factory equipment for $50,000. Salvage value was estimated at $2,000. The equipment will be depreciated over ten years using the double-declining-balance method. Counting the year of acquisition as one-half year, Mundo should record 20x1 depreciation expense of

a. $ 7,680 b. $ 9,000 c. $ 9,600 d. $10,000

Answer: 10 Year Life = 10% S.L. Rate x 2 = 20% D.D.B. Rate
$50,000 x 0.20 x 6/12 = $5,000 (20x0 Depreciation)
$50,000 - $5,000 = $45,000 x 0.20 = $9,000 (20x1 Depreciation)

3) Immediate Recognition: Some costs are associated with the current accounting period as expenses because:

a) Costs incurred during the period provide no discernible future benefits.

b) Costs recorded as assets in prior periods no longer provide discernible benefits.

c) Allocating costs either on the basis of association with revenue or among accounting periods is considered to serve no useful purpose. Examples include officers' salaries, most selling costs, amounts paid to settle lawsuits, and cost of resources used in unsuccessful efforts.

2. Royalties: Royalties are percentages of sales paid to an owner of a right (such as a patent or franchise) for use of that right. Royalties should be expensed in the period the sales are made.

3. Research and Development: ASC Topic 730 **r**equires charging to expense all research and development (R&D) costs incurred.

a. Elements of Research and Development: Materials, equipment, facilities, personnel, intangibles, contract services, and indirect costs. If facilities costs have alternative future uses beyond the current project, they should be capitalized and depreciated. Depreciation on these facilities is considered R&D expense. If the facilities have no alternative future uses, the costs should be immediately expensed.

b. Definitions:

1) Research: Research is the search for new knowledge.

2) Development: Development is the process of translating research findings into a new product or process.

3) Research and Development Expense: An R&D expense is essentially all expenditures up to the point that the product or process is brought into commercial production.

c. Accounting for the Costs of Computer Software To Be Sold, Leased or Otherwise Marketed: ASC Topic 985 specifies that costs incurred internally in creating a computer software product shall be charged to expense when incurred as research and development until "technological feasibility" has been established for the product. Technological feasibility is established upon completion of a detailed program design or, in its absence, completion of a working model. Thereafter, all software production costs shall be capitalized and subsequently reported at the lower of unamortized cost or net realizable value. Capitalized costs are amortized based on current and future revenue for each product with an annual minimum equal to the straight-line amortization over the remaining estimated economic life of the product.

Example: ComputerSoft, Inc. spent $100,000 to establish technological feasibility for a new software product. Additional costs of $300,000 were incurred to bring the product to a marketable condition. Thereafter, 10,000 units were produced at a cost of $500,000. Total revenue of $1,000,000 is expected from the product. Revenue generated during the current year was $600,000. A total benefit period of three years is anticipated. Costs to dispose of the remaining inventory are estimated at $300,000.

1. $100,000 is expensed immediately as research and development costs.

2. Capitalized costs are $300,000.

3. Amortization for the current period is the greater of:

a) $$\$300{,}000 \times \frac{\text{Current Revenue}}{\text{Current + Future Revenues}} = \$300{,}000 \times \frac{600{,}000}{1{,}000{,}000} = \$180{,}000^{*}$$

OR

b) $300,000 ÷ Benefit period (3 years) = $100,000

4. Capitalized costs are carried at the lower of unamortized costs - $120,000 ($300,000 - $180,000)

OR

net realizable value of $100,000 ($400,000 additional revenue anticipated less estimated disposal costs of $300,000). Since net realizable value is $20,000 lower than unamortized cost, an additional $20,000 of amortization should be taken.

5. Inventoried costs are $500,000.

E. Discontinued Operations

1. General: The results of discontinued operations and the gain or loss on disposal of a segment of a business are reported in the income statement net of tax separately from the results of continuing operations (and not as an extraordinary item).

2. Terminology:

a. Segment of a Business: This is a component of an enterprise whose activities represent a separate major line of business or class of customer. A segment may be a subsidiary, a division, or a department, provided that its assets and activities can be clearly distinguished, physically and operationally, from the other assets and activities of the entity.

b. Measurement Date of a Disposal: The date on which management commits to a formal plan to dispose of a segment of the business, whether by sale or abandonment. The plan must include identification of the major assets to be disposed of, the expected method of disposal, the period expected to be required for disposal, an active program to find a buyer (if the segment is to be sold rather than abandoned), the estimated results of operation of the segment from the measurement date to the disposal date, and the estimated proceeds from disposal.

c. Disposal Date: The date of closing the sale (if the disposal is by sale) or the date that operations cease (if the disposal is by abandonment).

3. Components of Discontinued Operations: There are two major components of the results of discontinued operations:

a. Income or Loss from Operation of the Discontinued Segment: The income or loss from operating the discontinued segment up through the measurement date is shown net of tax as income or loss from operation of discontinued operations.

b. Gain or Loss on Disposal of the Discontinued Segment: In general, the gain or loss on disposal consists of the sum of a) gain or loss from disposal of the net assets, and b) income or loss from operating the segment from the measurement date through the disposal date (also known as the phase-out period). When there is an extended phase-out period and financial statements are prepared before the disposal date, there will be a realized gain or loss from operating the segment from the measurement date to the financial statement date, an expected gain or loss from operating the segment from the financial statement date through the disposal date, and an expected gain or loss on disposal of the net assets. When an overall loss on disposal is expected, the loss should be recognized at the measurement date.

4. Additional Disclosures: In addition to the amounts reported in the financial statements, the following information should be disclosed in the notes to the financial statements:

a. Identity of the segment of the business that is being discontinued.

b. The expected disposal date, if known.

c. The expected manner of disposition.

d. A description of remaining assets and liabilities of the segment at the balance sheet date.

e. Income or loss from operations and any proceeds from disposal of the segment during the period from the measurement date to the balance sheet date.

5. Gain on Discontinued Operations: The rules for recognizing gains on disposal are more complex. When an overall gain on disposal is expected, the gain should be recognized when realized.

Example: On July 1, 20x7, Reed Corporation adopted a formal plan to dispose of its Swampland division. For the period January 1 to July 1, the Swampland division had a loss on operations of $200,000. Reed's management expects to sell the assets of the Swampland division on April 1, 20x8, at a net gain of $100,000. The loss from operating the division from July 1 to December 31 was $80,000 and the expected loss from operating the division from January 1, 20x8, to April 1, 20x8, is $40,000. Income from continuing operations before taxes for 20x7 was $1,000,000 and the tax rate applicable to all items is 40%. This information would be presented in the income statement as follows:

Reed Corporation
Partial Income Statement for 20x7

Income from continuing operations before taxes		1,000,000
Less: Income tax expense		400,000
Income from continuing operations		600,000
Discontinued operations		
Loss from operation of Swampland division, less applicable income taxes of $80,000	(120,000)	
Loss on disposal of Swampland division, including provision for losses during phase-out period of $120,000 and estimated gain on sale of assets of $100,000, less applicable income taxes of $8,000	(12,000)	(132,000)
Net income		468,000

F. Extraordinary Items

1. Old Rules: Until recently, GAAP distinguished between events that were both unusual and infrequent and those that were either unusual or infrequent, but not both. Events that were judged to be both unusual and infrequent were reported as "extraordinary items." As such they were to be reported separately on the income statement, net of any tax effects. Beginning in 2016, FASB has eliminated the separate income statement presentation for extraordinary items (both unusual and infrequent transactions), including any reference thereto.

2. Previous Tax Net Eliminated: FASB also eliminated the practice of specifically allocating the netting income tax effect of the item in question. So today the tax effect of such events is to be included in corporate income tax expense at the bottom of the income statement.

3. Unusual or Infrequent Items: Items which are unusual or infrequently occurring may still be disclosed as separate components of income or expense. However, to make it clear that they are not extraordinary, again they should not be shown net of tax.

G. Accounting Changes

1. Changes in Accounting Principle:

ASC Topic 250 requires retrospective application to prior periods' financial statements of changes in accounting principle unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. If impracticable to apply, ASC Topic 250 requires that the new accounting principle is to be applied to the balances of assets and liabilities as of the earliest period for which retrospective application is practicable. Also, an adjustment must be made to the opening balance of retained earnings rather than being reported on the income statement.

a. Definition: A change in accounting principle results from adoption of a generally accepted accounting principle different from the one previously used for reporting purposes. Neither initial adoption of an accounting principle nor adoption of a principle for transactions or events which are clearly different from previous transactions or events are considered to be changes in accounting principle. Also, a change from an unacceptable accounting principle to a generally accepted accounting principle is not a change in principle; rather, it is considered a correction of an error.

There is a presumption that an accounting principle, once adopted, should not be changed. That presumption can be overcome only if the enterprise justifies the changes to an alternative accounting principle on the basis that it is preferable. The nature of and justification for an accounting change must be disclosed in the year in which the change is made.

b. Reporting Changes in Accounting Principle: ASC Topic 250 requires a retrospective approach to changes in accounting principles. Previously, a cumulative effect of a change in principle was used which was included in the year of change.

1) Retrospective approach: Using a retrospective accounting change approach, an entity reporting the change adjusts its financial statements for each prior period presented to the same basis as the new accounting principle. An adjustment is made to the carrying amounts of assets and liabilities as of the beginning of the first year presented, plus an adjustment to the opening balance of retained earnings.

2) Impracticability: Entities should not use retrospective application if one of the following conditions exists.

- The entity cannot determine the effects of the retrospective application.
- Retrospective application requires assumptions about management's intent in a prior period.
- Retrospective application requires significant estimates that the entity cannot develop.

If any of the above conditions exists, the entity prospectively applies the new accounting principle.

3) Example: High-rise Construction Company used the completed contract method to account for long-term construction contracts for financial accounting and tax purposes in 20x7, its first year of operations. In 20x8, the company decided to change to the percentage-of-completion method for financial accounting purposes. The tax rate is 40% and the High-rise will continue to use the completed contract method for tax purposes.

The following table contains the relevant income from the long-term contracts for High-rise:

Date	Completed Contract	Percentage of Completion	Difference	40% Tax	Net of Tax
20x7	20,000	25,000	5,000	2,000	3,000
20x8	30,000	40,000	10,000	4,000	6,000

The journal entry required is as follows:

Construction in Process	5,000	
Retained Earnings		3,000
Deferred Income Tax Liability		2,000

Comparative Income Statements

	20x8	Restated 20x7	20x7 Originally Reported
Income Before Tax	$40,000	$25,000	$20,000
Income Tax	16,000	10,000	8,000
Net Income	$24,000	$15,000	$12,000

Retained Earnings Statement

	20x8	20x7 Restated	20x7 Originally Reported
Beginning balance previously reported	$12,000	$ -	$ -
Effect of accounting change	3,000	-	-
Beginning balance restated	15,000	-	-
Net income	24,000	15,000	12,000
Ending balance	$39,000	$15,000	$12,000

2. Change in Accounting Estimate: Estimates are necessary in accounting because financial statements must be prepared periodically before the ultimate consequences of many transactions are known. Examples of items for which estimates are necessary are uncollectible receivables, inventory obsolescence, service lives and salvage values of depreciable assets, warranty costs, recoverable mineral reserves, and periods benefited by a deferred cost.

a. Prospective Restatement: A change in accounting estimate is accounted for prospectively, i.e. in the period of the change if the change affects that period only or in the period of the change and future periods if the change also affects future periods. Financial statements for previous periods should not be restated nor should pro forma amounts for prior periods be reported.

b. Combination of Principle and Estimate: Some changes involve both a change in accounting principle and a change in accounting estimate. For example, an enterprise may change from deferring and amortizing a cost to recording it as an expense when incurred because future benefits have become doubtful. Thus, the change in principle is adopted in partial or complete recognition of the change in estimated future benefits. Since the effect of the change in principle is inseparable from the change in estimate, such changes are accounted for as changes in estimate.

c. Other Disclosures: The effect of a change in estimate on income before extraordinary items, net income, and related per share amounts of the current period must be disclosed for changes which affect several periods.

3. Change in Reporting Entity: Some accounting changes are the result of formation of a new reporting entity. (Note that purchase, creation, disposition, or cessation of a business unit does not constitute a change in reporting entity.) These changes are accounted for by restating the financial statements of all prior periods presented to show how the financial information would have appeared for the new reporting entity. The financial statements should describe the nature of the change and the reason for it. Examples of a change in entity include

- Presenting consolidated statements in place of statements for individual companies.
- Changing the set of subsidiaries or companies included in consolidated or combined financial statements.
- A business combination accounted for as a pooling of interests.

4. Correction of an Error:

a. Treatment: A correction of an error is accounted for as a prior period adjustment and comparative statements for prior periods are restated to correct for the effect of the error. Any effect attributable to years prior to the earliest year presented is shown as an adjustment of beginning retained earnings for the earliest year.

b. Includes: Examples of errors include

1) Non-GAAP: A change from an accounting principle which is not generally accepted to an accepted principle.

2) Mathematical Mistakes: Mathematical mistakes such as the miscalculation of depreciation expense.

3) Estimate Changes: Changes in estimates due to errors or inappropriate assumptions in preparing the original estimates.

4) Misapplication of GAAP: Mistakes in application of an accounting principle.

5) Cost – Asset Mistake: Incorrect classification of a cost as an expense rather than an asset or vice versa.

H. Earnings Per Share

1. Objectives of ASC Topic 260: The purpose of GAAP is to simplify the computation of earnings per share and to make the U.S. standard more compatible with the EPS standards of other countries, thus enhancing comparability among companies internationally.

2. Requirements: The earnings per share requirements of ASC Topic 260 apply to entities with publicly held stock or potential common stock.

a. Simple Capital Structure: If a company has a simple capital structure with no potential additional common stock, it must disclose only basic EPS.

b. Complex Capital Structure: Companies that have a complex capital structure (i.e. that have potential common stock such as options, warrants, and convertible debt or equity instruments) must disclose both basic and diluted EPS on the face of the income statement.

3. Basic Earnings Per Share: The starting point for both EPS calculations is basic EPS. The formula is earnings available to common shareholders divided by the weighted average number of shares outstanding.

a. Earnings Available to Common Shareholders – the Numerator: Earnings available to common is the portion of current earnings which is ultimately available for distribution to common shareholders. This is net income less the amount of current earnings which must be distributed to preferred shareholders for the current year. Thus, earnings available to common is net income minus preferred dividends declared for the current year or, if the preferred stock is cumulative and preferred dividends are not declared for the current year, the amount of cumulative dividends accruing for the current year.

b Weighted Average Number of Shares Outstanding – the Denominator: Calculation of the weighted average number of shares outstanding must take into account two types of changes in the number of shares outstanding.

1) Stock Splits and Stock Dividends: These result in changes in the number of shares outstanding which represent a redefinition of a share of the firm. These changes are accounted for retroactively by restoring all shares to year-end equivalent (YEE) shares.

Example: A firm with 1000 shares outstanding undergoes a 2:1 stock split on April 1. Before the split, each share represents ownership of 1/1000 of the firm. After the split, each share represents ownership of 1/2000 of the firm. These are reflected in the weighted average calculation as follows:

Dates	Actual Shares	Adjustment to YEE	YEE	Weights	Weighted YEE Shares
1/1- 3/31	1000	x2	2000	3/12	500
4/1-12/31	2000		2000	9/12	1500
Weighted average shares outstanding					2000

2) New Shares Issued and Treasury Stock: The second type of change is an expansion in the size of the firm due to the issuance of new shares or a contraction in the size of the firm due to retirement of shares or purchase of treasury shares. These are included in the computation as of the date on which the transaction occurred.

Example: Copperfield Company begins the year with 1000 shares outstanding. On March 1, Copperfield issues 900 new shares of stock. On July 1, Copperfield undergoes a 3 to 2 stock split. On August 1, Copperfield reacquires 350 of its shares as treasury stock. Finally, on November 1, Copperfield distributes a 10% stock dividend. These are reflected in the weighted average calculation as follows:

Dates	Actual Shares	Adjustment to YEE	YEE	Weights	Weighted YEE Shares
1/1-2/28	1000	x 1.10 x 1.5	1650	2/12	275.00
3/1-6/30	1900	x 1.10 x 1.5	3135	4/12	1045.00
7/1-7/31	2850	x 1.10	3135	1/12	261.25
8/1-10/31	2500	x 1.10	2750	3/12	687.50
11/1-12/31	2750		2750	2/12	458.33
Weighted average shares outstanding					2727.08

4. Diluted Earnings Per Share: Diluted earnings per share takes into account the numerator and denominator effects of potential common stock items issued by the company. Potential common stock items are convertible debt and equity instruments, and stock options, warrants and other rights.

a. Prescribed Procedure:

1) Incremental EPS Ranking Calculated: The procedure required by ASC Topic 260 is that an incremental EPS ratio be determined for each group of potential common stock items to determine their "if converted" impact. This is done by dividing the incremental effect on the numerator by the incremental effect on the denominator. After this has been done, the incremental EPS figures are ranked from the lowest ratio (most dilutive) to the highest (least dilutive).

2) Lowest EPS is Adopted: Once the ranking is in place, the company calculates EPS for continuing operations, taking into account the potential shares with the lowest incremental EPS first. If the resulting EPS is lower than basic EPS, the company goes to the item with the next lowest incremental EPS. This procedure is repeated, incorporating increasingly less dilutives shares, until the EPS figure increases. At that point, the calculation stops, and the EPS figure determined just before the increase is the one that reflects maximum dilution.

b. Convertible Securities: The method used to measure the dilutive effect on EPS of potential conversion of convertible securities is termed the "if-converted" method. It assumes that (1) the conversion took place at the later date of the beginning of the period or date of issuance of the security, and (2) the elimination of related dividends (convertible preferred shares) or interest (if a debt instrument) net of tax effect.

1) Convertible Preferred: The incremental EPS for convertible preferred is the preferred dividends saved (there is no tax effect) divided by weighted average number of shares that would result "if converted."

Example: Telcom Company had 1000 shares of $100 par value, 8% convertible, cumulative preferred stock outstanding for the entire year. Each share of preferred stock is convertible into 5 shares of common stock. The numerator effect is 8% x $100,000, or $8,000 of dividends saved. The denominator effect is 5000 x 12/12 = 5000 shares. The incremental EPS for this group of potential common shares is $8,000/5,000 shares, or $1.60.

2) Convertible Bonds: The increase in earnings available to common which would result if convertible bonds were converted into common stock is the decrease in interest expense which would come from retirement of the bonds offset by the increase in income tax expense which would result from the decrease in interest expense.

The increase in shares outstanding is the number of shares the bonds are convertible into weighted by the portion of the year the bonds were outstanding.

Example: Telcom Company had $100,000 of 10% convertible bonds outstanding from July 1 to the end of the year. Each $1,000 bond is convertible into 40 shares of common stock. The tax rate is 60%. The numerator effect is:

Decrease in interest expense = 6/12 x 10% x $100,000 =	$5,000
Increase in income tax expense = $5,000 x 60% =	-$3,000
Numerator effect	$2,000

The denominator effect is 100 bonds x 40 shares per bond x 6/12 of year = 2000 shares.

Incremental EPS for this group of potential common shares is $2,000/2,000 shares, or $1.00.

c. Stock Options, Warrants, and Rights: These items are included in the calculation of diluted EPS only when their exercise price is lower than the average market price of the company's stock. They are accounted for in the computation of weighted-average shares outstanding as of the later of the beginning of the year or date of issuance.

1) Numerator Effect: There is generally no effect on the numerator in the EPS computation if options, warrants, and rights are exercised.

2) Denominator Effect – Treasury Stock Method: The impact on the denominator is determined using what is referred to as the treasury stock method. The method assumes that, if stock options were exercised, the firm would have used the cash proceeds from exercise of the options to purchase shares of treasury stock. The treasury shares are presumed to have been purchased at the average market price of the company's stock.

Example: Telcom Company has 5000 options outstanding with an exercise price of $12 per share. Therefore, proceeds from exercise of the options would be 5000 x $12 = $60,000. The average market price per share of common stock during the year was $30. Calculation of denominator effect is:

Number of shares issued		5,000
Number of shares which could be purchased as treasury stock with $60,000 proceeds ($60,000/$30)	=	2,000
Net increase in shares (denominator effect)		3,000

Note that the incremental EPS would be $0 divided by 3,000 additional shares, or $0.

5. Calculating EPS – Illustration:

Example: Telcom Company has net income of $18,000 for the year. The weighted average number of shares outstanding was 5,000. The publicly held company has a complex capital structure because it has options outstanding, convertible preferred stock, and three different convertible bond issues. Dividends for preferred are $8,000 for the year. Information about the numerator and denominator effects for each of the securities is presented in the table below. Explanation of the solutions shown in the table is presented below the table.

	Numerator	Denominator	Incremental EPS
Basic EPS	$18,000-$8,000	5,000	
Diluted EPS Groups			
Options	0	3,000	0.00
Convertible Bonds A	$2,000	2,000	1.00
Convertible Bonds B	$11,000	10,000	1.10
Convertible Bonds C	6,000	5,000	1.20
Convertible Preferred	8,000	5,000	1.60

The figure to be reported for basic EPS, $2.00, is simply the $10,000 available to common shares ($18,000 less the $8,000 to preferred), divided by the weighted-average shares outstanding of 5,000.

For diluted EPS, note that the incremental EPS ratios have been ranked from lowest to highest. Begin with basic EPS, and adjust for the effects of the potential common stock groups one at a time. Start with the convertible security with the smallest incremental EPS ratio and work to the largest. If at any stage, the incremental EPS for the next security group is larger than the current EPS figure, there is no need to continue since conversion of any of the remaining securities would lead to increases in EPS (i.e., be anti-dilutive).

$\frac{10{,}000}{5{,}000}$	2.00	Basic EPS
$\frac{(10{,}000 + 0)}{(5{,}000 + 3{,}000)}$	1.25	Adding the effect of options
$\frac{(10{,}000 + 0 + 2{,}000)}{(5{,}000 + 3{,}000 + 2{,}000)}$	1.20	Adding the effect of Bonds A
$\frac{(10{,}000 + 0 + 2{,}000 + 11{,}000)}{(5{,}000 + 3{,}000 + 2{,}000 + 10{,}000)}$	1.15	Adding the effect of Bonds B

At this stage, the next security group (the Convertible Bonds C) has an incremental EPS ratio of 1.20 and the current EPS figure is 1.15. Therefore, this security (and the one after that, the convertible preferred shares) is anti-dilutive. To verify this,

$\frac{(10{,}000 + 0 + 2{,}000 + 11{,}000 + 6{,}000)}{(5{,}000 + 3{,}000 + 2{,}000 + 10{,}000 + 5{,}000)}$	1.16	Adding the effect of Bonds C
$\frac{(10{,}000 + 0 + 2{,}000 + 11{,}000 + 6{,}000 + 8{,}000)}{(5{,}000 + 3{,}000 + 2{,}000 + 10{,}000 + 5{,}000 + 5{,}000)}$	1.23	Adding the effect of convertible preferred

Therefore, diluted EPS is $1.15, the lowest figure before the inclusion of an additional incremental EPS caused an increase to occur.

Telcom will thus disclose, on the face of its income statement, basic EPS of $2 per share and diluted EPS of $1.15 per share.

6. Disclosures Required: The following disclosures are required:

a. Reconciliation: A reconciliation of the numerators and denominators of basic and diluted EPS from continuing operations.

b. Preferred Dividends: The effect of preferred dividends in determining income available to common shareholders in basic EPS.

c. Excluded Securities: The securities not included in the diluted EPS computation that could be dilutive in future periods.

d. Post Year-End Transactions: The impact of any transaction that occurred after year-end that would materially change the number of potential common shares outstanding.

III. BALANCE SHEET OVERVIEW

The technical name for the balance sheet is the "Statement of Financial Position" and is usually referenced as such in the CMA exam. The balance sheet provides information concerning the nature of the firm's financial resources, the claims of creditors against those resources, and the equity of the owners in the net resources of the firm. In order to provide useful information to users of the financial statements, the balance sheet is normally broken down into various classifications. The operating cycle is the time which distinguishes current and long-term items.

A. Operating Cycle

The average elapsed time from a cash outflow between the acquisition of inventory and the date of the cash inflow from the collection of the product's sale proceeds.

B. Current Assets

Cash and other assets that will be converted into cash, sold, or consumed within one year or the operating cycle, whichever is greater. Included are such items as marketable securities, notes and accounts receivable and inventories.

1. Accounts Receivable: Accounts receivable are normally reported at net realizable value, which equals the gross receivables less any allowance for uncollectible accounts.

a. Uncollectible Accounts:

(1) Allowance Method: This represents the GAAP method. Bad debt expense is accrued each period based on one of two acceptable approaches.

(a) Base is Net Credit Sales: This approach is based on the matching principle which has an income statement focus. Each period, the historical percent of uncollectible accounts is multiplied by the period's net credit sales. The amount calculated results in a debit to bad debt expense and a credit to the allowance for uncollectible accounts.

Example: Based upon its past collection experience, Alden Company provides for bad debt expense at the rate of 2% of credit sales. On January 1, 20x1, the allowance for doubtful accounts balance was $10,000. During 20x1 Alden wrote off $18,000 of uncollectible receivables and recovered $5,000 of bad debts written off in prior years. If credit sales for 20x1 totaled $1,000,000, the allowance for doubtful accounts balance at December 31, 20x1, should be

a. $12,000 *b. $17,000 c. $20,000 d. $30,000

Answer:

$ 10,000	Balance 1/1/x1
- 18,000	20x1 Write-off
+ 5,000	20x1 Recoveries
+ 20,000	20x1 Provision (1,000,000 x 0.02)
$ 17,000	Balance 12/31/x1

(b) Base is Outstanding Receivables: This approach has a balance sheet focus and concentrates on the net realizable value of receivables. Either one percentage rate is applied to all receivables or different percentage rates are applied to various aging categories on an aging schedule. Alternatively, an aged accounts receivable trial balance can be previewed to estimate the dollar balances deemed to be uncollectible. The amount calculated represents the desired ending balance in the allowance account. The year-end entry for bad debts is the amount necessary to bring the allowance account up to the desired balance.

Example: The following information pertains to Tara Co.'s accounts receivable at December 31:

Days outstanding	Amount	Estimated % uncollectible
0 - 60	$120,000	1%
61 - 120	90,000	2%
Over 120	100,000	6%
	$310,000	

During the year, Tara wrote off $7,000 in receivables and recovered $4,000 that had been written off in prior years. Tara's December 31 allowance for uncollectible accounts was $22,000. Under the aging method, what amount of allowance for uncollectible accounts should Tara report at December 31?

a. $ 9,000 b. $10,000 c. $13,000 d. $19,000

Answer: The correct answer is /a/. This calls for the balance sheet focus.

$120,000 x 1%	$1,200	
90,000 x 2%	1,800	
100,000 x 6%	6,000	
	$9,000	Balance needed

(c) Write-offs: Actual write-offs are made by debiting the allowance account and crediting accounts receivable. This has no impact on net income or working capital.

(d) Recoveries: Recoveries of accounts previously written off require two entries. The first entry reverses the original entry for the write-off and reinstates the account. The second is recorded as a normal collection of an open account receivable.

Allowance for Doubtful Accounts

Debit		Credit	
Write-offs	xx	Beginning balance	xx
		Recoveries	xx
		Annual expense	xx
		Ending balance	xx

(2) Direct Write-off Method: This is not GAAP, but may be used if the amount of bad debts is immaterial. No allowance account is used. Bad debts expense is accounts receivable determined to be uncollectible that are written off to expense at the time of uncollectibility. Recoveries of accounts previously written off are credited to an income statement account, "Recoveries of Uncollectible Amounts."

b. Accounts Receivable as a Source of Financing:

(1) Pledging: Accounts receivable can be used as collateral in a borrowing arrangement. Adequate disclosure should be made of the pledged accounts receivable.

(2) Assignment: Specific accounts receivable can be assigned to the lender in a borrowing arrangement on a notification or non-notification basis. Assigned accounts receivable should be segregated in a separate account. Collection of the assigned accounts should be used to satisfy the principal and interest on the borrowing.

(3) Factoring: The accounts receivable are sold outright to a purchaser known as a factor. If without recourse, the purchaser assumes the risk of ownership. Remove the accounts receivable and report a loss equal to the fee charged by the factor. If the sale is with recourse, the provisions of ASC Topic 860 apply. The transfer should be treated as a sale if all three of the following conditions are met:

(a) Assets Isolated: The assets are beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.

(b) Transferee Pledging Right: Each transferee obtains the right to pledge or exchange the transferred assets it received. Also qualifying is a transferee that is a qualifying special-purpose entity(SPE) with the right to pledge or exchange those interests. No conditions exist that constrain the transferee from taking advantage of its right to pledge or exchange the assets.

(c) Repurchase: The transferor does not maintain effective control over the transferred assets through a repurchase or an early redemption agreement, or the ability to cause the holder to return specific assets.

If any one of the above three conditions is not met, the transaction should be treated as a borrowing arrangement and a liability recorded for the financing provided.

2. Inventories: The term inventory is used to designate the aggregate of those items of tangible personal property that (a) are held for sale in the ordinary course of business (finished goods), (b) are in process of production for such sale (work in process), or (c) are to be currently consumed either directly or indirectly in the production of goods or services to be available for sale (raw materials and supplies). The method of valuing inventories should be consistently applied. If a change in method is made, the nature of the change and the effect on income must be disclosed.

a. Role of Inventories on Financial Statements: The major objective in accounting for the goods in inventory is the matching of costs against revenues in order that there may be proper determination of the realized income.

(1) Current and Carry-Forward Figure: The inventory at any given date is the balance of costs applicable to goods on hand remaining after the matching of absorbed costs with concurrent revenues. This balance is carried forward to future periods provided it does not exceed an amount properly chargeable against the revenues expected to be obtained from ultimate disposition of the goods carried forward.

(2) Exam Questions: Many inventory problems test your understanding of the following basic identity: the total costs to account for (inventory costs carried over from previous periods plus expenditures in the current period) is equal to the sum of costs relating to goods sold and costs of units on hand at the end of the period (expense for the period plus ending inventory).

b. Inventory Costs: Inventory cost is defined as the sum of the applicable expenditures and charges directly or indirectly incurred in bringing inventories to their existing condition and location. Items in transit shipped FOB shipping point are included in the inventory of the buyer; those shipped FOB destination are included in the inventory of the seller.

(1) Transportation: Often consists of shipping costs paid by the firm in purchasing goods for sale, usually referred to as Freight-in. May also include costs of shipping goods to branch stores, etc.

(2) Purchasing, Handling, and Storage Costs: These costs are part of the cost of bringing inventories to their existing condition and locations and thus should theoretically be included as part of the cost of inventory. However, it is costly to associate these costs with individual units or batches of inventory. For example, it would be difficult to assign the costs of running a purchasing department to individual items purchased. Moreover, it would be expensive to keep track of any costs assigned to individual items. Therefore, in practice, these costs are usually treated as period expenses.

c. General Guidelines For Valuing Inventory: In keeping with the principle that accounting is primarily based on historical cost, there is a presumption that inventories shall be stated at cost. However, a departure from the cost basis is required whenever the utility of the goods is no longer as great as its cost. In such cases, inventories should be stated at the lower of cost or market. Also, there are a few exceptional cases where inventory may be stated above cost.

d. Lower of Cost or Market: Accounting Research Bulletin No. 43 states that if the utility of goods is impaired by damage, deterioration, obsolescence, changes in price levels, or other causes, a loss shall be reflected as a charge against the revenues of the period in which it occurs. The measurement of such losses shall be accomplished by applying the rule of pricing inventories at lower of cost or market.

(1) Market Definition: The term “market” means current replacement cost (CRC) subject to an upper and lower limit. The upper limit (or ceiling) is net realizable value (NRV) which is estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal. The lower limit (or floor) is NRV minus an allowance for a normal profit margin. If CRC is greater than the upper limit, then use NRV as market. If CRC is below the lower limit, then use NRV minus a normal profit as market.

(2) Application: The application of lower of cost or market (LOCOM) is a two-step process: (1) determine the figure to use for "market" subject to the limits discussed above, and (2) value the inventory at the lower of cost or "market." Depending on which method most clearly reflects periodic income, LOCOM can be applied to individual items, components of inventory, or to total inventory.

Example: Inventory consists of three items with CRC, NRV, NRV-normal profit margin, and cost as shown in the table below. If LOCOM is applied to individual items, the three items in inventory will be valued at $120, as shown in the last column of the table.

Item	CRC	NRV	NRV-Profit	Market	Cost	LOCOM
1	30	35	28	30	29	29
2	80	70	63	70	80	70
3	15	25	21	21	23	21
				Total		120

Variation: If LOCOM is applied to total inventory, the inventory would be valued at $125:

	CRC	NRV	NRV-Profit	Market	Cost	LOCOM
Total Inventory	125	130	112	125	132	125

e. Major Inventory Accounting Methods:

(1) Perpetual: The perpetual inventory method records the effect on inventory of each purchase and each sale. Thus, there is no need for any closing or adjusting entries at the end of the period except to account for goods that are lost, stolen, damaged, etc.

(2) Gross Profit: The gross profit inventory method relies on two concepts: (1) Cost of Goods Sold can be estimated from Sales by using information about the normal relationship between selling price and cost of goods sold. For example, suppose past experience indicates that Cost of Goods Sold is typically 60% of Sales. If Sales are $100,000, a reasonable estimate of Cost of Goods Sold is $60,000. (2) Cost of Goods Sold plus Ending Inventory must equal Goods Available for Sale. Therefore, if Goods Available for Sale is $90,000 and estimated Cost of Goods Sold is $60,000, the estimated ending inventory would be $30,000. At the end of the period, these estimates are used for Cost of Goods Sold and for Ending Inventory. The gross profit method is acceptable only for interim financial statements or in situations where it is impossible to determine ending inventory directly, e.g., in the event of a fire or other casualty.

(3) Periodic: The periodic method is the most widely used. The effects of purchases and sales on Inventory and on Cost of Goods Sold are determined at the end of each period. Most of the valuation methods discussed in Section V are used with the periodic method of accounting for inventory.

f. Unit-Based Inventory Valuation Methods:

(1) Specific Identification: The cost of individual items in inventory is used to calculate the cost of ending inventory and the cost of goods sold. This method is not practical unless the number of items in inventory is fairly small, and items can be individually identified. Some items where this method is used are automobiles, large appliances, and heavy equipment.

(2) Average Cost Methods:

(b) Perpetual Moving Average: The average cost per unit is recomputed after each purchase by dividing total costs in inventory by the total units in inventory. Cost of Goods Sold for each sale is recorded at the average cost per unit in inventory at the time of the sale.

Example: Ronco Corporation had the beginning inventory, purchases, and sales shown in the table below.

Calculation of Cost of Goods Sold and
Ending Inventory Using Perpetual Moving Average

	Purchases		Sales		Balance		Average
	Units	Dollars	Units	Dollars	Units	Dollars	Cost/Unit
Beg Inventory					300	3,000	$10.00
January	100	1,100			400	4,100	$10.25
February 4	200	2,500			600	6,600	$11.00
March 6			200	2,200	400	4,400	$11.00
March 27	100	1,350			500	5,750	$11.50
Cost of Goods Sold			200	2,200			
Ending Inventory					500	5,750	

(b) Periodic Weighted Average: At the end of each period, the average cost per unit is calculated by dividing the cost of goods available for sale by the number of units available for sale.

Example: If Ronco Corporation used the Periodic Weighted Average:

Calculation of Cost of Goods Sold and
Ending Inventory Using Periodic Weighted Average

Total Purchases	400	4,950	
Beginning Inventory	300	3,000	
Goods Available for Sale	700	7,950	$11.357 per unit
Cost of Goods Sold	200	2,271	$11.357 per unit
Ending Inventory	500	5,679	$11.357 per unit
		7,950	

(3) Last In First Out (LIFO): Under the LIFO cost flow assumption, the costs associated with the most recently acquired goods are the first costs to flow out of Cost of Goods Sold. Tax regulations require that LIFO be used for financial reporting if it is used for tax purposes and that LIFO must be used for tax purposes if it is used for financial reporting. Permission of the IRS is required to adopt LIFO. When LIFO is adopted, the beginning inventory for the year of the change is converted to weighted average and becomes the LIFO base layer. LIFO inventory in subsequent years will usually consist of the base layer and additional layers added in later years. These additional layers will typically come from purchases made throughout the year; each layer, therefore, requires some cost flow assumption. The LIFO method has a better match of current costs being expensed against current revenues, but the ending inventory value may become unrealistically low over a long period of time.

Example: In 20x4, Kotz Corporation obtained permission to switch to LIFO. Beginning Inventory for the year consisted of 50 units purchased at $8; 100 units at $11; and 150 units at $10. Ending Inventory consisted of 425 units.

Purchases for the year were as follows:

02/04	100 units at $11	$1,100
07/02	200 units at $12	2,400
08/18	100 units at $13	1,300
	400 units	$4,800

The Beginning Inventory forms the base layer of 300 units with an average cost of $10 per unit [(400 + 1100 + 1500) -:- 300 = $10]. Since Ending Inventory is 425 units, an additional layer of 125 units was added this year. This layer must be costed using one of three cost flow assumptions for the layer. It is common to use either LIFO or weighted average for each layer. (Here, the weighted average cost of purchases during 20x4 was $4800 -:- 400 = $12 per unit.) However, the layer could also be costed on the FIFO basis. Ending Inventory under each of these three assumptions is as follows:

	LIFO		Weighted Average		FIFO	
Base Layer	300 at $10	3,000	300 at $10	3,000	300 at $10	3,000
20x4 Layers	100 at $11	1,100	125 at $12	1,500	100 at $13	1,300
	25 at $12	300			25 at $12	300
Ending Inventory		$4,400		$4,500		$4,600

(4) First In First Out (FIFO): Under the FIFO cost flow assumption, the cost associated with the goods first acquired are the first costs to flow out of Cost of Goods Sold. Thus, Ending Inventory includes the cost of the last goods acquired and usually consists of one or more layers of the most recent purchases. During periods of rising prices, this method will retain in inventory the most recent purchase costs, yielding an appropriate current value for ending inventory. However, it does not yield the best matching of current costs against current revenues since it retains the most current costs in inventory.

Example: Nouveau Co. had beginning inventory for the year of 400 units with a total cost of $1,600. Ending Inventory was 450 units. Purchases for the year were as follows:

01/13	400 units at $4.50	$1,800
01/27	100 units at $4.25	425
06/16	300 units at $5.00	1,500
	Total Purchases	$3,725

Ending Inventory at December 31 is

300 units at $5.00	$1,500
100 units at $4.25	425
50 units at $4.50	225
Ending Inventory	$2,150

Cost of Goods Sold = ($1600 + 3725) - $2150 = $3175

(5) Effect of Inventory Errors: If errors exist in the valuation of ending inventory, both the income statement and balance sheet of the current and next accounting periods will be affected. For example, if the current period ending inventory is understated (certain items in inventory were not counted), the costs being subtracted from goods available for sale will be understated making cost of goods sold overstated. If cost of goods sold is overstated, then income for the period will be understated. The net effect is to understate assets, income, and owner's equity. This will be reversed in the next accounting period as the understated inventory is carried forward as next periods beginning inventory (understated beginning inventory will understate cost of goods available for sale and cost of goods sold, which then overstates income for the period).

C. Long-Term Investments

This category includes investments in related companies, bonds which are not intended to be liquidated, funds accumulated to retire debt and the cash surrender value of life insurance.

D. Property, Plant and Equipment

Land, buildings, plant, fixtures, furniture, leasehold improvements and the capitalized value of certain leased assets are included.

E. Intangible Assets

Intangible assets are defined as long-term rights under the control of a firm due to legal or contractual agreements. Examples include patents, copyrights, franchises, trademarks, tradenames, organization costs, etc. Goodwill is an unidentified intangible asset that arises in a purchase business combination and is measured by the excess of the fair value of the consideration given over the fair value of the identified tangible and intangible assets acquired. A company should measure intangible assets at their fair value at the time they are acquired. Costs relating to internally generated goodwill, or to maintaining or restoring intangible assets are not capitalized and should be expensed as incurred.

1. Purchased Intangibles: The cost includes the acquisition costs (fair value of consideration given) and necessary costs to secure the rights related to intangible assets. An intangible asset is recognized as an asset under ASC Topic 350 if it (1) arises from a contractual or legal right, or (2) is separable, that is, able to be separated from the entity to be sold or transferred.

2. Examples of Intangible Assets: The following are examples of intangible assets that meet the criteria for recognition as an asset apart from goodwill.

a. Marketing-related Intangible Assets: Marketing-related intangible assets include trademarks and tradenames, service marks, trade dress (unique color, shape, or package design), and non-compete agreements.

b. Customer-related Intangible Assets: Included in this category are customer lists, order or production backlogs, and customer contracts and relationships.

c. Artistic-related Intangible Assets: Artistic intangible assets include literary works, books, and magazines; musical works (lyrics, advertising, jingles, etc.); pictures and photographs; and video and audiovisual material (motion pictures, music videos, television programs).

d. Contract-based Intangible Assets: This category of intangible assets include licensing, royalties, advertising, construction, management, service or supply contracts, lease and franchise agreements, and construction permits.

e. Technology-based Intangible Assets: Included are patented and unpatented technology, computer software, and trade secrets (such as secret formulas, processes, and recipes).

3. Internally Developed Intangibles: The cost generally includes the legal fees, filing fees and other incidental costs necessary to secure the rights related to the intangible asset. Keep in mind that all R&D must be expensed as incurred.

Example: On June 30, Union, Inc. purchased goodwill of $125,000 when it acquired the net assets of Apex Corp. During the year, Union incurred additional costs of developing goodwill by training Apex employees ($50,000) and hiring additional Apex employees ($25,000). Union's December 31 balance sheet should report goodwill of

a. $200,000 **b.** $175,000 **c.** $150,000 **d.** $125,000

Answer: Goodwill arises as a result of the purchase of a business. Costs related to internally generated goodwill or to maintaining goodwill purchased are not capitalized. Therefore, Union, Inc.'s capitalized goodwill before any impairment is $125,000. Answer /d/ would be the correct choice.

4. Amortization: Intangible assets (other than goodwill) may or may not be amortized depending on their useful lives to the entity. Intangible assets with finite lives are amortized, those with indefinite lives are not. Goodwill is not amortized. The straight-line method is used to amortize intangible assets if no better method is determined that reflects the pattern of decrease in the asset's value. If amortized, the intangible asset should be expensed over its useful life, with no arbitrary ceiling on the length of life. A separate accumulated amortization account is generally not used. Any intangible asset (other than goodwill) that is not being amortized should be evaluated annually to determine if amortization should begin (life goes from indefinite to definite). All intangible assets, including goodwill, should be tested for impairment of value at least annually. Any impairment loss should be recognized in the period in which the asset's recorded value is greater than its fair value.

F. Accounting for the Impairment or Disposal of Long-lived Assets

ASC Topic 360 addresses financial accounting and reporting for the impairment or disposal of long-lived assets of both business enterprises and not-for-profit entities. The Statement is applied to the group when long-lived assets are part of a group that includes other assets and liabilities.

1. Long-lived Assets to Be Held and Used: An impairment is defined as the condition that exists when the carrying amount of a long-lived asset (group) exceeds its fair value. An impairment loss is only recognized if the carrying amount of the asset (or group) is not recoverable and exceeds its fair value.

a. When to Test For Recoverability: Assets (or groups) must be tested for recoverability when warranted by events or changes in circumstances. Examples of events or changes in circumstances include (1) a significant decrease in its market price, (2) A significant adverse change in the extent or manner in which it is being used or in its physical condition, or (3) a significant adverse change in legal factors or in the business climate that could affect its value or an adverse action or assessment by a regulator. The recoverability test compares the carrying amount of the asset (or group) to the expected undiscounted net cash flows from its use.

b. Depreciation Estimates: An asset that is impaired under ASC Topic 360 should be examined for a change in its useful life or salvage value. After recognizing an impairment loss, depreciation of the asset (group) would be revised, taking into consideration any changes in expected life or salvage value.

c. Allocating Impairment Losses and New Cost Basis: A recognized impairment loss is allocated on a pro rata basis using relative carrying amounts to the assets in the asset group that are covered by the Statement. Any impairment loss recorded creates a new cost basis for an asset and it is depreciated over its remaining useful life.

d. Estimates of Future Cash Flows for Recoverability Test: ASC Topic 360 provides guidance on three aspects of the recoverability test: 1) the cash flow estimation approach, 2) the cash flow estimation period, and 3) the types of asset-related expenditures that should be included in developing estimates of future cash flows.

e. Reporting and Disclosures: An impairment loss is to be reported as a component of income from continuing operations before income taxes (a portion of income from operations). Also, the following disclosures must be made:

(1) A description of the impaired asset (group) and the facts and circumstances leading to the impairment.
(2) The amount of the impairment loss.
(3) The method of determining fair value.

2. Assets to be Disposed of Other Than by Sale: ASC Topic 360 requires an asset (or group) that will be disposed of other than by sale to continue to be classified as held for use (and depreciated) until the disposal date. Abandonments and exchanges for similar productive long-lived assets are transactions included in this category.

a. Long-lived Assets to be Abandoned: Under ASC Topic 360, long-lived assets to be abandoned are disposed of at the time the entity ceases to use them. If an entity commits to a plan to abandon an asset prior to the end of its estimated useful life, the asset should be evaluated for impairment as an asset to be held and used. Depreciation should be revised to reflect (1) the use of the asset over a shortened period and (2) the remaining carrying value.

b. Long-lived Asset to be Exchanged for a Similar Long-lived Asset or to be Distributed to Owners in a Spinoff: These assets should continue to be classified as held for use until the exchange or distribution occurs. At the date of exchange or distribution, an impairment loss is recognized for the excess of the carrying amount of the asset (group) over its fair value.

3. Assets to be Disposed of by Sale: ASC Topic 360 applies a single accounting model to long-lived assets to be disposed of by sale, regardless of the situation. The statement also accomplished the following:

(1) Established six criteria to determine when a long-lived asset is held for sale.
(2) Provided guidance if the criteria for classification as held for sale are met after the balance sheet date but before the entity issues its financial statements.
(3) Provides guidance on the accounting for a change to a plan of sale.

4. Reporting Requirements:

a. Reporting of Discontinued Operations: A component of an entity is defined as any portion that contains operations and cash flows that can be distinguished from the rest of the entity. This can be either a reportable segment, an operating segment, a reporting unit, or an asset group. An entity is required to report in discontinued operations the results of operations of a component of an entity that has been disposed of or is classified as held for sale if two conditions are met: (1) the operations and cash flows of the component have been eliminated from the ongoing operations of the entity as a result of the disposal transaction and (2) the entity will not have any significant continuing involvement in the operations of the component after the disposal transaction.

b. Reporting Disposal Gains or Losses in Continuing Operations: Losses for long-lived assets classified as held for sale that is not a component of an entity are reported in income from continuing operations before income taxes.

c. Reporting Long-lived Assets as Held for Sale: Long-lived assets that are classified as held for sale are to be presented separately in the statement of financial position. Disclosures must be made of the major classes of assets and liabilities that are classified as held for sale. Other disclosures required include a description of the facts and circumstances leading to the expected disposal, and the gain or loss relating to measuring an asset classified as held for sale at fair value less costs to sell.

G. Other Assets

This account is usually for assets that don't fit into another category such as deferred items and prepayments.

H. Current Liabilities

This category includes those obligations that will be liquidated by the use of current assets or the creation of other current liabilities in one year or the operating cycle, whichever is greater. These include short-term notes and accrued liabilities. Accrued liabilities include such items as salaries payable at the end of the accounting period and warranties on products sold. Warranty expense is recorded in the period the product is sold. An estimate of the amount of warranty costs expected attributable to the sales occurring during the period is made and is taken as an expense in the year of sale. This entry is made in order to properly match the costs with the revenues earned. An expense (warranty expense) is debited and a liability account (warranty liability) is credited. When actual liability work is performed, the warranty liability is reduced (debited).

I. Long-Term Liabilities

These are liabilities that will be paid in more than one year. Included in this category are items such as debentures, mortgages and obligations under capital leases.

J. Stockholders' Equity

This is the category that represents the various ownership interests in the business. Common and preferred stock, retained earnings and treasury shares are the usual components.

1. Preferred and Common Shares: Preferred stock is stock that has some preference over common stock (dividends, liquidation, etc.). Common stock represents the rights to ownership of the corporation. IF only one class of stock exists it is commonly known as capital stock. Preferred and common shares may have a par or stated value, or may have no-par value. When stock has a par or stated value, the credits which correspond to the amount received for the stock are split into two components: 1) the par or stated value of the stock and 2) the excess of the amount received above par or stated value. The excess above par or stated value is credited to "PIC in Excess of Par – common," which is alternatively referred to as "Premium on common." With no par stock, the entire amount received is credited to a single account, called simply "Common Stock."

2. Additional Paid-In Capital:

a. Includes: There are numerous sources of Additional Paid-in Capital (APIC). Also, a number of alternative terms are used: "PIC in Excess of Par," "Capital in Excess of Par," and "Capital Contributed in Excess of Par" are all common alternatives. Each source of APIC gives rise to a separate account. In published financial statements, these accounts are often combined and reported as a single amount under the heading "APIC" or one of the alternative terms above.

b. Exam Questions: For multiple choice questions on the exam, it is important to determine whether the question relates to the total of all the individual APIC accounts or whether it relates to one of the individual accounts. For problems, it is good practice to make entries (and present the balance, if required) for each APIC account separately, unless the problem specifically asks for the total of all accounts.

c. Examples: Some examples of items which give rise to APIC are:

- Issuance of stock for more than par value
- Amounts forfeited by defaulting stock subscribers
- Donations by stockholders
- Donations by other parties, e.g., donation of a plant site by a municipality

- Treasury stock transactions
- Retirement of stock at less than the original issue price
- Quasi-reorganizations
- Issuance of stock options
- Expiration of stock options
- Conversion of convertible bonds into stock
- Conversion of convertible stock into another class of stock

Example: Bonds with a face value of $1000, unamortized premium of $140 and Unamortized Bond Issue Costs of $40 (for a carrying value of $1100) are converted into 20 shares of $1 par value common stock which has a current market value of $40 per share or $800. There are two acceptable methods to account for this conversion: the book value method (records the stock at the book value of the bonds) and the market value method (records the stock at its market value).

Book Value Method		
B/P	1,000	
Premium on B/P	140	
Unamortized Bond Issue Costs		40
Common Stock - at par		20
PIC in Excess of Par - common		1,080

Market Value Method		
B/P	1,000	
Premium on B/P	140	
Unamortized Bond Issue Costs		40
Common Stock - at par		20
PIC in Excess of Par - common		780
Gain on conversion of convertible bonds		300

Example: Preferred stock with a par value of $100 which was originally issued for $160 is converted into five shares of $10 par value common stock which has a current market value of $45 per share. There is only one acceptable method to account for conversion of one class of equity into another class: the book value method (records the common stock at the book value of the preferred stock).

Book Value Method		
Preferred Stock - at par	100	
PIC in Excess of Par - preferred	60	
Common Stock - at par		50
PIC in Excess of Par - common		110

3. Retained Earnings and Dividends: Retained Earnings is the third major component of owners' equity. The balance in Retained Earnings reflects the cumulative earnings of the firm since its inception adjusted for distributions of assets or stock to stockholders, the effects of treasury stock transactions, and certain events associated with quasi-reorganization.

a. Statement of Retained Earnings: The Statement of Retained Earnings reconciles the balance in the retained earnings account from the beginning to the end of the period. The reconciling items are net income or loss, dividends declared and prior period adjustments. If retained earnings are appropriated, it would be shown as a deduction from the total account balance; the amount would also be included in the unappropriated balance in the owners' equity section of the balance sheet.

1) Beginning Balance Adjustments: Prior period adjustments are to be reflected as adjustments to the beginning balance. According to SFAS 16, prior period adjustments are correction of an error in the financial statements of a prior period or adjustments that result from realization of income tax benefits of pre-acquisition operating loss carry-forwards of purchased subsidiaries. Errors are mathematical mistakes, mistakes in the application of accounting principles or misuse of facts (including oversight) that existed at the time the financial statements were prepared. This does not include a change in an accounting estimate, but it does include a change from an accounting principle that is not generally accepted to one that is GAAP.

2) Methods: There are three generally accepted methods of presentation:

a) Separate Statement: The Statement of Retained Earnings can be a separate statement as presented on the following page:

Book Corporation
Statement of Retained Earnings
For the Year Ended December 31, 20x2

Balance, December 31, 20x1		
As originally reported		$2,376,600
Deduct prior period adjustment,		
Correction of accounting error in 20x1		
Net of $6,000 tax savings		(14,000)
Restated Beginning Retained Earnings		2,362,600
Net Income		2,510,000
		4,872,600
Deduct Dividends		
Preferred Stock	25,400	
Common Stock	74,000	(99,400)
Total Retained Earnings, December 31, 20x2		4,773,200
Less: Appropriation for Plant Expansion		(2,000,000)
Appropriation for Debenture Retirement		(1,000,000)
Unappropriated Balance		$1,773,200

b) Income Statement Inclusion: The Statement of Retained Earnings can be included at the end of the Income Statement. This has the advantage of having all items affecting income, including operating items and prior period adjustments appear on one statement. The disadvantage, however, is that the net income figure is not at the end of the statement, but is buried in the body of the statement and thus loses emphasis.

Book Corporation
Combined Statement of Income
And Retained Earnings
For the Year Ended December 31, 20x2
(Income Statement portion omitted)

Net Income		$2,510,000
Retained Earnings, December 31, 20x1		
As originally reported	2,376,600	
Deduct prior period adjustment,		
Correction of accounting error in 20x1		
Net of $6,000 tax savings	(14,000)	2,362,600
		4,872,600
Deduct Dividends		
Preferred Stock	25,400	
Common Stock	74,000	(99,400)
Total Retained Earnings, December 31, 20x2		4,773,200
Less: Appropriation for Plant Expansion		(2,000,000)
Appropriation for Debenture Retirement		(1,000,000)
Unappropriated Balance		$1,773,200

c) **Owners' Equity Statement Inclusion:** A third alternative presentation is to include retained earnings in a combined statement with the other owners' equity accounts and reconcile the activity in all of them together (in a columnar format, if desired).

Book Corporation
Combined Statement of Owner's Equity
For the Year Ended December 31, 20x2

	Preferred Stock	Common Stock	APIC	Foreign Currency	Retained Earnings
Balance, Dec 31, 20x1	$100,000	$1,000,000	$540,000	$(66,414)	$2,376,600
Prior period adjustment					(14,000)
Net Income					2,510,000
Dividends					(99,400)
Translation adjustment				(29,628)	
Common Stock issued		10,000	7,000		
Balance, Dec 31, 20x2	$100,000	$1,010,000	$547,000	(96,042)	$4,773,200
Appropriated for					
Plant Expansion					(2,000,000)
Debenture Retirement					(1,000,000)
Unappropriated Balance					$1,773,200

b. **Appropriations of Retained Earnings (R/E):** The board of directors may "appropriate" R/E for special purposes. An appropriation of R/E has two effects: 1) transfers part of the balance in R/E to "R/E Appropriated for...," thereby informing the financial statement reader that a portion of retained earnings should be set aside for a special purpose, and 2) restricts payment of dividends. An alternative title for the account "R/E Appropriated for..." is "Reserve for...." The appropriation should be reversed as soon as the purpose for which the appropriation is established has passed.

Note that the appropriation of R/E does not 1) affect reported net income in any way (losses or gains should never be charged against the appropriation), nor 2) set aside cash for a special purpose (the fact that there is a balance in "R/E Appropriated for..." does not mean that the firm has that amount of cash on hand).

c. **Dividends in General:** Dividends are distributions to stockholders from previous corporate earnings (retained earnings). Dividends can be in the form of cash, shares of the corporate stock, or in property owned by the corporation (such as an investment). When a company has both common and preferred stock outstanding, the distribution of dividends must take into account certain features of preferred stock. Preferred stock usually is entitled to a fixed dividend rate, expressed as either a percentage of par value or as an amount per share. Preferred stock may be either cumulative or noncumulative and may be either participating or nonparticipating. Note that common stock dividends are not cumulative. When dividends are declared, it is necessary to calculate the amount to go to preferred shareholders and the amount to go to common shareholders.

1) **Four-Step Procedure:** This can be reduced to a four-step procedure, where you only proceed to the next step if you have additional dividends to be distributed.

a) **Preferred Arrearage:** Pay any preferred dividends in arrears. If the preferred is noncumulative or if the preferred dividends for previous years have been paid, there will be no preferred dividends in arrears.

b) **Preferred Current:** Pay the preferred dividends for the current year.

c) Current Year:

(1) If the preferred is nonparticipating, pay any remaining amounts to common shareholders.

(2) If the preferred is participating, pay common dividends to match the rate of dividends (or the dollar amount of dividends per share for no par stock) paid to preferred shareholders for the current year. Go on to Step 4.

d) Divide Remainder: Divide any remaining dividends between preferred and common shareholders according to relative par values (or according to relative number of shares for no par stock).

2) Example: Common - $1 par, 1,000,000 shares outstanding.
Preferred - $100 par, 6%, cumulative, fully participating, 1000 shares outstanding.
There are three years dividends in arrears.
$99,400 is to be distributed.

Answer:

		Preferred	Common
1.	Arrears (3 years @ 6% x $100,000)	18,000	
2.	Current (6% x $100,000)	6,000	
3.	Matching amount (6% x $1,000,000)		60,000
4.	Allocation of remainder ($15,400) according to relative par values	1,400	14,000
	Totals	25,400	74,000

d. Cash Dividends: Cash dividends are recorded at the date of declaration by debiting R/E and crediting Dividends/Payable. At the date of payment, Dividends Payable is debited and Cash is credited. A third date associated with dividends, the date of record, is not accompanied by any journal entry.

e. Property Dividends: Property dividends are recorded using the fair value of the property distributed as of the date of declaration. Thus, it may be necessary to make a separate entry to account for any difference between the book and fair value of the property distributed.

Example: On December 20, Tyson Corp. declared a property dividend of marketable securities which Tyson Corp. has been holding as an investment. The securities are to be distributed on January 28 of the following year to shareholders of record on January 10. The market value of the securities is $300,000 on December 20, $310,000 on January 10, and $305,000 on January 28. The carrying value of the securities is $200,000. The entries to record the property dividend are

December 20		
Investment in Zorro Corp. shares	100,000	
Gain on disposal of investments		100,000
R/E	300,000	
Property Dividends Distributable		300,000
January 28		
Property Dividends Distributable	300,000	
Investment in Zorro Corp. shares		300,000

f. Stock Dividends and Stock Splits: Stock dividends and stock splits change the number of shares outstanding by changing the number of shares held by current shareholders. It is important to distinguish between the way the change in the number of shares is described and the way it is accounted for.

1) Descriptions of Distributions of Shares: Any change in the number of shares could be described either as a stock dividend or as a stock split. A stock dividend is expressed as the percentage change in the number of shares outstanding. A stock split is expressed as the ratio of the new number of shares outstanding to the old number of shares outstanding.

2) Accounting for Distributions of Stock: There are three acceptable methods of accounting for these changes in the number of shares outstanding. The three methods are usually referred to as accounting for the change as a

a) Small Stock Dividend: Retained earnings are capitalized (i.e., transferred to capital accounts) equal to the fair value of the additional shares issued.

Example: X Corporation increases the number of shares of its $10 par value common stock from 1000 to 1100 and accounts for the increase as a stock dividend. The fair value of the 100 additional shares is $30 per share.

R/E	3,000	
Common Stock - at par		1,000
PIC in Excess of Par - common		2,000

b) Large Stock Dividend: Retained earnings are capitalized equal to the par value of the additional shares issued.

Example: X Corporation increases the number of shares of its $1 par value common stock from 2000 to 3000 and accounts for the increase as a 50% stock dividend. The fair value of the 1000 additional shares is $25 per share.

R/E	1,000	
Common Stock - at par		1,000

c) Stock Split: There is no change in any of the owners' equity accounts. While the total number of shares has changed, the balance in the par value account is unchanged. Thus, it is necessary to adjust the par value per share.

Example: X Corporation increases the number of shares of its $10 par value common Stock from 4000 to 8000 and accounts for the increase as a stock split. Since the balance in "Common Stock - at par" will remain at $40,000, the par value per share must be changed to $5, i.e., $40,000 / 8000 shares.

3) Choosing a Method: The preferred method of accounting depends on the size of the distribution of additional shares. When the additional shares distributed are less than 20% to 25% of the original number of shares outstanding, the preferred method is 1). When the additional shares distributed are more than 20% to 25% of the original number of shares outstanding, the preferred method is 2).

K. Statement of Financial Position (Balance Sheet)

JUST COMPANY
STATEMENT OF FINANCIAL POSITION
DECEMBER 31, 20xx

ASSETS		
Current Assets		
Cash		$100
Trading and Available-for-Sale Securities		130
Notes receivable		
200		
Accounts receivable	$300	
Less: Allowance for doubtful accounts	(10)	290
Inventories at LIFO cost		
400		
Prepaid expenses		150
Total current assets		$1,270
Long-Term Investments		
Investments in common stock (equity method)		$1,000
Investment in bonds		2,000
Bond sinking fund		500
Cash surrender value of officers' life insurance		100
Total long-term investments		$3,600
Property, Plant, and Equipment		
Land		$1,200
Buildings	$1,300	
Less: Accumulated depreciation	(600)	700
Furniture and fixtures	$1,100	
Less: Accumulated depreciation	(500)	600
Leased assets under capital lease	$500	
Less: Accumulated depreciation	(100)	400
Total property, plant, and equipment		$2,900
Intangible Assets		
Patents		$300
Goodwill		400
Total intangible assets		$700
Other Assets		
Deferred pension costs		$150
Long-term prepayment		250
Total other assets		$400
TOTAL ASSETS		$8,870

LIABILITIES AND STOCKHOLDERS' EQUITY

Current Liabilities		
Notes payable		$100
Accounts payable		150
Income taxes payable		50
Current portion of obligation under capital lease		100
Accrued wages payable		50
Total current liabilities		$450
Long-Term Liabilities		
Notes Payable	$ 180	
Plus unamortized note premium	20	$200
Bonds payable	$2,000	
Less unamortized discount on bonds payable	(20)	1,980
Deferred income taxes		400
Obligation under capital lease		320
Total long-term liabilities		$2,900
Total Liabilities		$3,350
Stockholders' Equity		
Paid-in capital		
Preferred, 7%, cumulative		
Authorized and outstanding		
30 shares of $10 par value	$300	
Common		
Authorized, 500 shares of $1 par value;		
issued 400 shares, outstanding 300 shares	400	
Additional paid-in capital	50	$750
Earnings retained in the business		
Appropriated for bond indebtedness	$ 100	
Unappropriated	4,870	4,970
Total paid-in capital and retained earnings		$5,720
Less: Treasury stock (100 shares at cost)		(200)
Total stockholders' equity		$5,520
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY		$8,870

IV. THE STATEMENT OF CASH FLOWS

ASC Topic 230, Statement of Cash Flows, requires a Statement of Cash Flows as part of a full set of financial statements. The statement should not report an amount of cash flow per share. The primary purpose of the Statement of Cash Flows is to provide information about the entity's cash receipts and cash disbursements during a period to investors, creditors and others: It is used to:

- Assess the enterprise's ability to generate positive future net cash flows.
- Assess the enterprise's ability to meet its obligations, its ability to pay dividends, and its needs for external financing.
- Assess the reasons for differences between net income and associated cash receipts and payments.
- Assess the effects on an enterprise's financial position of both its cash and non-cash investing and financing transactions during the period.

A. Reporting Objectives

The statement should report the cash effects of an enterprise's operations, its investing transactions, and its financing transactions in a manner that reconciles beginning and ending cash and cash equivalents.

B. Related Disclosures

Related disclosures should report the effects of investing and financing transactions that affect an enterprise's financial position but do not directly affect cash flows during the period (non-cash activities).

C. Reconciliation

A reconciliation of net income and net cash flow from operating activities should be provided in the body of the statement or in the related disclosures.

D. Cash and Cash Equivalents Changes

The statement shall explain the change during the period in cash and cash equivalents. Cash equivalents are short-term, highly liquid investments that are both (1) readily convertible to known amounts of cash and (2) so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. Generally, only investments with original maturities of three months or less qualify under this definition. Examples include treasury bills, commercial paper, money market funds, and similar securities.

E. Gross or Net Amounts

Generally, information about the gross amounts of cash receipts and cash payments during a period is more relevant than information about the net amounts. However, the net amount of related receipts and payments may be appropriate for certain classes of cash flows where (1) turnover is quick, (2) amounts are large, and (3) maturities are short (generally where the original maturity is three months or less).

F. Balance Sheet Reconciliation

The total amounts of cash and cash equivalents at the beginning and end of the period shown in the statement of cash flows shall be the same amounts as similarly titled line items or subtotals in the balance sheet.

G. Policy Disclosure

The preparer should disclose their policy for determining which items are treated as cash equivalents.

H. Classification Of Cash Receipts And Cash Payments

1. Cash Flows from Operating Activities: Operating activities include cash inflows and outflows from all transactions and other events that are not defined as investing or financing activities. Operating activities generally involve producing and selling goods and providing services. Therefore, cash flows from operating activities reflect the cash effects of transactions and other events that enter into the determination of net income.

a. Cash Inflows:

- Cash receipts from the sales of goods and services, including the collection of accounts and notes arising from those sales.
- Cash receipts from interest and dividends.
- All other cash receipts that do not stem from financing or investing activities.

b. Cash Outflows:

- Cash payments to acquire materials for manufacture or goods for resale.
- Cash payments for general and administrative expenses.
- Cash payments to other suppliers and employees for other goods or services.
- Taxes, duties and fines paid.
- Interest paid on indebtedness.
- All other cash payments that do not stem from transactions defined as investing or financing activities.

2. Cash Flows from Investing Activities: Investing activities include a variety of functions. Examples include making and collecting loans, and acquiring and disposing of debt or equity instruments (other than cash equivalents). Property, equipment, and other productive assets transactions are also included under this category.

a. Cash Inflows:

- Receipts from collections or sales of loans made by the enterprise and other entities' debt instruments (except cash equivalents).
- Receipts from sales of equity instruments of other enterprises and from returns of those investments.
- Receipts from sales of plant assets and other productive assets.

b. Cash Outflows:

- Disbursements for loans made by the firm and payments to acquire debt instruments (other than cash equivalents).
- Payments to acquire equity instruments of other enterprises.
- Payments to purchase plant, equipment and other productive assets.

3. Cash Flows from Financing Activities: Financing activities include obtaining resources from owners and providing them a return on their investment. This includes borrowing money and repaying amounts borrowed and paying for other resources obtained from creditors through the issuance of long-term debt instruments.

a. Cash Inflows:

- Proceeds from issuing equity instruments.
- Proceeds from issuing debt instruments. This may include bonds, debentures, mortgages, and promissory notes.

b. Cash Outflows:

- Payments of distributions to owners. This includes dividends or other cash outlays to reacquire the entity's equity instruments.
- Repayments of amounts borrowed.
- Other principal payments to creditors who have extended long-term credit.
- Purchase of treasury stock.

4. Foreign Currency Cash Flows: The statement shall report the reporting currency equivalent of foreign currency cash flows using the exchange rates in effect at the time of the cash flows. An appropriately weighted average exchange rate may be used. The statement shall report the effect of exchange rate changes on cash balances held in foreign currencies. This should be included as a separate part of the reconciliation of the change in cash and cash equivalents during the period.

5. Non-Cash Activities: The results of non-cash activities which represent significant financing and investing activities should not be included in the statement. Instead, they should be presented in a separate schedule or footnotes. Examples include exchanges of land for stock, conversion of bonds into stock, and the signing of a capital lease agreement.

I. Reporting Cash Flows from Operating Activities

1. Direct Method: Firms are encouraged to report cash flows from operating activities by the direct method. The minimum requirements are:

- Cash collected from customers.
- Interest and dividends received.
- Other operating cash receipts.
- Cash paid to employees and other suppliers of goods or services, including suppliers of insurance, advertising, etc.
- Interest and taxes paid.
- Other operating cash payments.

If the direct method is used, a reconciliation of net income to net cash flow from operating activities should be provided in a separate schedule. This is essentially the application of the indirect method.

2. Indirect Method: Firms that choose to report by the indirect (reconciliation) method shall report the same amount for net cash flow from operating activities as under the direct method. This is accomplished by adjusting net income to reconcile to net cash flow. This reconciliation may take place in the body of the statement or in a separate schedule. If the indirect method is used, taxes paid and interest paid should be reported in a separate schedule.

J. Example of the Preparation of the Cash Flow Statement

Ann Marie, Inc.
COMPARATIVE BALANCE SHEETS
December 31, 20x8 and 20x9

ASSETS	**20x9**	**20x8**
Cash	$55,000	$50,000
Treasury Bills	10,000	20,000
Accounts Receivable, net	60,000	65,000
Inventory	94,600	62,000
Total Current Assets	219,600	197,000
Property, plant and equipment	190,000	200,000
Accumulated depreciation	(33,000)	(30,000)
Patents	9,000	10,000
Total Noncurrent Assets	166,000	180,000
Total Assets	$385,600	$377,000

LIABILITIES		
Dividends payable	$17,000	$10,000
Accounts payable	35,300	50,000
Income tax payable	54,200	42,000
Notes payable	-0-	20,000
Total Current Liabilities	106,500	122,000
Deferred income taxes	8,600	10,000
Convertible bonds payable	60,000	100,000
Unamortized bond discount	(5,300)	(10,000)
Total Noncurrent Liabilities	63,300	100,000

STOCKHOLDERS' EQUITY		
Preferred Stock	10,000	10,000
Common Stock	75,000	60,000
Additional Paid-in capital	18,000	15,000
Retained Earnings	112,800	70,000
Total Stockholders' Equity	215,800	155,000
Total Liabilities and Stockholders' Equity	$385,600	$377,000

Ann Marie, Inc.
STATEMENT OF INCOME
for the year ended December 31, 20x9

Revenues		$1,200,000
Expenses		
Cost of goods sold	$500,000	
Selling expenses	300,000	
General and administrative expenses	250,000	
Interest expense	40,000	1,090,000
Income before income tax		110,000
Income tax expense		
Current	54,200	
Deferred	(1,400)	52,800
Income before extraordinary item		57,200
Extraordinary gain - retirement of long-term debt, net of $2,400 applicable income tax		2,600
Net income		$59,800

Additional Information:

[1] Income before tax includes the following items:

Depreciation expense ($2,000 in selling expenses and $6,000 in general and administrative expenses)	$8,000
Amortization of patents (included in general and administrative expenses)	1,000
Amortization of bond discount	800
Loss on sale of plant assets (included in selling expenses)	3,000

[2] Plant assets were purchased for $10,000 in 20x9.
[3] Plant assets with a historical cost of $20,000 and a book value of $15,000 were sold at a $3,000 loss during 20x9.
[4] Bonds with a $20,000 face value and a book value of $18,100 were retired with a cash payment of $13,100 during 20x9.
[5] Bonds with a $20,000 face value and a book value of $18,000 were converted into 1,500 shares of $10 par value common stock during 20x9.
[6] Notes payable represent bank loans of short-term duration.
[7] The dividend liability of $10,000 at December 31, 20x8 was paid in early 20x9. Dividends of $17,000, which were declared in late 20x9, are to be paid in early 20x0.
[8] Accounts payable relate to merchandise purchased for resale.

Solution:

Step 1: Determine the net change in Cash and Cash Equivalents for the year.

	20x9	20x8	Change
Cash	$55,000	$50,000	+ 5,000
Cash equivalents	10,000	20,000	-10,000
Net change in cash and cash equivalents			- 5,000

Step 2: Determine Net Cash Flow from Operating Activities.

Direct Method

Cash collected from customers	[1]		$1,205,000
Cash paid to suppliers	[2]	$547,300	
Selling Expenses	[3]	295,000	
General and Administrative	[4]	243,000	
Interest Expense	[5]	39,200	
Tax expense	[6]	44,400	1,168,900
Cash flow from operating activities			$ 36,100

[1] Beginning A/R + Sales - Ending A/R
$65,000 + $1,200,000 - $60,000 = $1,205,000

[2] Ending Inventory + Cost of Goods Sold - Beginning Inventory = Purchases
$62,000 + $500,000 - $94,600 = $532,600
Beginning A/P + Purchases - Ending A/P
$50,000 + $532,600 - $35,300 = $547,300

<——-non-cash expense——>

[3] Selling Expense - Loss on plant assets - depreciation
$300,000 - $3,000 - $2,000 = $295,000

<——non-cash expense———->

[4] General & Admin. - depreciation - amortization of patent
$250,000 - $6,000 - $1,000 = $243,000

<——non-cash expense—->

[5] Interest expense - amortization of bond discount
$40,000 - $800 = $39,200

[6] Net income tax expense - Increase in taxes payable + tax paid on gain + decrease in deferred taxes
$52,800 - $12,200 + $2,400 + $1,400 = $44,400

Indirect Method

Net Income	$59,800
Loss on sale of plant assets (selling exp.)	3,000
Depreciation Expense ($2,000 + $6,000)	8,000
Gain on retirement of convertible bonds	(5,000)
Amortization of bond discount	800
Decrease in deferred income taxes	(1,400)
Amortization of patents	1,000
Decrease in accounts receivable	5,000
Increase in Inventory	(32,600)
Decrease in accounts payable	(14,700)
Increase in income tax payable	12,200
Net cash flow from operating activities	$ 36,100

Step 3: Analyze each remaining account to determine its category. This would be a cash inflow or outflow from either an investing, financing or non-cash activity.

(a) Plant assets were purchased for $10,000 (cash outflow, investing activity).
(b) Plant assets were sold for $12,000 (cash inflow, investing activity).
  Book value - loss on sale = sale proceeds
  $15,000 - $3,000 = $12,000
(c) Paid cash dividends of $10,000 (cash outflow, financing activity).
(d) Declared dividends of $17,000 (non-cash financing activity).
(e) Retired convertible bonds for $13,100 (cash outflow, financing activity).
(f) Short-term notes payable decreased by $20,000, therefore these notes are deemed to be paid off during the year. (cash outflow, financing activity).
(g) Bonds with a face value of $20,000 were converted into common stock with a par value of $15,000. (non-cash financing activity).

Step 4: Not applicable because there were no foreign currency transactions during the year.

Step 5: Prepare a formal Statement of Cash Flows. Complete the required supplemental schedules including (a) schedule of non-cash investing and financing activities, (b) schedule of interest and taxes paid (if the indirect method was used), (c) reconciliation of net income to net cash flow from operating activities (if the direct method was used).

Ann Marie, Inc.
STATEMENT OF CASH FLOWS
For the year ended December 31, 20x9
Increase (Decrease) in Cash and Cash Equivalents

Cash flows from operating activities:	
Cash received from customers	1,205,000
Cash paid to suppliers	(547,300)
Cash paid for selling expense	(295,000)
Cash paid for general and admin. expense	(243,000)
Cash paid for interest expense	(39,200)
Cash paid for income tax expense	(44,400)
Net cash flows from operating activities	36,100
Cash flows from investing activities:	
Proceeds from sale of plant assets	$12,000
Purchase of plant assets	(10,000)
Net cash flows from investing activities	2,000
Cash flows from financing activities:	
Dividends paid	($10,000)
Principal payment note payable	(20,000)
Retired convertible bonds payable	(13,100)
Net cash flows from financing activities	(43,100)
Net increase (decrease) in Cash and Cash Equivalents	(5,000)
Cash and Cash Equivalents beginning of year	70,000
Cash and Cash Equivalents, end of year	65,000

Reconciliation of net income to cash provided by operating activities:

Net Income	$59,800
Loss on sale of plant assets (selling exp.)	3,000
Depreciation Expense ($2,000 + $6,000)	8,000
Gain on retirement of convertible bonds	(5,000)
Amortization of bond discount	800
Decrease in deferred income taxes	(1,400)
Amortization of patents	1,000
Decrease in accounts receivable	5,000
Increase in Inventory	(32,600)
Decrease in accounts payable	(14,700)
Increase in income tax payable	12,200
Net cash flow from operating activities	36,100

Supporting schedule of non-cash financing and investing activities:

Book value of bonds payable that were converted into 1,500 shares of $10 par value common stock.	$18,000

Disclosure of accounting policy:

For purposes of the statement of cash flows, the Company considers all highly liquid debt instruments purchased with a maturity of three months or less to be cash equivalents.

V. DIFFERENCES BETWEEN IFRS AND GAAP

U.S. Generally Accepted Accounting Principles (GAAP) have several key differences from International Financial Reporting Standards (IFRS, which is used in more than 100 countries). IFRS is considered to be principles based, whereas GAAP is considered to be rules based prescribing industry and/or transaction guidance. Some say that this allows IFRS to better reflect the economic view of a transaction than U.S. GAAP. As cross-border transactions and U.S. owned foreign subsidiaries continue to grow, convergence of U.S. GAAP and IFRS is occurring. The goal is one set of uniform global accounting reporting standards. Some of the differences that exist are shown below.

COMPARISON CHART

Item	U.S. GAAP	IFRS
Objectives of Financial Statements	GAAP provides separate objectives for business entities and non-business entities	IFRS only has one objective for all types of entities
Financial Statements Required Components	Balance sheet, income statement, statement of comprehensive income, changes in equity, cash flow statement, and footnotes. Separation of current and non-current assets and liabilities are recommended.	Balance sheet, income statement, changes in equity, cash flow statement, and footnotes. Separation of current and non-current assets and liabilities are required.
Comparative Financial Information	Two years minimum normally must be presented in a format full set of financial statements.	One year minimum required.
Intangible Assets Purchased	Acquired intangible assets are recorded at fair value.	Intangible assets are only recognized if the asset has future economic benefit and has measured reliability.
Intangible Assets Developed	Development costs are to be expensed.	Costs in the development phase may be capitalized.
Inventory Costs	Last-in, first-out (LIFO) and first-in, first-out (FIFO) inventory valuations are acceptable.	FIFO method of valuation is acceptable, but LIFO is not allowed under IFRS.
Inventory Write Downs	Once inventory is written down the write down cannot be reversed in future periods.	If inventory is written down, the write down can be reversed in a future period if specific criteria is met.
Fixed Assets	Property, plant, and equipment are valued at cost less any accumulated depreciation.	A revaluation method is allowed based on fair value of the asset on the date of evaluation, less subsequent accumulated depreciation and impairment losses.
Extraordinary Items	Extraordinary items are reported separately as a special item on the income statement.	Extraordinary items are not usually reported under IFRS.
Tax deferrals	Allows for the classification of the deferrals as current or non-current, depending on the circumstances.	Only allows non-current treatment of deferrals.

RIGOS CMA REVIEW

PART 1 - CHAPTER 1

EXTERNAL FINANCIAL REPORTING DECISIONS

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RIGOS CMA REVIEW

PART 1 - CHAPTER 1

EXTERNAL FINANCIAL REPORTING DECISIONS

Multiple-Choice Questions

1. The level of sophistication expected of the users of financial information is
   a. That of an individual experienced in financial accounting reporting procedures.
   b. That of an individual who has extensive business experience but has no experience with financial reporting.
   c. That of an individual who is willing to study the information with reasonable diligence.
   d. That of an individual who has limited knowledge and experience in both business and financial reporting.

2. The primary objectives of financial reporting are to provide information that is useful to all of the following **except**
   a. To present and potential investors, creditors and other users of financial statements in making rational investment and credit decisions.
   b. In assessing the fair value of the economic resources as of a moment in time and the results of operations for a period of time.
   c. In assessing future cash flows related to the enterprise's obligations and its ability to meet financial obligations to pay dividends.
   d. In assessing the economic resources of the enterprise and claims against those resources.

3. During a period when an enterprise is under the direction of a particular management, its financial statements will directly provide information about
   a. Both enterprise performance and management performances.
   b. Management performance but **not** directly provide information about enterprise performance.
   c. Enterprise performance but **not** directly provide information about management performance.
   d. Neither enterprise performance nor management performance.

4. When bad debt expense is estimated on the basis of percentage of past actual losses from bad debts to past net credit sales, and this percentage is adjusted for anticipated conditions, the accounting concept of
   a. Matching is being followed.
   b. Matching is not being followed.
   c. Substance over form is being followed.
   d. Going concern is not being followed.

5. Uncertainty and risks inherent in business situations should be adequately considered in financial reporting. This statement is an example of the concept of
   a. Conservatism.
   b. Completeness.
   c. Neutrality.
   d. Representational faithfulness.

6. The valuation of a promise to receive cash in the future at present value on the financial statements of a business entity is valid because of the accounting concept of
   a. Entity.
   b. Materiality.
   c. Going concern.
   d. Neutrality.

7. What are the Statements of Financial Accounting Concepts intended to establish?
   a. Generally accepted accounting principles in financial reporting by business enterprises.
   b. The meaning of "present fairly in accordance with generally accepted accounting principles."
   c. The objectives and concepts for use in developing standards of financial accounting and reporting.
   d. The hierarchy of sources of generally accepted accounting principles.

8. **Statement of Financial Accounting Concepts No. 5,** "Recognition and Measurement in Financial Statements of Business Enterprises," indicates that in order for an event to be recognized in financial statements, it must be
   a. Relevant, reliable, and measurable.
   b. Relevant, reliable, and useful.
   c. Relevant, reliable, and timely.
   d. Reliable, useful, and measurable.

9. In **Statement of Financial Accounting Concepts No. 5**, "Recognition and Measurement in Financial Statements of Business Enterprises", several alternatives have been identified for measuring items on the statement of financial position. Which of the following alternatives may be used?

	Present Value	Current Cost	Net Realizable Value
a.	No	No	No
b.	No	Yes	Yes
c.	Yes	Yes	No
d.	Yes	Yes	Yes

10. Under Statement of Financial Accounting Concepts No. 6, comprehensive income includes which of the following?

	Losses	Contribution Margin
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

11. Under FASB Statement of Financial Accounting Concepts No. 5, which of the following items would cause earnings to differ from comprehensive income for an enterprise in an industry **not** having specialized accounting principles?

a. Unrealized loss on investments in available-for-sale securities.
b. Unrealized loss on investments in trading securities.
c. Loss on exchange of similar assets.
d. Loss on exchange of dissimilar assets.

12. According to the FASB conceptual framework, an entity's revenue may result from

a. A decrease in an asset from primary operations.
b. An increase in an asset from incidental transactions.
c. An increase in a liability from incidental transactions.
d. A decrease in a liability from primary operations.

13. Which of the following is an example of the expense recognition principle of associating cause and effect?

a. Allocation of insurance cost.
b. Sales commissions.
c. Depreciation of fixed assets.
d. Officers' salaries.

14. Which of the following is expensed under the principle of systematic and rational allocation?

a. Salesmen's monthly salaries.
b. Insurance premiums.
c. Transportation to customers.
d. Electricity to light office building.

15. Limitations of the statement of financial position include all of the following **except**

a. The use of historical cost for valuing assets and liabilities.
b. Inclusion of information on capital maintenance.
c. Exclusion of some economic resources and obligations.
d. The use of estimates in the determination of certain items.

16. Under Statement of Financial Accounting Concepts No. 6, gains on assets unsold are identified, in a precise sense, by the term

a. Unrecorded.
b. Unrealized.
c. Unrecognized.
d. Unallocated.

17. One of the elements of a financial statement is comprehensive income. Comprehensive income excludes changes in equity resulting from which of the following?

a. Loss from discontinued operations.
b. Prior period error correction.
c. Dividends paid to stockholders.
d. Unrealized loss on investments in non-current marketable equity securities.

Items 18 and 19 are based on the following information.

Kristina Company is a diversified corporation engaged in several different activities. The Board of Directors has established an Accounting Policies and Procedures Department, the purpose of which is to ensure Kristina Company's compliance with generally accepted accounting principles.

18. During December 20x7, the Specialty Aircraft Division received $3 million from a customer as an advance payment for an airplane that the company will construct during 20x8. The division controller needs information on how to treat the $3 million credit balance in the accounts receivable account at December 31, 20x7.

a. The division should recognize $3 million as revenue for 20x7; based on the historical cost principle.
b. The division should recognize $1.5 million as revenue in each of the year's 20x7 and 20x8 since the project covers a two-year period; based on the matching principle.

c. The division should record the $3 million as deferred revenue during 20x7, then make adjusting entries to record current revenue for subsequent years according to the stage of completion of the construction of the airplane, based on the recognition principle.
d. The division should record $3 million as a current liability for 20x7, then recognize the entire amount as revenue in 20x8, the year of construction, based on the realization period.

19. The Building Construction Division commenced operations in December 20x7. There is particular concern about the proper accounting treatment for the division's long-term contracts. The division manager stated that the contracts are fixed price, with the collectability of the contract price reasonably assured. The division will maintain progress reports and should have little difficulty accumulating or projecting costs.
a. The division should use the installment method of accounting for the construction contracts based on the matching principle
b. The division should use the percentage-of-completion method of accounting for the construction contracts based on the matching principle.
c. The division should use the completed contract method of accounting for the construction contracts based on the concept of conservatism.
d. The division should use the proportionate completed contract method of accounting for the construction contracts based on the historical cost principle.

20. There are many similarities between lessee and lessor accounting for the capitalization of leases. Which one of the following is a criterion for the capitalization of a lease by a lessee?
a. The lease transfers ownership of the property to the lessee by the end of the lease term.
b. The lease term is at least 90% of the remaining life of the asset at the beginning of the lease.
c. The present value of the minimum lease payments is 75% or more of the fair market value of the leased asset.
d. Future costs are reasonably predictable.

The Following Data Apply to Items 21 and 22.

On January 1, 20x4, Plantation Restaurant is planning to enter as the lessee into the two lease agreements described below. Each lease is noncancelable, and Plantation does not receive title to either leased property during or at the end of the lease term. All payments required under these agreements are due on January 1 of each year.

Lessor	Hadaway, Inc.	Cutter Electronics
Type of property	Oven	Computer
Yearly rental	$15,000	$4,000
Lease term	10 years	3 years
Economic life	15 years	5 years
Purchase option	None	None
Renewal option	None	None
Fair market value at inception of lease	$125,000	$10,200
Unguaranteed residual value	None	$2,000
Lessee's incremental borrowing rate	10%	10%
Executory costs paid by	Lessee	Lessor
Annual executory costs	$800	$500
PV factor at 10% (of an annuity due)	6.76	2.74

21. Plantation Restaurant should treat the lease agreement with Hadaway, Inc. as a(n)
a. Capital lease with an initial asset value of $101,400.
b. Operating lease, charging $14,200 in rental expense and $800 in executory costs to annual operations.
c. Operating lease, charging the present value of the yearly rental expense to annual operations.
d. Operating lease, charging $15,000 in rental expense and $800 in executory costs to annual operations.

22. Plantation Restaurant should treat the lease agreement with Cutter Electronics as a(n)
a. Capital lease with an initial asset value of $10,960.
b. Capital lease with an initial asset value of $9,590.
c. Operating lease, charging $4,000 in rental expense to annual operations.
d. Operating lease, charging $3,500 in rental expense and $500 in executory costs to annual operations.

23. Garber Corporation is the lessee in a lease arrangement with Janos, Inc. to lease land and a building. If the lease contains a bargain

purchase option, Garber should record the land and the building, in accordance with SFAS 13, "Accounting for Leases", as a(n)

a. Operating lease and capital lease, respectively.
b. Capital lease and operating lease, respectively.
c. Capital lease but separately classified.
d. Operating lease.

24. Initial direct costs incurred by the lessor under a sales-type lease should be

a. Deferred and allocated over the economic life of the leased property.
b. Expensed in the period incurred.
c. Deferred and allocated over the term of the lease in proportion to the recognition of rental income.
d. Added to the net investment in the lease and amortized over the term of the lease as a yield adjustment.

25. Careful reading of an annual report will reveal that off-balance sheet debt includes

a. Amounts due in future years under operating leases.
b. Transfers of accounts receivable without recourse.
c. Premium on long-term debt.
d. Current portion of long-term debt.

26. For a capital lease, the amount recorded initially by the lessee as a liability should

a. Exceed the present value at the beginning of the lease term of minimum lease payments during the lease term.
b. Exceed the total of the minimum lease payments during the lease term.
c. Not exceed the fair value of the leased property at the inception of the lease.
d. Equal the total of the minimum lease payments during the lease term.

27. For a capital lease, an amount equal to the present value at the beginning of the lease term of minimum lease payments during the lease term, excluding that portion of the payments representing executory costs such as insurance, maintenance, and property taxes to be paid by the lessor, together with any profit thereon, should be recorded by the lessee as a (an)

a. Expense.
b. Liability but not an asset.
c. Asset but not a liability.
d. Asset and a liability.

28. In a lease that is recorded as a sales-type lease by the lessor, unearned interest

a. Does not arise.
b. Should be recognized in full as income at the lease's inception.
c. Should be amortized over the period of the lease using the interest method.
d. Should be amortized over the period of the lease using the straight-line method.

29. The following information pertains to Tara Co.'s accounts receivable at December 31:

Days outstanding	Amount	Estimated % uncollectible
0 - 60	$120,000	1%
61 - 120	90,000	2%
Over 120	100,000	6%
	$310,000	

During the year, Tara wrote off $7,000 in receivables and recovered $4,000 that had been written off in prior years. Tara's December 31 allowance for uncollectible accounts was $22,000. Under the aging method, what amount of allowance for uncollectible accounts should Tara report at December 31?

a. $ 9,000
b. $10,000
c. $13,000
d. $19,000

30. A method of estimating uncollectible accounts that emphasizes asset valuation rather than income measurement is the allowance method based on

a. Aging the receivables.
b. Direct write off.
c. Gross sales.
d. Credit sales less returns and allowances.

31. Alden Corporation provides an allowance for its doubtful accounts receivable. At December 31, 20x8, the allowance account had a credit balance of $8,000. Each month Alden accrues bad debt expense in an amount equal to 2% of credit sales. Total credit sales during 20x9 amounted to $2,000,000. During 20x9 uncollectible accounts receivable totaling $22,000 were written off against the allowance account. An aging of accounts receivable at December 31, 20x9, indicates that an allowance of $42,000 should be provided for doubtful accounts as of that date. Accordingly, bad debt expense previously accrued during 20x9 should be increased by

a. $62,000
b. $42,000
c. $26,000
d. $16,000

32. Gar Co. factored its receivables without recourse with Ross Bank. Gar received cash as a result of this transaction, which is best described as a

a. Loan from Ross collateralized by Gar's accounts receivable.
b. Loan from Ross to be repaid by the proceeds from Gar's accounts receivable.
c. Sale of Gar's accounts receivable to Ross, with the risk of uncollectible accounts retained by Gar.
d. Sale of Gar's accounts receivable to Ross with the risk of uncollectible accounts transferred to Ross.

33. The criteria used to determine if control has been surrendered by the transferor in a transfer of financial assets include all of the following **except**

a. Lack of repurchase or redemption agreement.
b. Transferal of physical possession of asset to transferee.
c. Transferee has pledging or exchange rights over the asset.
d. Asset isolated from the transferor and its creditors.

34. Generally, which inventory costing method approximates most closely the current cost for each of the following?

	Cost of Goods Sold	Ending Inventory
a.	LIFO	FIFO
b.	LIFO	LIFO
c.	FIFO	FIFO
d.	FIFO	LIFO

35. During periods of rising prices, when the FIFO inventory method is used, a perpetual inventory system results in an ending inventory cost that is

a. The same as in a periodic inventory system.
b. Higher than in a periodic inventory system.
c. Lower than in a periodic inventory system.
d. Higher or lower than in a periodic inventory system, depending on whether physical quantities have increased or decreased.

Questions 36 and 37 are based on the following:

At December 31, 20x1 and 20x0, Gravin Corporation had 90,000 shares of common stock and 20,000 shares of convertible preferred stock outstanding, in addition to 9% convertible bonds payable in the face amount of $2,000,000. During 20x1, Gravin paid dividends of $2.50 per share on the preferred stock. The preferred stock is convertible into 20,000 shares of common stock. The 9% convertible bonds are convertible into 30,000 shares of common stock. Net income for 20x1 was $970,000. Assume an income tax rate of 40%.

36. How much is the basic earnings per share for the year ended December 31, 20x1?

a. $ 7.70
b. $ 8.36
c. $ 8.82
d. $10.22

37. How much is the diluted earnings per share for the year ended December 31, 20x1?

a. $ 7.70
b. $ 8.21
c. $ 9.35
d. $10.22

38. The primary objective of accounting for inventory is

a. The proper valuation of inventory to more closely match its net realizable value.
b. To provide investors and creditors with information about the fair market value of the inventory.
c. The consistent valuation of inventory from period to period.
d. The matching of the appropriate expense against revenue to obtain a proper determination of income.

39. In its first four years of operations ending December 31, 20x2, Alder, Inc.'s depreciation for income tax purposes exceeded its depreciation for financial statement purposes. This temporary difference was expected to reverse in 20x3, 20x4, and 20x5. Alder had no other temporary differences and elected early adoption of SFAS 109. Alder's 20x2 balance sheet should include

a. A noncurrent contra asset for the effects of the differences between asset bases for financial statement and income tax purposes.
b. Both current and noncurrent deferred tax assets.
c. A current deferred tax liability only.
d. A noncurrent deferred tax liability only.

40. Thorn Co. applies Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes." At the end of 20x3, the tax effects of temporary differences were as follows:

	Deferred tax assets (liabilities)	Related asset classification
Accelerated tax Depreciation	($75,000)	Noncurrent asset
Additional costs in inventory for tax purposes	25,000	Current asset
	($50,000)	

A valuation allowance was not considered necessary. Thorn anticipates that $10,000 of the deferred tax liability will reverse in 20x4. In Thorn's December 31, 20x3, balance sheet, what amount should Thorn report as noncurrent deferred tax liability?

a. $40,000.
b. $50,000.
c. $65,000.
d. $75,000.

41. In its 20x3 income statement, Cere Co. reported income before income taxes of $300,000. Cere estimated that, because of permanent differences, taxable income for 20x3 would be $280,000. During 20x3 Cere made estimated tax payments of $50,000, which were debited to income tax expense. Cere is subject to a 30% tax rate. What amount should Cere report as income tax expense?

a. $34,000.
b. $50,000.
c. $84,000.
d. $90,000.

42. None of the following items from Wilson Corporation's 20x8 tax return enter into the calculation of the deferred tax credit **except**

a. Depreciation expense computed under MACRS in excess of financial accounting depreciation.
b. Cost of goods sold computed using LIFO for inventory valuation purposes.
c. Executive bonuses accrued and paid in 20x8.
d. Bad debts determined to be worthless and written off in 20x8.

43. Regarding disclosure of income taxes, including deferred taxes,

a. The benefits of operating loss carry-forwards are not considered a component of income tax expense.
b. The significant components of income tax expense attributable to continuing operations for each year presented should be disclosed in the financial statement or accompanying notes.
c. The income tax expense attributable to continuing operations includes taxes applicable to extraordinary items.
d. Current tax expense or benefit and deferred tax expense or benefit are not components of the period's income tax expense to be disclosed.

44. The gain or loss from disposal of a segment

a. Is reported as a component of net income and distinguished from the operating gain or loss realized by the segment prior to the measurement date.
b. Includes the operating gain or loss realized by the segment from the beginning of the fiscal year to the disposal date.
c. Is reported as an addition or subtraction for the beginning balance of retained earnings on the statement of retained earnings.
d. Is reported as an extraordinary item on the income statement.

45. When reporting the discontinuance of a business segment, **ASC Topic 225,** "Reporting the Results of Operations," specifies that

a. The results of the segment operations during the phase-out period are reported as part of the gain or loss from continuing operations.
b. The income (loss) from segment operations is calculated from the date the segment started operations.
c. The gain or loss on discontinued operations should be reported net of tax as a separate item before extraordinary items.
d. The costs directly associated with discontinuance should be included as an expense of continuing operations.

46. When a segment of a business has been discontinued during the year, the loss on disposal should

a. Be an extraordinary item.
b. Be an operating item.
c. Exclude operating losses of the current period up to the measurement date.
d. Exclude operating losses during the phase-out period.

47. According to U.S. GAAP, where on the income statement should a multinational company report the loss from the disposal sale of a major operating unit?

a. Report the loss, pretax, in a separate section between income from continuing operations and net income.
b. Report the loss, net of tax, in a separate section between income from continuing operations and net income.
c. Report the loss, pretax, in a separate section between income from operations and income before income tax.
d. Report the loss, net of tax, in a separate section between income before tax and net income.

48. Disc Corporation's warehouse property was condemned by the local county government in June 20x7 to become part of a new county park system. The proceeds from the condemnation award exceeded the property's book value and were received in July 20x7. In September 20x7, Disc invested all of the proceeds in a new warehouse complex costing substantially more than the condemnation award. At December 31, 20x7, Disc Corporation's year-end financial statements would

a. Recognize an ordinary gain on the condemnation.
b. Recognize an extraordinary gain on the condemnation.
c. Defer recognition of a gain so long as the proceeds from the condemnation were used to acquire a similar asset.
d. Defer recognition of the gain until the newly acquired warehouse is sold.

49. A transaction that is material in amount, unusual in nature, but **not** infrequent in occurrence, should be presented separately as a (an)

a. Component of income from continuing operations, but **not** net of applicable income taxes.
b. Component of income from continuing operations, net of applicable income taxes.
c. Extraordinary item, net of applicable income taxes.
d. Prior period adjustment, but **not** net of applicable income taxes.

50. Wydner Company has decided to change in the current year from the straight-line method to the sum-of-the-years'-digits method for recording depreciation expense for certain assets. The cumulative effect of this change should be

a. Reflected in the income of the current period.
b. Reflected in the income of both current and prior periods.
c. Spread over the remaining life of the assets involved.
d. Recorded as an adjustment to the beginning balance of retained earnings.

51. According to **ASC Topic 250**, "Accounting Changes," a change from last-in, first-out (LIFO) costing to first-in, first-out (FIFO) costing requires

a. Retroactive treatment in the financial statements.
b. Prospective treatment in the financial statements.
c. That the cumulative effect of the change appear in the income statement.
d. Retroactive treatment on a pro forma basis only.

52. Brighton Co. changed from the individual item approach to the aggregate approach in applying the lower of FIFO cost of market to inventories. The cumulative effect of this change should be reported in Brighton's financial statements as a

a. Prior period adjustment, with separate disclosure.
b. Component of income from continuing operations, with separate disclosure.
c. Component of income from continuing operations, without separate disclosure.
d. Component of income after continuing operations, with separate disclosure.

53. The effect of a change in accounting principle that is inseparable from the effect of a change in accounting estimate should be reported

a. By restating the financial statement of all prior periods presented.
b. As a correction of an error.
c. As a component of income from continuing operations, in the period of change and future periods if the change affects both.

d. As a separate disclosure after income from continuing operations, in the period of change and future periods if the change affects both.

54. A change in the periods benefited by a deferred cost because additional information has been obtained is
   a. A correction of an error.
   b. An accounting change that should be reported by restating the financial statements of all prior periods presented.
   c. An accounting change that should be reported in the period of change and future periods if the change affects both.
   d. Not an accounting change.

55. In the preparation of financial statements, prior period adjustments should
   a. Be separately disclosed and deducted directly from operating income before determining current period net income.
   b. Be listed as the last item net of tax in determining current period of net income.
   c. Not be shown anywhere on the current period financial statements.
   d. Be taken directly to the opening balance of retained earnings net of tax.

56. According to **ASC Topic 250,** "Accounting Changes," a change in the salvage value of a plant asset is an example of a(n)
   a. Prior period adjustment.
   b. Accounting principle change.
   c. Accounting estimate change.
   d. Error correction.

57. While preparing its 20x3 financial statements, Dek Corp. discovered computational errors in its 20x2 and 20x1 depreciation expense. These errors resulted in overstatement of each year's income by $25,000, net of income taxes. The following amounts were reported in the previously issued financial statements:

	20x2	20x1
Retained earnings, 1/1	$700,000	$500,000
Net income	150,000	200,000
Retained earnings, 12/31	$850,000	$700,000

Dek's 20x3 net income is correctly reported at $180,000. Which of the following amounts should be reported as prior period adjustments and net income in Dek's 20x3 and 20x2 comparative financial statements?

	Year	Prior period adjustment	Net income
a.	20x2	–	$150,000
	20x3	($50,000)	180,000
b.	20x2	($50,000)	$150,000
	20x3	–	180,000
c.	20x2	($25,000)	$125,000
	20x3	–	180,000
d.	20x2	–	$125,000
	20x3	–	180,000

The following Data Apply to Items 58 and 59.

Data concerning items in Wilson's inventory follow.

	Cameras	Lenses
Historical cost per unit	$210.00	$106.00
Selling price per unit	217.00	145.00
Cost to distribute per unit	19.00	8.00
Current replacement cost per unit	203.00	105.00
Normal profit margin per unit	32.00	29.00

58. The limits to the market value (i.e., the ceiling and the floor) that should be used in the lower of cost or market comparison of cameras are
   a. $217 and $198.
   b. $217 and $185.
   c. $198 and $166.
   d. $185 and $166.

59. The amount that should be used in the lower of cost or market comparison of lenses is
   a. $105.
   b. $106.
   c. $108.
   d. $137.

60. If inventory prices are expected to increase over time, a management team would select the LIFO method of inventory valuation when
   a. A debt covenant specifies the maintenance of a minimum current ratio.

b. Management bonuses are based on reported net income.
c. Cash flows are a dominant company consideration.
d. Higher reported income is expected to lead to higher stock prices.

61. Most plant assets have a limited useful physical life. All of the following factors limit the useful life of a plant asset **except**
a. Tax regulation.
b. Wear and tear.
c. Deterioration and decay.
d. Inadequacy.

62. Depreciation of plant assets refers to the process of
a. Asset valuation for Statement of Financial Position purposes.
b. Allocating the cost of the asset to the periods of use.
c. Accumulating a fund for the replacement of the asset.
d. Accounting for costs and to reflect the change in general price levels.

The Following Data Apply to Items 63 and 64.

When Payne Co. decided to go into the business of delivering pizzas at lunch time to a nearby office complex, the company acquired a delivery truck at a cost of $20,000. The truck had an estimated useful life of five years and a $2,000 salvage value. The company also acquired a used car for deliveries at a cost of $4,800, with an estimated useful life of three years and a $600 salvage value.

63. The depreciation on Payne's delivery truck for year two using the double-declining balance method would be
a.$4,320.
b.$4,800.
c.$6,000.
d.$7,200.

64. The depreciation on Payne's used delivery car for year three using the sum-of-the-years'-digits method would be
a. $200.
b. $700.
c. $800.
d. $1,400.

The Following Data Apply to Items 65 and 66.

Since 20x0, Ames Steel Company has replaced all of its major manufacturing equipment and now has the following equipment recorded in the appropriate accounts. Ames uses a calendar year as its fiscal year.

- A forge purchased January 1, 20x0, for $100,000. Installation costs were $20,000, and the forge has an estimated 5-year life with a salvage value of $10,000.

- A grinding machine costing $45,000 purchased January 1, 20x1. The machine has an estimated 5-year life with a salvage value of $5,000.

- A lathe purchased January 1, 20x3 for $60,000. The lathe has an estimated 5-year life with a salvage value of $7,000.

65. Using the straight-line depreciation method, Ames' 20x3 depreciation expense is
a. $36,464.
b. $40,334.
c. $40,600.
d. $40,848.

66. Using the double-declining balance method, Ames' 20x3 depreciation expense is
a. $36,464.
b. $40,334.
c. $40,600.
d. $40,848.

67. During 20x1, Yvo Corp. installed a production assembly line to manufacture furniture. In 20x2, Yvo purchased a new machine and rearranged the assembly line to install this machine. The rearrangement did not increase the estimated useful life of the assembly line, but it did result in significantly more efficient production. The following expenditures were incurred in connection with this project:

Machine	$75,000
Labor to install machine	14,000
Parts added in rearranging the assembly line to provide future benefits	40,000
Labor and overhead to rearrange the assembly line	18,000

What amount of the above expenditures should be capitalized in 20x2?

a. $147,000
b. $107,000
c. $ 89,000
d. $ 75,000

68. When a fixed asset with a five-year estimated useful life is sold during the second year, how would the use of the sum-of-the-years'-digits method of depreciation instead of the straight-line method of depreciation affect the gain or loss on the sale of the fixed asset?

	Gain	Loss
a.	Decrease	Increase
b.	Increase	Decrease
c.	No effect	No effect
d.	No effect	Decrease

69. The following information is available for the Silver Company for the three months ended March 31:

Merchandise inventory, January 1	$ 900,000
Purchases	3,400,000
Freight-in	200,000
Sales	4,800,000

The gross margin recorded was 25% of sales. What should be the merchandise inventory at March 31?

a. $ 700,000
b. $ 900,000
c. $1,125,000
d. $1,200,000

70. In a period of rising prices, the use of which of the following inventory cost flow methods would result in the highest cost of goods sold?

a. FIFO.
b. LIFO.
c. Weighted average cost.
d. Moving average cost.

71. During 20x9, Olsen Company discovered that the ending inventories reported on its financial statements were understated as follows:

Year	Understatement
20x6	$50,000
20x7	$60,000
20x8	$ -0-

Olsen ascertains year-end quantities on a periodic inventory system. These quantities are converted to dollar amounts using the FIFO cost flow method. Assuming no other accounting errors, Olsen's retained earnings at December 31, 20x8, will be

a. Correct.
b. $ 60,000 understated.
c. $ 60,000 overstated.
d. $110,000 understated.

72. Regarding the development of computer software that is to be commercially marketed

a. All costs incurred should be expensed in the same manner as other research and development costs.
b. The costs incurred to complete a working model that established technological feasibility should be capitalized.
c. All costs incurred prior to the first sale of the product should be capitalized.
d. The costs incurred after technological feasibility has been established should be capitalized.

73. The accounting profession has adopted various standards to be followed when reporting inventory in the financial statements. All of the following are required to be reported in the financial statements or disclosed in notes to the financial statements **except** for

a. Inventory detail, such as raw materials, work-in-process, and finished goods.
b. Significant financing agreements, such as product financing arrangements and pledging of inventories.
c. The method used in determining cost.
d. Unrealized profit on inventories.

74. Tony Brown uses the first-in, first-out (FIFO) method to value inventory and is concerned about the impact on inventory valuation of a switch from a periodic inventory system to a perpetual inventory system. Which one of the following statements is **correct**?

a. The impact cannot be calculated.
b. Inventory and cost of goods sold will be the same whether or not a perpetual or periodic inventory system is used.
c. Inventory will be valued lower under a perpetual inventory system.
d. Inventory will be valued higher and cost of goods sold will be the same under a perpetual inventory system.

75. In a multiple-step income statement for a retail company, all of the following would be included in the operating section **except**

a. Sales.
b. Cost of goods sold.
c. Dividend revenue.
d. Administrative expenses.

76. The following inventory valuation errors have been discovered for Nivelle Company.

- The 20x6 year-end inventory was overstated by $23,000.

- The 20x7 year-end inventory was understated by $61,000.
- The 20x8 year-end inventory was understated by $17,000.

The reported income before taxes for Nivelle Company was

Year	Income Before Taxes
20x6	$138,000
20x7	254,000
20x8	168,000

Reported income before taxes for 20x6, 20x7, and 20x8 should have been

a. $161,000, $170,000, and $212,000, respectively.
b. $115,000, $338,000, and $124,000, respectively.
c. $161,000, $338,000, and $90,000. respectively.
d. $115,000, $338,000, and $212,000, respectively.

77. When reporting both basic and diluted earnings per share

a. They should be presented with equal prominence on the face of the income statement.
b. They need not be shown on the face of the income statement but must be disclosed in the notes to the financial statements.
c. They need not be shown for any extraordinary items or the cumulative effect of an accounting principle change.
d. The basic amounts are to be given prominence on the face of the income statement, and the diluted amounts may be disclosed in the notes to the financial statements.

78. When classifying assets as current and noncurrent for reporting purposes,

a. The amounts at which current assets are carried and reported must reflect realizable cash values.
b. Assets are classified as current if they are reasonably expected to be realized in cash or consumed during the normal operating cycle.
c. Prepayments for items such as insurance or rent are included in an "other assets" group rather than as current assets as they will ultimately be expensed.
d. The time period by which current assets are distinguished from noncurrent assets is determined by the seasonal nature of the business.

79. If the going-concern assumption is no longer valid for a company,

a. Land held as an investment would be valued at its net realizable value.
b. All prepaid assets would be completely written off immediately.
c. Total contributed capital and retained earnings would remain unchanged.
d. The allowance for uncollectible accounts would be eliminated.

80. Items that are presented on the Statement of Financial Position at their original contract price include

a. Land and goodwill.
b. Land, buildings, and equipment.
c. All intangible assets.
d. Land and accounts payable.

81. A statement of financial position is intended to help investors and creditors

a. Assess the amount, timing, and uncertainty of prospective net cash inflows of a firm.
b. Evaluate economic resources and obligations of a firm.
c. Evaluate economic performance of a firm.
d. Assess the management's efficient and profitable use of the firm's resources.

82. The following is Gold Corp.'s June 30 trial balance:

Cash overdraft		$ 10,000
Accounts receivable (net)	$ 35,000	
Inventory	58,000	
Prepaid expenses	12,000	
Land held for resale	100,000	
Property, plant, and equipment (net)	95,000	
Accounts payable and accrued expenses		32,000
Common stock		25,000
Additional paid-in capital		150,000
Retained earnings		83,000
	$300,000	$300,000

Additional information:

- Checks amounting to $30,000 were written to vendors and recorded on June 29, resulting in a cash overdraft of $10,000. The checks were mailed on July 9.
- Land held for resale was sold for cash on July 15.
- Gold issued its financial statements on July 31.

In its June 30 balance sheet, what amount should Gold report as current assets?

a. $225,000.
b. $205,000.
c. $195,000.
d. $125,000.

83. A statement of cash flows is intended to help users of financial statements

a. Evaluate a firm's liquidity, solvency, and financial flexibility.
b. Evaluate a firm's economic resources and obligations.
c. Determine a firm's components of income from operations.
d. Determine whether or not accounts receivable are collectible.

84. The information reported in the statement of cash flows should help investors, creditors, and others to assess all of the following **except** the

a. Amount, timing, and uncertainty of prospective net cash inflows of a firm.
b. Company's ability to pay dividends and meet obligations.
c. Company's ability to generate future cash flows.
d. Management with respect to the efficient and profitable use of the firm's resources.

85. Which **one** of the following items would be specifically required in a statement of cash flows prepared following the "all financial resources" concept?

a. Inclusion of both operating and nonoperating cash flow information.
b. Inclusion of combined parent and subsidiary cash flow information.
c. Inclusion of nonmonetary exchanges.
d. Inclusion of separate cash flow information for both parent and subsidiary.

86. In preparing a Statement of Cash Flows, an item that would be included in determining cash provided by operations would be the

a. Amortization of a bond premium.
b. Proceeds from the sale of equipment for cash.
c. Cash dividends received.
d. Purchase of treasury stock.

87. **ASC Topic 230**, "Statement of Cash Flows," classifies cash receipts and cash payments by operating, investing, and financing activities. All of the following should be classified as investing activities **except**

a. Cash outflows to purchase manufacturing equipment.
b. Cash inflows from the sale of bonds of other entities.
c. Cash outflows to lenders for interest.
d. Cash inflows from the sale of a manufacturing plant.

88. Deed Co. owns 2% of Beck Cosmetic Retailers. A property dividend by Beck consisted of merchandise with a fair value lower than the listed retail price. Deed in turn gave the merchandise to its employees as a holiday bonus. How should Deed report the receipt and distribution of the merchandise in its statement of cash flows?

a. As both an inflow and outflow for operating activities.
b. As both an inflow and outflow for investing activities.
c. At fair value for dividend revenue and listed retail price for employee compensation expense.
d. As a noncash activity.

89. All of the following are proper captions for reporting earnings per share **except**

a. Cash flow per share.
b. Earnings per common share.
c. Earnings per common share – assuming full dilution.
d. Earnings per common and dilutive common equivalent share.

90. Which of the following cash flows per share should be reported in a statement of cash flows?

a. Cash flows per share only.
b. Diluted cash flows per share only.
c. Both cash flow and diluted cash flows per share.
d. Cash flows per share should **not** be reported.

91. The net income for Cypress Inc. was $3,000,000 for the year ended December 31, 20x3. Additional information is as follows:

Depreciation on fixed assets	$1,500,000
Proceeds from sale of land	200,000
Increase in accounts payable	300,000
Dividends on preferred stock	400,000

The net cash provided by operating activities in the statement of cash flows for the year ended December 31, 20x3, should be

a. $4,200,000.
b. $4,500,000.
c. $4,600,000.
d. $4,800,000.

92. The following information was taken from the accounting records of Oak Corporation for the year ended December 31, 20x3.

Proceeds from issuance of common stock	$4,000,000
Dividends paid on preferred stock	400,000
Bonds payable converted to common stock	2,000,000
Payment for purchase of machinery	500,000
Proceeds from sale of plant building	1,200,000
2 percent stock dividend on common stock	300,000
Gain on sale of plant building	200,000

The net cash flows from investing and financing activities that should be presented on Oak's Statement of Cash Flows for the year ended December 31, 20x3, are, respectively

a. $700,000 and $3,600,000.
b. $700,000 and $3,900,000.
c. $900,000 and $3,900,000.
d. $900,000 and $3,600,000.

93. In a statement of cash flows, which of the following items is reported as a cash outflow from financing activities?

I. Payments to retire mortgage notes.
II. Interest payments on mortgage notes.
III. Dividend payments.

a. I, II, and III.
b. II and III.
c. I only.
d. I and III.

94. Alp, Inc. had the following activities during the year:

- Acquired 2,000 shares of stock in Maybel, Inc. for $26,000.
- Sold an investment in Rate Motors, Inc. for $35,000 when carrying value was $33,000.
- Acquired a $50,000, 4-year certificate of deposit from a bank. (During the year, interest of $3,750 was paid to Alp.)
- Collected dividends of $1,200 on stock investments.

In Alp's statement of cash flows for the year, net cash used in investing activities should be

a. $37,250.
b. $38,050.
c. $39,800.
d. $41,000.

95. Selected information from Basket Company's accounting records for the year is as follows:

Proceeds from issuance of common stock	$8,000,000
Proceeds from issuance of preferred stock	2,000,000
Dividends paid on common stock	1,000,000
Dividends paid on preferred stock	400,000
Purchases of treasury stock	300,000
Sales of stock to officers and employees not included above	200,000

In a statement of cash flows, the net cash flow from financing activities would be

a. $8,500,000.
b. $10,000,000.
c. $9,500,000.
d. $8,300,000.

96. In a statement of cash flows, which of the following would increase reported cash flows from operating activities using the direct method? (Ignore income tax considerations.)

a. Dividends received from investments.
b. Gain on sale of equipment.
c. Gain on early retirement of bonds.
d. Change from straight-line to accelerated depreciation.

97. When using the indirect method to prepare the statement of cash flows, the amortization of goodwill should be presented as a(n)

a. Cash flow from investing activities.
b. Cash flow from financing activities.
c. Deduction from net income.
d. Addition to net income.

The Following Data Apply to Items 98 and 99.

Royce Company had the following transactions during the fiscal year ended December 31, 20x4:

- Accounts receivable decreased from $115,000 on December 31, 20x3, to $100,000 on December 31, 20x4.
- Royce's Board of Directors declared dividends on December 31, 20x4, of $.05 per share on the 2.8 million shares outstanding, payable to shareholders of record on January 31, 20x5. The company did not declare or pay dividends for fiscal year 20x3.
- Sold a truck with a net book value of $7,000 for $5,000 cash, reporting a loss of $2,000.
- Paid interest to bondholders of $780,000.
- Cash increased from $106,000 on December 31, 20x3, to $284,000 on December 31, 20x4.

98. Royce Company uses the direct method to prepare its Statement of Cash Flows at December 31, 20x4. The interest that is paid to bondholders would

a. Be reported in the Financing Section, as a use or outflow of cash.
b. Be reported in the Operating Section, as a use or outflow of cash.
c. Be reported in the Investing Section, as a use or outflow of cash.
d. Be reported in the Debt Section, as a use or outflow of cash.

99. Royce Company uses the indirect method to prepare its 20x4 Statement of Cash Flows, and would show a(n)

a. Source or inflow of funds of $5,000 from the sale of the truck in the Financing Section.
b. Use or outflow of funds of $140,000 in the Financing Section, representing dividends.
c. Deduction of $15,000 in the Operating Section, representing the decrease in year-end account receivable.
d. Addition of $2,000 in the Operating Section for the $2,000 loss on the sale of the truck.

100. Appalachian Outfitters Inc., a mail order supplier of camping gear, is putting together its current year statement of cash flows. A comparison of the company's year-end balance sheet to the prior year's balance sheet shows the following changes from a year ago.

Assets		**Liabilities & Net Worth**	
Cash & Marketable Securities	$ (600)	Accounts Payable	$ 250
Accounts Receivable	200	Accruals	50
Inventories	(100)	Long-term Note	(300)
Gross Fixed Assets	4,600	Long-term Debt	1,400
Accumulated Depreciation	(500)	Common Stock	0
		Retained Earnings	2,200
Total	$3,600	Total	$3,600

The firm's payout ratio is 20%. During the current year, net cash provided by operations amounted to

a. $2,900.
b. $3,050.
c. $3,450.
d. $4,050.

The Following Data Apply to Items 101 – 103.

Allan Construction signed a $48 million contract on September 1, 20x0, with the city of Springfield to construct a tunnel under the Maple River. On that date, the estimated cost to complete the tunnel, which was to be completed by June 20x3, was $36 million. Allan's fiscal year ends November 30, and the company uses the percentage-of-completion method of revenue recognition. Data regarding the tunnel contract, which was begun on December 1, 20x0, are given below

	At November 30 (in thousands)	
	20x1	20x2
Actual costs to date	$12,000	$30,000
Estimated costs to complete	24,000	10,000
Progress billings to date	10,000	28,000
Cash collected to date	8,000	24,000

101. The gross profit or loss recognized in the fiscal year ended November 30, 20x1, from the tunnel contract would be

a. $12,000,000 gross profit.
b. $4,000,000 gross profit.
c. $6,000,000 gross profit.
d. $3,000,000 gross profit.

102. The gross profit or loss recognized in the fiscal year ended November 30, 20x2, from the tunnel contract would be

a. $8,000,000 gross profit.
b. $4,000,000 gross loss.
c. $2,000,000 gross profit.
d. $6,000,000 gross profit.

103. Assume that the estimated costs to complete at November 30, 20x2, were $20 million rather than the $10 million shown in the schedule above. The gross loss recognized on the contract from its inception through November 30, 20x2, would be

a. $7,500,000.
b. $14,000,000.
c. $1,200,000.
d. $2,000,000.

104. In order to properly account for an installment sale, all of the following must be readily determinable **except**

a. The amount of gross profit to be deferred.
b. The total cash collected on each year's sales.
c. The operating costs to be deferred.

d. Costs associated with default and repossession.

105. The mining industry frequently recognizes revenue using the completion of production method. This method is acceptable under the revenue recognition principle for all of the following reasons **except** that

a. Production costs can be readily determined.
b. Sales prices are reasonably assured.
c. Assets are readily realizable.
d. Units are interchangeable.

106. When the right of return exists, all of the following criteria must be met before revenue is recognized **except** that the

a. Amount of future returns can be reasonably estimated.
b. Seller's price to the buyer is substantially fixed at the date of the sale.
c. Buyer's obligation to the seller must be liquidated.
d. Buyer is obligated to pay the seller and the obligation is not contingent on the resale of the product.

107. Roth Company is a distributor of perishable foods whose prices fluctuate seasonally and with agricultural growing conditions. Roth's customers have the right to return unsold goods within a specified period of time. As a result, Roth must

a. Use the cost recovery method of revenue recognition.
b. Record sales when the return privilege has expired.
c. Record sales that have been reduced by an estimate of future returns.
d. Use the installment method of revenue recognition.

108. Tillary Company, which began business on January 1, appropriately uses the installment sales method of accounting. The following data are available for the year:

Installment accounts receivable, December 31	$200,000
Deferred gross profit, December 31 (before recognition of realized gross profit)	140,000
Gross profit on sales	40%

The cash collections and the realized gross profit on installment sales for the year ended December 31 should be

	Cash Collections	Realized Gross Profit
a.	$100,000	$80,000
b.	$100,000	$60,000
c.	$150,000	$80,000
d.	$150,000	$60,000

109. For financial statement purposes, the installment method of accounting may be used if the

a. Collection period extends over more than 12 months.
b. Installments are due in different years.
c. Ultimate amount collectible is indeterminate.
d. Percentage-of-completion method is inappropriate.

110. Deb Co. records all sales using the installment method of accounting. Installment contracts call for 36 equal monthly cash payments. According to the FASB's conceptual framework, the amount of deferred gross profit relating to collections 12 months beyond the balance sheet date should be reported in the

a. Current liability section as deferred revenue.
b. Noncurrent liability section as a deferred revenue.
c. Current section as a contra account.
d. Noncurrent asset section as a contra account.

The Following Data Apply to Items 111 and 112.

Rinker Corporation had 40,000 shares of common stock outstanding on November 30, 20x7. On May 20, 20x8 a 10 percent stock dividend was declared and distributed. During June of 20x8, Rinker issued options to its existing stockholders giving them the right to acquire one additional share of stock for each share of stock held. The option price of the additional share was $6 per share. The average price of Rinker's common stock for the year was $20 per share. The company's net income for the fiscal year was $229,680.

111. Basic earnings per share (rounded to the nearest cent) of Rinker common stock for the fiscal year ended November 30, 20x8, was

a. $3.07 per share.
b. $5.22 per share.
c. $5.74 per share.
d. $3.73 per share.

112. Diluted earnings per share (rounded to the nearest cent) of Rinker common stock for the fiscal year ended November 30, 20x8, was

a. $3.87 per share.
b. $3.19 per share.
c. $3.07 per share.
d. $2.90 per share.

113. In 20x1 Dubious Corporation began selling a new line of products that carry a two-year warranty against defects. Based upon past experience with other products, the estimated warranty costs related to dollar sales are as follows:

First year of warranty	2%
Second year of warranty	5%

Sales and actual warranty expenditures for 20x1 and 20x2 are presented below:

	20x1	20x2
Sales	$500,000	$700,000
Actual warranty expenditures	10,000	30,000

What is the estimated warranty liability at the end of 20x2?

a. $39,000
b. $44,000
c. $49,000
d. $84,000

114. At December 31, 20x2, and 20x3, Apex Co. had 3,000 shares of $100 par, 5% cumulative preferred stock outstanding. No dividends were in arrears as of December 31, 20x1. Apex did not declare a dividend during 20x2. During 20x3, Apex paid a cash dividend of $10,000 on its preferred stock. Apex should report dividends in arrears in its 20x3 financial statements as a(an)

a. Accrued liability of $15,000.
b. Disclosure of $15,000.
c. Accrued liability of $20,000.
d. Disclosure of $20,000.

115. Cash dividends on the $10 par value common stock of Ray Company were as follows:

1st quarter	$ 800,000
2nd quarter	900,000
3rd quarter	1,000,000
4th quarter	1,100,000

The 4th quarter cash dividend was declared on December 20, to stockholders of record on December 31. Payment of the 4th quarter cash dividend was made on January 9 of the following year. In addition, Ray declared a 5% stock dividend on its $10 par value common stock on December 1, when there were 300,000 shares issued and outstanding and the market value of the common stock was $20 per share. The shares were issued on December 21. What was the effect on Ray's stockholders' equity accounts as a result of the above transactions?

	Common Stock	Additional Paid-in Capital	Retained Earnings
a.	$ - 0 -	$ - 0 -	$3,800,000 dr
b.	$150,000 cr	$ - 0 -	$3,950,000 dr
c.	$150,000 cr	$150,000 cr	$4,100,000 dr
d.	$300,000 cr	$300,000 dr	$3,800,000 dr

EXTERNAL FINANCIAL REPORTING DECISIONS

Essay Questions

Essay 1 Estimated time 30 minutes

Ritter Supply produces paints and related products for sale to the construction industry throughout the southwest United States. While sales have remained relatively stable despite a decline in the amount of new construction, there has been a noticeable change in the timeliness with which Ritter's customers are paying their bills.

Ritter sells its products on payment terms of 2/10, n/30. In the past, over 75 percent of the credit customers have taken advantage of the discount by paying within ten days of the invoice date. During the fiscal year ended November 30, 20x1, the number of customers taking the full 30 days to pay has increased. Current indications are that less than 60 percent of the customers are now taking the discount. Uncollectible accounts as a percentage of total credit sales have risen from the 1.5 percent provided in past years to 4.0 percent in the current year.

In response to a request for more information on the deterioration of accounts receivable collections, Ritter's controller has prepared the following report:

Ritter Supply
Accounts Receivable Collections
November 30, 20x1

The fact that some credit accounts will prove uncollectible is normal, and annual bad debt write-offs had been 1.5 percent of total credit sales for many years. However, during the fiscal year ending November 30, 20x0, this percentage increased to 4.0 percent. The current accounts receivable balance is $1,500,000, and the condition of this balance in terms of age and probability of collection is shown below.

Proportion of Total	Age Categories	Probability of Collection
64.0%	1-10 days	99.0%
18.0	11-30 days	97.5
8.5	Past due 31-60 days	95.0
5.0	Past due 61-120 days	80.0
3.0	Past due 121-180 days	65.0
1.5	Past due over 180 days	20.0

At the beginning of the fiscal year, December 1, 20x0, the Allowance for Doubtful Accounts had a credit balance of $26,300. Ritter has provided for a monthly bad debt expense accrual during the fiscal year just ended based on the assumption that four percent of total credit sales will be uncollectible. Total credit sales for the 20x0-20x1 fiscal year amounted to $8,000,000, and write-offs of uncollectible accounts during the year totaled $292,500.

REQUIRED:

A. Prepare an accounts receivable aging schedule at November 30, 20x1, for Ritter Supply using the age categories identified in the controller's report showing

1. The amount of accounts receivable outstanding for each age category and in total.
2. The estimated amount that is uncollectible for each category and in total.

B. Compute the amount of the year-end adjustments necessary to bring Ritter Supply's Allowance for Doubtful Accounts to the balance indicated by the aging analysis.

C. Calculate the net realizable value of Ritter Supply's accounts receivable at November 30, 20x1. Ignore any discounts that may be applicable to the accounts not yet due.

D. Describe the accounting to be performed for subsequent collections of previously written-off accounts receivable.

Essay 2 Estimated time 30 minutes

Lombardi Home Improvement Company installs replacement siding, windows, and louvered glass doors for single family homes and condominium complexes in northern New Jersey and southern New York. The company is in the process of preparing its annual financial statements for the fiscal year ended May 31, 20x2, and Dick Wolfe, controller for Lombardi, has gathered the following data concerning inventory and depreciable assets:

- During the last two years, Lombardi experienced slow but steady growth; as a result, the company decided to increase the number of work crews from eight to nine. On September 2, 20x1, Lombardi purchased a truck for the new work crew. The truck was purchased from a New Jersey car dealer for a total cost of $31,600. The truck will be used for six years, after which it will have an estimated residual value of $1,000. Since Lombardi's base of operations is located in New York, the New Jersey car dealer did not collect New York sales tax. On September 5, 20x1, Lombardi paid New York sales tax and title registration of $2,200 directly to the New York Motor Vehicle Department.

- Each of Lombardi's trucks is equipped with a hydraulic lift to load and unload siding and other materials. This lift was installed on the new truck for a total cost of $1,400 and has a useful life of six years with no residual value.

- Each truck also carries an air compressor to run various power tools. Unlike the lifts which are welded to the trucks, the air compressors remain free-standing so that they may be moved around the construction sites. The air compressor carried on one of Lombardi's older trucks broke down at the end of August 20x1, and the Maintenance Department determined that it was not worth repairing. The air compressor had been purchased on October 4 three years earlier for $336. On September 4, 20x1, Lombardi purchased two new air compressors for a total cost of $800, paying $740 cash and receiving a $60 trade-in allowance for the old air compressor. All air compressors have an estimated useful life of four years with no residual value.

- Lombardi uses straight-line depreciation for all items of equipment and computes depreciation to the nearest full month.

- At May 31, 20x2, the balance in Lombardi's Raw Material Inventory account was $408,000, and the Allowance to Reduce Inventory to Market had a credit balance of $29,500. Wolfe summarized the relevant inventory cost and market data at May 31 in the schedule below.

Wolfe assigned Laura Salem, an intern from a local college, the task of calculating the amount that should appear on Lombardi's May 31, 20x2, financial statements for inventory under the lower of cost or market rule as applied to each item in the inventory. Salem expressed concern over departing from the cost principle.

Lombardi Home Improvement Company

	Cost	Replacement Cost	Sales Price	Net Realizable Value	Normal Profit
Aluminum Siding	$ 70,000	$62,500	$ 64,000	$ 56,000	$ 5,100
Cedar shake siding	86,000	79,400	94,000	84,800	7,400
Louvered doors	112,000	124,000	186,400	168,300	18,500
Thermal windows	140,000	126,400	154,800	140,000	15,400
Total	$408,000	$392,300	$499,200	$449,100	$46,400

REQUIRED:

A. 1. Determine the proper balances at May 31, 20x2, in the asset account for the recently purchased truck, the associated Accumulated Depreciation account, and the asset account for the newly acquired air compressors.

2. For the fiscal year ended May 31, 20x2, calculate the amount of the gain or loss (if any) related to the air compressor that was traded for the two new air compressors.

B. 1. Determine the proper balance in the Allowance to Reduce Inventory to Market at May 31, 20x2.

2. For the fiscal year ended May 31, 20x2, determine the amount of the gain or loss that would be recorded due to the change in the Allowance to Reduce Inventory to Market.

C. Explain the rationale for the use of the lower of cost or market rule as it applies to inventories.

Essay 3 Estimated time 30 minutes

All-World Sporting Goods, Inc. has been experiencing growth in the demand for its products over the last several years. The last two Olympic Games greatly increased the popularity of basketball around the world. As a result, a European sports retailing consortium entered into an agreement with All-World's Roundball Division to purchase basketballs and other accessories on an increasing basis over the next 5 years.

To be able to meet the quantity commitments of this agreement, All-World had to obtain additional manufacturing capacity. A real estate firm located an available factory in close proximity to All-World's Roundball manufacturing facility, and All-World agreed to purchase the factory and used machinery from Eastern Athletic Company on October 1, 20x1. Renovations were necessary to convert the factory for All-World's manufacturing use.

The terms of the agreement required All-World to pay Eastern $50,000 when renovations started on January 1, 20x2, with the balance to be paid as renovations were completed. The overall purchase price for the factory and machinery was $400,000. The building renovations were contracted to Burke Construction at $100,00. The payments made, as renovations progressed during 20x2, are shown below. The factory was place in service on January 1, 20x3.

	1/1	4/1	10/1	12/31
Eastern	$50,000	$100,000	$100,000	$150,000
Burke		30,000	30,000	40,000

On January 1, 20x2, All-World secured a $500,000 line-of-credit with a 12% interest rate to finance the purchase cost of the factory and machinery, and the renovation costs. All-World drew down on the line-of-credit to meet the payment schedule shown above; this was All-World's only outstanding loan during 20x2.

Walter Noble, All-World's controller, will capitalize the maximum allowable interest costs for this project. All-World's policy regarding purchases of this nature is to use the appraisal value of the land for book purposes and prorate the balance of the purchase price over the remaining items. The building had originally cost Eastern $300,000 and had a net book value of $50,000, while the machinery originally cost $125,000 and had a net book value of $40,000 on the date of sale. The land was recorded on Eastern's books at $40,000. An appraisal conducted by independent appraisers at the time of acquisition, valued the land at $240,000, the building at $84,000, and the machinery at $36,000.

Charles Jerrold, chief engineer, estimated that the renovated plant would be used for 15 years, with an estimated salvage value of $30,000. Jerrold estimated that the productive machinery would have a remaining useful life of 5 years and a salvage value of $3,000. All-World's depreciation policy specifies the 200% declining-balance method for machinery and the 150% declining-balance method for the plant. One-half year's depreciation is taken in the year the plant is placed in service and one-half is allowed when the property is disposed of or retired. All-World uses a 360-day year for calculating interest costs.

REQUIRED:

A. Determine the amounts to be recorded on the books of All-World Sporting Goods, Inc. as of December 31, 20x2, for each of the following properties acquired from Eastern Athletic Equipment Company.

1. Land.
2. Building.
3. Machinery.

B. Calculate All-World Sporting Goods, Inc.'s 20x3 depreciation expense, for book purposes, for each of the properties acquired from Eastern Athletic Equipment Company.

C. Discuss the arguments for and against the capitalization of interest costs.

Essay 4 Estimated time 30 minutes

On December 29, 20x7, Dallas Corporation leased twenty trucks to Reutzel Express Company under a six-year, noncancelable lease. Additional information regarding the lease and the trucks is presented below.

- The lease requires equal annual payments of $145,200 that are due on December 31 each year, and the first rent was paid December 31, 20x7. These payments provide Dallas Corporation with a 12 percent return on the net investment; this implicit interest rate is known by Reutzel.

- The lease does not pass ownership of the trucks at the end of the lease, but Reutzel may purchase all of the trucks at the end of the lease for a total of $10,000. The estimated residual value of all of the trucks is $25,000 at the end of the lease term and $1,000 at the end of nine years.

- The fair value of the trucks is $674,000. The cost of the trucks to Dallas is $650,000, and each truck has an expected useful life of nine years.

- Reutzel's incremental borrowing rate is 14 percent.

- Reutzel pays the executory costs (insurance, taxes and other fees not included in the annual lease payments) of $485 per year and depreciates all of its trucks using straight-line depreciation.

- The collectability of the lease payments is reasonably predictable, and there are no important uncertainties surrounding the amount of unreimbursable costs yet to be incurred by Dallas Corporation.

- Present value factors for 12 percent are presented below.

Period	Present Value of $1 Received at the End of the Period	Present Value of an Ordinary Annuity of $1	Present Value of an Annuity Due of $1
6	0.51	4.11	4.60
9	0.36	5.33	5.97

- Present value factors for 14 percent are presented below.

Period	Present Value of $1 Received at the End of the Period	Present Value of an Ordinary Annuity of $1	Present Value of an Annuity Due of $1
6	0.46	3.89	4.43
9	0.31	4.95	5.64

REQUIRED:

A. 1. Explain the four criteria used to determine that a lease should be accounted for as a capital lease by the lessee.

2. Identify which of these criteria are met by the lease between Dallas Corporation and Reutzel Express Company?

B. In general, what are the advantages of leasing to Reutzel Express Company?

C. Without prejudice to your response to previous requirements, assume that Reutzel Express Company recorded the lease on December 31, 20x7 as a capital lease in the amount of $673,300. Prepare all the journal entries required to record the capital lease on the books of Reutzel Express Company for the fiscal year ended December 31, 20x8.

D. Explain how the lease should be presented on Reutzel Express Company's Statement of Financial Position dated December 3, 20x8. (Do not include footnote disclosure.)

Essay 5 Estimated time 30 minutes

Brian Walters, an accountant at Masters Printing Company, is ready to prepare the company's external financial statements as of December 31, 20x3. Walters needs to adjust the accounts for the following items.

1. On March 1, 20x3, Masters purchased a three-year insurance policy for $18,000 which had been recorded as prepaid insurance.

2. After preparing a year-end aging analysis of accounts receivable, Walters determined that the reserve for doubtful accounts should be adjusted to $35,000.

3. Masters has made two major purchases of equipment: (1) $5,000,000 on January 1, 20x2, with an estimated salvage value of $1,000,000 and estimated life of 10 years, and (2) $3,000,000 on July 1, 20x3, with an estimated salvage value of $1,200,000 and estimated life of 10 years. These purchases have been recorded; however, no depreciation entries have been made for 20x3. Masters uses the straight-line method of depreciation for financial accounting purposes.

4. Masters has just received the annual pension information from its actuarial firm. This report shows total pension expense of $32,000 for 20x3 and total required 20x3 contributions to the plan of $36,800. The 20x3 contribution payment will be made on January 31, 20x4.

5. On October 1, 20x3, Masters recorded receipt of $200,000 as revenue from Wellco Magazine, Inc. to print four quarterly health magazines of equal quantities; Masters published the first issue in December 20x3.

6. Masters issued bonds to help finance the new equipment on April 1, 20x3; the issuance of the bonds was properly recorded in April. These are 10-year, 8 percent annual bonds with the first payment due on March 31, 20x4. The bonds were sold at 99 par producing proceeds of $3,960,000; the discount will be amortized using the straight-line method.

7. Prior to January 1, 20x3, the company issued 1,000,000 shares of common stock at its par value of $2.00. On May 1, 20x3, the company repurchased 20,000 common shares at $3.75 per share, and these shares of treasury stock were properly accounted for at cost. Walters is ready to deposit a check on December 28, 20x3, for the sale of 10,000 of these shares which were sold at $7.00 per share.

8. On December 15, 20x3, Masters' Board of Directors declared the first dividend of $.10 per share payable to shareholders of record on December 31, 20x3, to be disbursed on March 1, 20x4.

9. Masters has an effective tax rate of 40 percent; all taxes will be paid in April 20x4.

REQUIRED:

A. Prepare journal entries for the above adjustments. Disregard deferred tax considerations. Provide supporting calculations.

B. By selecting appropriate examples from the material prepared in Requirement A, explain how Masters Printing Company's Statement of Financial Position encompasses the (1) going concern assumption, (2) the historic cost principle, and (3 the matching principle.

Essay 6 Estimated time 30 minutes

Kimpton Company currently owns two jet aircraft which are now fifteen years old. Maintenance costs are quite high, and in the last few years the Board of Directors has restricted corporate travel. At its last meeting, Paul Gardner, chairman of the Board, expressed concern about operating costs in general, and specifically, the operating costs of these aircraft. Therefore, the Board decided to institute a formal cost-cutting program.

As part of this program, the Board decided to reduce its fleet to one aircraft by selling both of the present aircraft and acquiring a new turboprop aircraft which requires lower annual operating costs than either of the two jets currently owned. Gardner asked Susan Werner, Kimpton's controller, to analyze the possibility of leasing the new aircraft, and if leased, to explain how the transaction would be reported on the company's financial statements.

REQUIRED:

A. List and describe the four criteria that must be considered by Kimpton Company in order to determine whether or not a lease agreement should be capitalized.

B. Distinguish between an unguaranteed and a guaranteed residual value.

C. Describe the disclosure requirements for Kimpton Company if the lease were a capital lease.

Essay 7 Estimated time 30 minutes

Dan Carpenter was recently elected as president of Oxford Company. Carpenter met with his controller, Alice Moore, to be briefed on the forthcoming year-end audit.

On the subject of inventories, Carpenter told Moore what the firm's banking representative, Jean Worth, told him at a meeting the previous day. Because of inflation, some companies have switched to the last-in, first-out (LIFO) method for valuing inventories. However, Worth clearly stated that a company should select an inventory cost flow method that most appropriately reflects periodic income; each method has a different impact on the financial statements, specifically, net earnings and working capital. Worth added that the other two generally accepted and most commonly used methods for inventory valuation are average cost and first-in, first-out (FIFO).

REQUIRED:

A. Briefly describe the fundamental cost flow assumptions of the
1. last-in, first-out (LIFO) method.
2. average cost method.
3.first-in, first-out (FIFO) method.

B. Explain the effect that a change from FIFO to LIFO has on net earnings and working capital, assuming a moderate level of inflation.

C. Briefly discuss the reasons for using LIFO in an inflationary economy.

PART 1 - CHAPTER 1

EXTERNAL FINANCIAL REPORTING DECISIONS

Answers

1. /c/ The level of sophistication expected of users of financial information is that of an individual who is willing to read and study the information with reasonable diligence. A high level of expertise in business and financial reporting is not expected; however, inexperience and limited knowledge is also not expected.

2. /b/ Answers A, C, and D are all objectives of financial reporting as identified in SFAC No. 1, "Objectives of Financial Reporting by Business Enterprises." However, there is no objective to provide information that would be useful in assessing the fair value of either economic resources or results of operations. Although some fair value reporting is required (e.g. in the area of certain marketable securities), it is not a measurement or reporting requirement for all elements included on the financial reports.

3. /c/ Although certain conclusions can be drawn indirectly about some aspects of management's performance from the financial statements, the focus of the statements is to provide direct information about enterprise performance for a period of time and the financial position of the enterprise as of a point in time.

4. /a/ The matching concept is being followed because the firm is attempting to record the appropriate amount of bad debt expense in the same accounting period as the related credit sales. Recording bad debt expense in this manner is unrelated to the concepts of substance over form or going concern.

5. /a/ The concept of conservatism requires that uncertainty and risk be adequately considered in financial reporting. It provides that when there is a doubt as to the accounting for a certain transaction, the preference for possible errors in measurement would be an understatement of net income and net assets. The other three options (B, C, and D) are unrelated to the issue of risk and uncertainty.

6. /c/ The going-concern concept assumes that the accounting entity will continue in operation indefinitely, in the absence of evidence to the contrary. Instead of recording a receivable at the total amount due, the firm would record a receivable at its present value. Any difference between the total amount and present value would be recorded over the life of the receivable. Options A, B, and D have nothing to do with the recording of receivables at present value.

7. /c/ The Statements of Financial Accounting Concepts are pronouncements which are intended by the FASB to set forth objectives and fundamentals that will be used as a basis for future development of financial accounting and reporting standards.

8. /a/ According to SFAC No. 5 and SFAC No. 2, an event is recognized in the financial statements when it is relevant, reliable, and measurable.

9. /d/ All three alternatives presented are methods identified in SFAC No. 5 as being suitable for measuring various items on the statement of financial position.

10. /c/ According to SFAC No. 6, comprehensive income is an all-inclusive definition of income which includes all items except investments by owners and distributions to owners.

11. /a/ An unrealized loss on available-for-sale securities is not reported on the income statement and thus does not become a part of earnings. The loss would be reported as a separate component of the stockholders' equity section of the balance sheet. It would, therefore, contribute to a change in equity from non-owner sources, and as such, would be a component of comprehensive income for the period.

12. /d/ According to SFAC No. 6, revenues arise from an increase in assets or a decrease in liabilities generated by activities that are related to ongoing, major or central operations. Option A is incorrect because assets are decreasing. Options B and C refer to incidental, not primary, transactions.

13. /b/ The commission is a direct result of the sale.

14. /b/ B is the best answer because A, C, and D are not allocations.

15. /b/ The full set of financial statements, of which the statement of financial position is a part, is based on the concept of financial capital maintenance. Options A, C, and D identify legitimate limitations of the statement.

16. /b/ A gain on an asset that is unsold is referred to as unrealized. A gain is realized only when it is caused by the actual sale of the asset.

17. /c/ Comprehensive income includes all changes in equity over a period of time except for transactions involving inflows from or distributions to owners. Dividends paid to stockholders is a distribution to owners, and so would be excluded from comprehensive income. All other options listed would be included in comprehensive income.

18. /d/ The advance payment of $3 million should be shown in a current liability account entitled Advance Billings on the Statement of Financial Position of Kristina Company at December 31, 20x7. The aircraft will be constructed during 20x8; therefore, based on the realization principle, the revenue associated with the construction cannot be recognized until 20x8.

19. /b/ The Building Construction Division should use the percentage-of-completion method of revenue recognition. When accounting for long-term contracts, the percentage-of-completion method is preferred because it recognizes income as work progresses and matches expenses with revenues more accurately than the completed contract method of revenue recognition, particularly when contracts span several accounting periods.

20. /a/ Option A represents one of the four criteria for lease capitalization by the lessee under ASC Topic 840. No other option represents one of the four criteria of the lessee.

21. /d/ It is an operating lease because none of the four criteria for lease capitalization under ASC Topic 840 are met. Therefore, the $15,000 yearly rental is rental expense, and the $800 annual executory costs are also charged to expense (annual operations).

22. /b/ It is a capital lease because the present value of minimum lease payments (excluding executory costs) exceeds 90% of the fair value of the asset at the inception of the lease. The capitalized amount is $9,590 which equals $4,000 (yearly rental) minus $500 (executory costs paid for by the lessor) multiplied by the present value factor of 2.74.

23. /c/ This contract would be evaluated as a capital lease for both the land and the building because a bargain purchase option, one of the four identifying criteria to establish a capital lease, is present. However, the components of the lease would be separately classified for accounting and reporting purposes since the land is not a depreciable asset, but the building is.

24. /b/ Initial direct costs are treated differently by the lessor depending on the type of lease. For sales-type leases, initial direct costs are expensed.

25. /a/ Periodic payments required under an operating lease are recorded as they are made; therefore, no liability for future payments appears on the face of the financial statements. As a result, disclosures about terms and amounts of future minimum rental payments relating to non-cancelable operating leases that are to be in effect for more than one year must be disclosed in the footnotes to the statements. Careful reading of the statements would, therefore, reveal the existence of this "off-balance sheet" debt. Options B through D are incorrect because all would be reflected in the amounts reported on the face of the statements.

26. /c/ The amount capitalized as the lease obligation by the lessee is generally the present value of the minimum lease payments. This amount, however, may not exceed the fair market value of the leased property at the inception of the lease.

27. /d/ When a lease meets one or more of the requirements and is classified as a capital lease, both an asset and a liability are recorded. Executory costs (insurance, maintenance, taxes) are not included when the lessee reimburses them.

28. /c/ For a capital lease, the lessor will record a receivable equal to the minimum lease payment times the number of payments to be made. This receivable will be reduced by a contra-asset account called "unearned interest." The unearned interest amount is the gross receivable less the net discounted present value of the minimum lease payments. The unearned interest is amortized using the effective interest method (the interest rate is multiplied times the principal amount outstanding). This procedure is followed on both sales-type and direct financing leases.

29. /a/ Balance sheet focus. Desired balance 12/31 based on sum of products in aging schedule.

$1,200	($120,000 x 1%)
1,800	($90,000 x 2%)
6,000	($100,000 x 6%)
$9,000	Allowance balance needed.

30. /a/ The balance sheet focus using the aging of receivables schedule to determine the bad debts adjustment is an asset valuation approach.

31. /d/

$ 42,000	Desired balance 12/31/x9 -- based on aging schedule
$ 8,000	Balance at 12/31/x8
+ 40,000	Monthly accrual total (0.02 x $2,000,000)
- 22,000	20x9 write-offs
$ 26,000	Balance 12/31/x9 before adjustment
$16,000	Additional bad debt expense required

32. /d/ When accounts receivable are factored without recourse, the transaction is treated as a sale in which the purchaser assumes all risks.

33. /b/ Control has been surrendered only if (1) the assets have been isolated and are beyond the reach of the transferor and its creditors (Answer D), (2) the transferee has the right to pledge or exchange the asset (Answer C), and (3) the transferor has not retained an element of control through a repurchase or early redemption agreement (Answer A). Note that there is no specific requirement that the transferee have physical possession of the asset/s.

34. /a/ The most recent costs incurred for merchandise purchased will most closely approximate current cost as of the date of the financial statements. The

LIFO system assumes a cost flow which places most recent costs on the income statement in COGS. The FIFO system, however, assumes a cost flow which places the earliest costs incurred in COGS and the most recent costs are accounted for in the ending inventory.

35. /a/ Regardless of whether FIFO is used in a perpetual or periodic system, the cost in ending inventory will be the same amount. This is not the case, however, under the LIFO or weighted-average systems.

36. /d/ $970,000 - $50,000 (preferred dividend) -:- 90,000 common shares = basic EPS of $10.22.

37. /a/ Incremental ratio for conversion of preferred shares is $50,000 dividends saved -:- 20,000 additional shares = 2.5.

Incremental ratio for conversion of 9% bonds is $108,000 ($180,000 interest net of taxes at 40%) -:- 30,000 additional shares = 3.6.

Basic EPS = $10.22 (from #146)

<u>Consider effect of preferred shares:</u>
($920,000 + $50,000)/(90,000 + 20,000) = $8.82

<u>Consider effect of 9% bonds:</u>
($920,000 + $50,000 + $108,000) / (90,000 + 20,000 + 30,000) = $7.70.

Since the effect of both convertible securities is dilutive, diluted EPS is <u>$7.70</u>

38. /d/ Matching revenue and expense is a basic measurement principle. (A) is incorrect because various methods can be used in valuing inventory, which may or may not be at net realizable value. (B) is incorrect because inventory is kept at a cost base – fair market value may disclosed in footnotes. (C) is incorrect because inventory value methods may be changed, with proper disclosure showing the effect of the change.

39. /d/ If deduction for income tax purposes is greater than deduction for financial statement purposes in earlier years, taxable income for tax purposes in later years will be higher, thereby generating a deferred liability. The deferred amount must be classified based on the related asset. Since deprecation relates to a long-term asset, the deferred tax liability is classified as long-term.

40. /d/ The classification of deferred tax liability is based on the nature of the underlying asset. Since depreciation relates to a noncurrent asset, the entire $75,000 of temporary difference is classified as noncurrent, even though $10,000 will reverse in the next period.

41. /c/ Permanent differences do not cause any difference between income taxes expense and income taxes payable. Therefore, income tax expense is $84,000 (taxable income of $280,000 x 30%).

42. /a/ This is the only item listed that produces a difference between book and tax income.

43. /b/ Because income tax expense attributable to continuing operations can be made up of several components, ASC Topic 740 requires that the significant components making up income tax expense be disclosed on the face of the income statement or in the notes. No other options is in accordance with the disclosure requirements of ASC Topic 740.

44. /a/ The gain or loss from disposal of a segment must be reported as a component of net income <u>separately</u> from the operating gain or loss of the segment prior to the measurement date. No other option complies with the provision of ASC Topic 225.

45. /c/ The results of operations and the gain or loss on disposal of a segment of a business are reported in the income

statement net of tax separately from the results of continuing operations and before extraordinary items.

46. /c/ Losses from operating a discontinued segment prior to the measurement date are included in the loss from operations of the discontinued segment rather than in the loss on disposal.

47. /b/ According to U.S. GAAP the loss from the disposal of a major operating unit is shown between income from continuing operations and net income as a separate item titled "discontinued operations," and is shown net of its income tax effect.

48. /a/ The gain is deferred for taxes, but is recognized for financial reporting. If the transaction is unusual or infrequent, the gain may be separately shown, but as a portion of operating income and not net of tax. Extraordinary items have been eliminated from reporting.

49. /a/ Transactions which are unusual in nature or occur infrequently can be shown as separate components of income but must not be shown net of tax. Extraordinary items are no longer reported.

50. /a/ The cumulative effect of the change in most accounting principles is reflected in the income of the current period. The change in depreciation method is not an exception to this general principle. No other option complies with the provisions of ASC Topic 250.

51. /a/ The change from LIFO to any other inventory method is one of the exceptions to the general rule that the cumulative effect is reported currently in the income statement. According to ASC Topic 250, the change from LIFO should be given retroactive treatment in the financial statements.

52. /d/ This is a change in the method of inventory pricing and is reported as a cumulative effect change with separate disclosure.

53. /c/ The effect of a change in accounting principle that is inseparable from a change in estimate is accounted for as a change in estimate. This requires reporting the effect as a component of income from continuing operations in the period of the change and in any future periods affected.

54. /c/ A change in benefit periods is a change in estimate. It is accounted for prospectively; i.e. in the period of change and any future periods benefited.

55. /d/ According to ASC Topics 250 and 270, prior period adjustments are made directly to the opening balance of retained earnings, net of tax.

56. /c/ Salvage value is an estimate in the first place and estimates sometimes have to be changed.

57. /c/ 20x2's retained earnings statement should show a prior-period adjustment of $(25,000) relating to the overstatement of 20x1's income. 20x2 income should be $125,000 ($150,000 originally reported less the $25,000 overstated in 20x2). 20x3's income is correctly stated at $180,000.

58. /c/

Selling price	217
Less cost to distribute	19
NRV (ceiling)	198
Less normal profit margin	32
NRV - profit (floor)	166

59. /b/

Selling price	145
Less cost to distribute	8
NRV	137
Less normal profit margin	29
NRV - profit	108
Replacement cost	105

Since the historical cost of 106 is below the middle value of 108, historical cost is used.

60. /c/ With LIFO, ending inventory is valued with older (lower) prices. COGS is valued with the current (higher) prices. This reduces gross margin and leads to lower reported income for tax purposes. Lower taxable income means less cash paid in taxes. Recognizing this advantage, IRS requires companies using LIFO for tax purposes to also use it for financial statements, so they can't report low taxable income and higher financial income to their stockholders.

61. /a/ Tax regulations do not affect the useful life of an asset under financial accounting principles. Answers B, C , and D are all used in the determination of the useful life of an asset.

62. /b/ This is an example of the matching principle where the asset cost is allocated to expense over its useful life (periods of benefit). Depreciation is not attempting to present the current market valuation of the asset, nor do we accumulate funds for its replacement.

63. /b/ With a five year life, straight line depreciation would be 20% per year, so double declining balance would be 40% of the book value at the beginning of the year. First year depreciation would be 40% of 20,000, or 8,000. Deducting that from the book value gives a book value at the beginning of the second year of 12,000. Multiply that by 40% for depreciation of 4,800 in year 2.

64. /b/ The delivery car has a life of three years: 1 + 2 + 3 = 6. The cost of 4,800 minus the salvage value of 600 gives 4,200 to be depreciated. For the last year, depreciation is:

1/6 x 4,200 = 700

65. /c/ The depreciation expense for 20x3 using the straight-line method totals $40,600, computed as follows:

Forge:
(100,000 costs + 20,000 installation - 10,000 salvage value) -:- 5 years = $22,000

Grinding Machine:
(45,000 cost - 5,000 salvage value) -:- 5 years = $8,000

Lathe:
(60,000 cost - 7,000 salvage value) -:- 5 years = $10,600

66. /d/ The depreciation expense for 20x3 using the double-declining balance method totals $40,848. See the following computation and schedules:

Depreciation Rate:
100% -:- 5 years = 20% x 2 = 40% a year. This rate is applied to the book value (cost less accumulated depreciation) as of the beginning of each year.

Forge:	
20x0, $120,000 x 40%	48,000
20x1, $72,000 x 40%	28,800
20x2, $43,200 x 40%	17,280
20x3, $25,920 x 40%	10,368
Grinding Machine:	
20x1, $45,000 x 40%	18,000
20x2, $27,000 x 40%	10,800
20x3, $16,200 x 40%	6,480
Lathe:	
20x3, $60,000 x 40%	24,000

67. /a/ All the costs should be capitalized. Rearrangement costs are capitalized if they have future benefits.

68. /b/ Sum-of-the-years'-digits depreciation is initially higher than straight line depreciation, resulting in a lower book value than the straight-line method. Therefore, gains would be greater (increase) and losses would be lower (decrease) when sum-of-the-years-digits is used rather than straight line.

69. /b/ Sales - Gross Margin = Cost of Goods Sold

Beginning Inventory + Purchases + Costs - COGS = Ending Inventory

$4,800,000 - 25% ($4,800,000) = $3,600,000

$900,000 + 3,400,000 + 200,000 - 3,600,000 = $900,000

70. /b/ In a period of rising prices, the most current costs are the highest. Since the LIFO inventory system places the most recent costs in cost of goods sold, its use would produce the highest cost of goods sold during an inflationary period. FIFO cost flow would produce a high ending inventory and low cost of goods sold. Weighted average and moving average would produce figures between LIFO and FIFO costs.

71. /a/ An inventory misstatement is self-correcting over a two-year period. This is because the ending inventory figure of the first period becomes the beginning inventory for the following period. Ending inventory errors impact net income in the same direction as the misstatement; i.e. under- or overstatement. However, in the next period, the error (now in the beginning inventory) has an equal but opposite effect, thus canceling out the previous year's misstatement. For the data given:

20x6, Net income understated	-$50,000
20x7, Beginning inventory effect	+ 50,000
Ending inventory effect	- 60,000
20x8, Beginning inventory	+ 60,000
Net effect of errors	$ 0

72. /d/ Software development costs incurred before technological feasibility are charged to expense. Only software development costs incurred after technological feasibility are capitalized.

73. /d/ Each of the options A through C is a required disclosure item for inventories. Inventory profits are reported when inventory is sold, i.e. when realized. Unrealized profits are not reported.

74. /b/ Under the FIFO system, the costs associated with the goods first acquired are the first costs to flow to cost of goods sold. The costs in ending inventory are associated with the most recently acquired goods as of the end of the year. The same dollar amounts for COGS and ending inventory will result under both the periodic and perpetual systems because the first-in costs are the same under both methods. This is NOT true for either LIFO or weighted average, because under LIFO the last-in costs are constantly changing as new purchases are made during the year, and under the weighted average method, a new average unit cost is computed after each purchase (a moving average system).

75. /c/ Dividend revenue is from investments not from the operation of the business.

76. /b/ Overstated ending inventory reduces COGS, thereby overstating income. Understated ending inventory understates income.

20x6 reported income	138,000
Less overstated inventory	23,000
Corrected income	115,000
20x7 reported income	254,000
Add 20x6 inventory	23,000
Add understated inventory	61,000
Corrected income	338,000
20x8 reported income	168,000
Less 20x7 inventory	61,000
Add understated inventory	17,000
Corrected income	124,000

77. /a/ For a public entity, ASC Topic 260 requires that both basic and diluted earnings per share be reported on the face of a statement that has equal prominence with the financial statements. This will generally mean that the information be displayed on the face of the income statement.

78. /b/ An asset is classified as current if it is reasonably expected to be realized in cash or consumed within one year or the operating cycle whichever is greater. Therefore, option B is a true statement (although not a complete statement). All other options are false with respect to the decision to classify an asset as current or noncurrent.

79. /a/ The liquidation value (net realizable value) is more relevant.

80. /d/ All the other choices have at least some items that are depreciated, amortized, or presented at lower of cost or market.

81. /b/ One of the objectives of presenting a statement of financial position is to provide information that will help investors and creditors evaluate the economic resources and obligations of a firm. Answer A is incorrect because it relates to a statement of cash flows. Answer C is not correct because the economic performance of a firm is presented on the operating statement. Answer D is not correct because the statement of financial position on its own does not provide sufficient information to determine if management has utilized the firm's resources efficiently and profitably. The complete set of financial statements is needed to make that assessment.

82. /a/

$20,000	Cash balance
35,000	Accounts receivable
58,000	Inventory
12,000	Prepaid expenses
100,000	Land held for resale
$225,000	Total current assets

- Cash overdraft did not exist on June 30 as checks were mailed July 9. Add back $30,000 in checks to $10,000 overdraft to arrive at June 30 balance.

- An asset (the land) held for resale qualifies for inclusion as a current asset.

83. /a/ This is the only answer which is a true statement about the intended use of the cash flows statement. Answer B relates to information provided by a Statement of Financial Position. Answer C refers to the Statement of Operations. Answer D relates to an aging schedule and has nothing to do with a Statement of Cash flows.

84. /d/ The information on the cash flow statement does not allow an assessment of management's efficient and profitable use of the firm's resources. The statement of financial position and statement of operations are both needed to make such an assessment. Options A through C all relate to information that can be gained from an examination of the cash flows statements.

85. /c/ This covers such things as exchanging stock for property.

86. /a/ The amortization of a bond premium adjusts interest expense which is included in operating activities. Issuing and retiring the bond would be financing activities as would the treasury stock transaction (D). The equipment (B) and dividends received (C) would be investing activities.

87. /c/ Interest paid to lenders is an operating outflow and not a financing outflow. All other options present cash inflows or outflows which are always considered investing activities.

88. /d/ Property dividends are not cash flows. They are included in the cash flow statement through presentation in a supporting schedule of non-cash financing and investing activities.

89. /a/ According to ASC Topic 230, a firm is prohibited from reporting cash flow per share. All other options are acceptable captions for reporting earnings per share.

90. /d/ Cash flows per share are not reported.

91. /d/ Net income $3,000,000

Net income	$3,000,000
Add:	
Depreciation	1,500,000
Increase in A/P	300,000
Net cash provided by operating activities	$4,800,000

Note that proceeds from the sale of land is classified as an investing activity and dividends on preferred stock is financing.

92. /a/ Investing Activities:

Investing Activities:	
Payment for machinery	$(500,000)
Proceeds from sale of building	1,200,000
Net cash flows from investing activities	$ 700,000
Financing Activities:	
Proceeds – stock issue	$4,000,000
Cash dividends paid	(400,000)
Net cash flows from financing activities	$3,600,000

Bonds payable converted to common stock and the issuance of a stock dividend would be included in the schedule of noncash financing and investing activities. The gain on sale of land is already included in the $1.2 million proceeds. It should not be subtracted out as the $1.2 million properly reflects the total cash received from the sale. The gain would be a subtraction from cash provided by operations computed using the indirect method.

93. /d/ Interest payments are operating cash outflows.

94. /d/ Net Cash Used in Investing Activities:

Sale of Rate Motors, Inc. investment	$ 35,000
Maybel stock purchase	-26,000
Purchase of certificate of deposit	-50,000
	$(41,000)

95. /a/

$8,000,000
+2,000,000
-1,000,000
- 400,000
- 300,000
+ 200,000
$8,500,000

96. /a/ Dividends received from investments are cash flows from operating activities. Options B and C are not operating activities. Option D would not be included in the statement using the direct method.

97. /d/ The indirect method requires net income as reported on the income statement to be adjusted for noncash and non-operating items. The amortization of goodwill is a noncash expense that would be added back to net income in the computation of cash flows from operating activities.

98. /b/ Although bond interest paid arises from a financing activity, all interest paid on indebtedness is included in the computation of cash flows from operating activities.

99. /d/ Answer D is correct because the cash flow generated by the disposal of the truck is reported in the Investing Section of the Statement of Cash Flows. As a result, the $2,000 loss included in the determination of net income must be added back to net income in the determination of cash flows from operating activities. Answer A is not correct because the $5,000 inflow would be reported in the Investing Section. Answer B is not correct because the dividends were to be paid in 20x5. Their declaration in 20x4 has no effect on the cash flows of that year. Answer C is not correct because the $15,000 decrease in accounts receivable would be an addition, not a deduction, in the Operating Section.

100. /c/ Net Profit after Taxes = Change in Retained Earnings/(1-Payout Ratio) = $2,200/.8 = 2,750. The operating cash flow section of the statement is then constructed as follows:

Net Profit after Taxes	$2,750
Depreciation Charges	500
Increase in Accounts Receivable	(200)
Decrease in Inventories	100
Increase in Accounts Payable	250
Increase in Accruals	50
Net Cash Provided by Operating Activities	$3,450

101. /b/ $48M – (12M + 24M) = $12M Total G.P.
$12M x {12M ÷ (12M + 24M)} = $4M Recognized G.P.

102. /c/ $48M – (30M + 10M) = $8M Total G.P.
$8M x {30M ÷ (30M + 10M)} = $6M Cumulative Recognized G.P.

$6M – $4M = $2M Recognized in Year 2.

103. /d/ $48M – (30M + 20M) = $2M Total Estimated Loss

104. /c/ In order to account for an installment sale, it is not necessary to determine the operating costs to be deferred. In fact profits, not operating costs, are deferred. All other options must be determinable to properly account for installment sales.

105. /a/ This is an acceptable exception to the general revenue recognition principle. It is allowable when options B, C, and D are present. Option A is not a reason why this method is acceptable. Production costs in the mining industry are unrelated to revenue recognition.

106. /c/ All of the other choices are required by FASB, plus two other restrictions. See the list in the chapter.

107. /b/ Because of the uncertainty in this industry and because a right of return privilege exists, GAAP requires that a conservative approach be taken wherein the sale is recorded when the return privilege has expired.

108. /d/ $140,000 total gross profit ÷ 40% = $350,000 total installment sales receivable. $350,000 – $200,000 balance December 31 = $150,000 cash collections. $150,000 x 40% = $60,000 realized gross profit. (Note also that Option D is the only one in which the relationship between cash collections and gross profit percent is 40%.)

109. /c/ The installment method of revenue recognition is acceptable for accounting only when the selling price is not reasonably assured or there is difficulty in estimating the degree of collectability.

110. /c/ Although the account Deferred Gross Profit is most often treated as a liability account for reporting purposes, it is conceptually a contra-asset account offsetting the installment receivables. It is included in current or noncurrent assets according to the estimated months to collection.

111. /b/ When computing basic EPS, earnings available to common shareholders is divided by the weighted-average shares outstanding. No consideration is given to any potential shares in this computation; therefore, the options are not a factor.

Stock dividends are assumed to have occurred as of the beginning of the year. Therefore, the weighted-average shares outstanding are 40,000 x 1.10, or 44,000.

$229,680/44,000 shares = $5.22.

112. /a/ Diluted EPS takes into account the numerator and denominator effect of the exercise of options or conversion of convertible securities. Options are included where the exercise price is less than the average market price of the shares – the case in this instance.

There would be no numerator effect from the exercise of the options. The treasury stock method is used to determine the denominator effect.

Proceeds from exercise of options is $264,000 (44,000 option rights at $6 per share). This could be used to repurchase 13,200 treasury shares ($264,000/$20 average price per share).

The denominator impact is 44,000 additional shares less 13,200 treasury shares, weighted for half a year (options issued during June). (44,000 – 13,200) x 6/12 = 15,400 incremental shares.

Diluted EPS:
$229,680/(44,000 + 15,400) = $3.87.

113. /b/

$1,200,000 sales x 0.07 estimated warranty liability	$84,000
Less actual warranty expenditures	40,000
Liability at year end	$44,000

114. /d/ Annual preferred dividends are $15,000 ($300,000 x 5%). Any dividends in arrears have a payment priority once dividends are declared. Since there was no dividend declaration in 20x1, the total $15,000 for that year was in arrears in 20x2. The dividend declaration in 20x2 must have been for only the $10,000 paid to the preferred stockholders because any additional amount would have also been paid to the preferred stockholders up to the $15,000 in arrears for 20x1. A dividend is not a liability until it is declared. Since $10,000 was declared and paid, no additional liability exists for accrual. However, the balance of dividends in arrears ($5,000 for 20x1 and the $15,000 accumulated for 20x2) must be disclosed in notes to the financial statements.

115. /c/ RE is debited for $3,800,000 because of the cash dividends. To record the stock dividend, RE is debited for $300,000 while Common Stock is increased by $150,000 and APIC by $150,000.

PART 1 - CHAPTER 1

EXTERNAL FINANCIAL REPORTING DECISIONS

Essay Answers

Essay Answer 1

A. Ritter Supply
Accounts Receivable Aging Schedule
November 30, 20x1

Category	Aging Ratios	A/R Balances	Uncollectible %	Uncollectible Amounts
Not yet due	64.0	$960,000	1.0	$ 9,600
Current	18.0	270,000	2.5	6,750
31-60 days	8.5	127,500	5.0	6,375
61-120 days	5.0	75,000	20.0	15,000
121-180 days	3.0	45,000	35.0	15,750
Over 180 days	1.5	22,500	80.0	18,000
Totals		$1,500,000		$71,475

B. The adjustment necessary to bring the Allowance for Doubtful Accounts to the balance indicated by the aging analysis is $17,675, calculated as follows:

Allowance for doubtful accounts, 12/1/x0	$ 26,300
Additions:	
Bad debt accrual (credit sales $8,000,000 x 4% uncollectible)	320,000
Total	346,300
Less current year write-offs	292,500
Unadjusted allowance, 11/30/x1	53,800
Required adjustment ($71,475 - $53,800)	17,675
Adjusted allowance, 11/30/x1	$ 71,475

C. The net realizable value of Ritter Supply's accounts receivable at November 30, 20x1, (ignoring any discounts that may be applicable to the accounts not yet due) is $1,428,525, calculated as follows:

Accounts receivable balance, 11/30/x1	$1,500,000
Less allowance for doubtful accounts	71,475
Net realizable accounts receivable	$1,428,525

D. When determinations are made that collections of outstanding accounts are highly unlikely they are written off; however, collection efforts are continued. If collections are made for accounts previously written-off, the account(s) are reestablished by debiting Accounts Receivable and crediting the Allowance for Doubtful Accounts. Cash is debited for the collected amount(s) with a corresponding credit to the reestablished Accounts Receivable.

Essay Answer 2

A.1. The proper balances in the three respective accounts at May 31, 19x2, for Lombardi Home Improvement Company are as follows:

Asset Account - Truck

Purchase price	$31,600
Sales tax and title registration*	2,200
Installation of hydraulic lift	1,400
Book value of asset	$35,200

*If separate fee, registration is usually expensed.

Accumulated Depreciation - Truck

Depreciable cost
= Book value - Residual value
= $35,200 - $1,000
= $34,200

Monthly depreciation
= Depreciable cost -:- useful life
= $34,200 -:- (6 x 12)
= $475 per month

Accumulated depreciation
= $475 x 9 months
= $4,275

Asset Account - Air Compressors

Normally the asset should be recorded at the net book value of the asset surrendered plus cash paid (boot). However, the value recorded cannot exceed market value. Therefore, the asset should be recorded at $800, as calculated below.

Net book value of old asset
= Cost - Accumulated depreciation
= $336 - $245*
= $91

*($336 -:- 48 months) x 35 months

Value of new asset
= Net book value of old + boot
= $91 + $740
= $831

The $831 value exceeds the market value; therefore, the new air compressors should be recorded at $800.

A.2. There would be a $31 loss related to the air compressor that was traded for the two new air compressors calculated as follows.

Net book value	$91
Less trade-in value	60
Loss	$31

B.1. The balance in the Allowance to Reduce Inventory to Market at May 31, 20x2, should be $34,200 as calculated in the schedule below.

Calculation of Proper Balance
in the Allowance to Reduce Inventory to Market
at May 31, 20x2

	Cost	Replacement Cost	NRV (Ceiling)	NRV less normal profit (Floor)	LCM
Aluminum Siding	$ 70,000	$62,500	$ 56,000	$ 50,900	$ 56,000
Cedar shake siding	86,000	79,400	84,800	77,400	79,400
Louvered doors	112,000	124,000	168,300	149,800	112,000
Thermal windows	140,000	126,400	140,000	124,600	126,400
Total	408,000				$373,800

Inventory cost	$408,000
LCM valuation	373,800
Allowance at May 31, 20x2	$ 34,200

---

2. For the fiscal year ended May 31, 20x2, the loss that would be recorded due to the change in the Allowance to Reduce Inventory to Market would be $4,700.

Balance prior to adjustment	$29,500
Required balance	34,200
Loss to be recorded	$ 4,700

C. The use of lower of cost or market (LCM) rule is based on both the matching principle and the concept of conservatism. The matching principle applies because the application of the LCM rule allows for the recognition of a decline in the utility (value) of inventory as a loss in the period in which the decline takes place.

The departure from the cost principle for inventory valuation is permitted on the basis of conservatism. The general rule is that the historical cost principle is abandoned when the future utility of an asset is no longer as great as its original cost.

Essay Answer 3

A. The amounts to be recorded on the books of All-World Sporting Goods, Inc. as of December 31, 20x2, for each of the properties acquired from Eastern Athletic Equipment Company are calculated as follows:

1. Land (appraised value) $240,000

2. Building:

Purchase price allocation[1]	$112,000
Renovations	100,000
Capitalized interest[2]	21,600
Total	$233,600

3. Land:

Purchase price allocation[1] $48,000

Supporting Calculations

[1]Balance of purchase price to be allocated.

Total purchase price	$400,000
Less land appraisal	240,000
To be allocated	$160,000

	Appraisal values	Ratios	Allocated values
Building	$ 84,000	84/120 = .70	$112,000
Machinery	36,000	36/120 = .30	48,000
Totals	$120,000		$160,000

[2]Capitalizable interest.

Dates of loans in 20x2	Amounts	Periods outstanding	Interest @ 12%
1/1	$ 50,000	12/12	$ 6,000
4/1	130,000	9/12	11,700
10/1	130,000	3/12	3,900
12/31	190,000	-	
Totals	$500,000		$21,600

B. All-World Sporting Goods, Inc.'s 20x3 depreciation expense, for book purposes, for each of the properties acquired from Eastern Athletic Company is as follows:

Land:
No depreciation

Building:

Depreciation rate	1.5 x 1/15 = .10
20x3 depreciation	
Cost x Rate x 1/2 year	
$233,600 x .10 x 1/2	= $11,680

Machinery:

Depreciation rate	2.00 x 1/5 = .40
20x3 depreciation	
Cost x Rate x 1/2 year	
$48,600 x .40 x 1/2	= $9,600

C. Arguments for the capitalization of interest costs include the following:

- Diversity of practices among companies and industries called for standardization in practices.
- Total interest costs should be allocated to enterprise assets and operations, just as material, labor, and overhead costs are allocated. That is, under the concept of historical costs, all costs incurred to bring an asset to the condition and location necessary for its intended use should be reflected as a cost of that asset.

Arguments against the capitalization of interest include the following:

- Interest capitalized in a period would tend to be offset by amortization of interest capitalized in prior periods.
- Interest cost is a cost of financing, not of construction.

Essay Answer 4

A. 1. From the lessee's point of view, a non-cancellable lease would be classified as a capital lease if it meets at least one of the following criteria.

- The lease transfers ownership of the property to the lessee at the end of the lease term.
- The lease contains a bargain purchase option.

- The lease term is equal to 75% or more of the estimated economic life of the leased property.

- The present value of the minimum lease payments, excluding executory costs, equals or exceeds 90% of the fair value of the leased property.

2. The lease between Reutzel Express Company and Dallas Corporation meets the following criteria.

   - The right to purchase the trucks at the end of the lease term for $10,000, when the estimated fair market value is $25,000, is a bargain purchase option.

   - The present value of the minimum lease payments, not including the executory costs, is greater than 90% of the fair market value of the trucks, calculated as follows.

Lease payments ($145,200 x 4.60)	$667,920
Bargain purchase price ($10,000 x 0.51)	5,100
Present value of minimum lease payments	$673,020
Fair value of trucks	$674,000
	x 90%
Ninety percent of the fair value of the trucks	$606,600

B. The following may be advantages to a lessee of leasing over buying

- Leasing permits 100% financing at fixed interest rates versus 60% to 80% financing when purchasing, thus conserving cash.

- Leasing may reduce the risk of obsolescence.

- Leasing may preserve lines of credit or avoid violating restrictive loan covenants which prohibit the issuance of additional debt securities.

- Leasing can be at an interest rate lower than the incremental borrowing rate.

C. The journal entries required to record a capital lease on Reutzel Express Company's books for the year-ended-December 31, 20x8, are as follows.

	Debit	Credit
Executory costs	$ 485	
Cash (or accounts payable)		$ 485
Depreciation Expense - capital lease[1]	74,700	
Accumulated depreciation capital lease		74,700
Interest expense[2]	63,372	
Obligations under capital leases[3]	81,828	
Cash		145,200

Supporting Calculations

[1] Depreciation

$$\frac{\text{(Cost-Salvage value)}}{\text{economic life}} = \text{depreciation expense}$$

$$\frac{(\$673{,}300 - \$1{,}000)}{9} = \$74{,}700$$

The economic life is used because the lease contains a bargain purchase option.

[2] Remaining Obligation

($673,300 - $145,200) x 12% = $63,372

[3] Annual Payment Less Interest

$145,200 - $63,372 = $81,828

D. The lease should be presented on Reutzel Express Company's Statement of Financial Position dated 12/31/x8 as follows.

- Leases would be shown, net of accumulated depreciation, in the asset section under the caption of Property, Plant, and Equipment.

Assets	
Property, Plant, and Equipment	
Leased equipment under capital leases	$673,300
Less: Accumulated depreciation	74,700
Net	$598,600

- Under the liability section, the lease obligation would be split between the current and long-term portions as follows.

Current liabilities	
Obligations under capital leases	$91,647
	or $129,643
Long-term liabilities	
Obligations under capital leases	$354,625
	or $316,629

Supporting Calculations

($673,300 - $145,200 - $81,828) x 12% =	$53,553
$145,200 - $53,553 =	$91,647
$446,272 - $91,647 =	$354,625
or	
$145,200 / 112% =	$129,643
$446,272 - $129,643 =	$316,629

Essay Answer 5

Adjusting Entries

Entry 1

	Debit	Credit
Insurance expense	5,000	
Prepaid insurance		5,000

To record ten months of insurance expense in 20x3. As the company purchased a three-year insurance policy for $18,000 on March 1, 20x3, the expense applicable to 20x3 amounts to $5,000.

[($18,000/36 months) x 10 months = $5,000]

Entry 2

	Debit	Credit
Bad debt expense	10,000	
Allowance for doubtful accounts		10,000

To record an additional $10,000 to Allowance for Doubtful Accounts in order to increase the current $25,000 balance to a balance of $35,000.

Entry 3

	Debit	Credit
Depreciation expense	490,000	
Accumulated depreciation		490,000

To record depreciation expense for 20x3, calculated as follows:

	Equipment Purchased	
	January 20x2	July 20x3
Cost of equipment	5,000,000	3,000,000
Salvage value	1,000,000	1,200,000
Net deprec. value	4,000,000	1,800,000
Estimated life	-:- 10 yrs	-:- 10 yrs
Annual depreciation	400,000	180,000
20x3 expense months	12	6
20x3 depreciation expense	400,000	90,000

Entry 4

	Debit	Credit
Pension expense	32,000	
Accrued pension cost	4,800	
Accounts payable		36,800

To record the 20x3 estimated pension contribution liability which is to be paid in 20x4. According to the actuarial firm's pension report, pension expense for 20x3 is $32,000 and the total required contribution amounts to $36,800.

Entry 5

	Debit	Credit
Revenues	150,000	
Deferred revenues		150,000

To adjust revenues to reflect that, of the $200,000 subscription revenue received in advance only 25 percent, or $50,000, was earned in 20x3.

Entry 6

	Debit	Credit
Interest expense	243,000	
Discount on bonds		3,000
Interest payable		240,000

To record the applicable 20x3 amortization of the discount on 10-year bonds issued on April 1, 20x3, calculated as follows:

Discount on bonds [(40,000/120 months) x 9 months)	3,000
Interest payable (4,000,000 x .08 x 9/12)	240,000
Interest expense	243,000

Entry 7

	Debit	Credit
Cash	70,000	
Treasury stock		37,500
Paid-in capital - treasury stock		32,500

To record the gain of $32,500 realized on the sale of treasury stock. The treasury stock was sold for a total of $70,000 (10,000 x $7), with the cost of these shares being $37,500 (10,000 shares x $3.75 per share).

Entry 8

Retained earnings	99,000	
Dividends payable		99,000

To record dividends payable, calculated as follows:

Common stock shares issued	1,000,000
Less treasury stock purchased, 5/1	20,000
Plus treasury stock sold, 12/28	10,000
Shares issued, outstanding 12/31	990,000
Dividend @ $.10 per share	$99,000

Entry 9

Tax expense	164,240	
Taxes payable		164,240

To record the 20x3 tax liability payable in 20x4. On the assumption that the financial reporting income equals taxable income (as deferred taxes are to be ignored), tax expense and taxes payable equal $164,240 computed as follows:

Masters Printing Company
Income Statement
December 31, 19x3

Revenue	$1,850,000
Expenses:	
Salaries	$ 350,000
Admin. expense	215,400
Utilities	74,000
Bad debt expense	30,000
Insurance expense	5,000
Pension expense	32,000
Depreciation expense	490,000
Interest expense	243,000
Total expenses	1,439,400
Income before taxes	410,600
Tax expense (@40%)	164,240
Net income	$ 246,360

B. An example of how Masters Printing Company's Statement of Financial Position encompasses the

1. Going concern assumption (the assumption that the entity will have a long life) is as follows:

    - The prepaid insurance account represents the unused portion to be expensed as it is used; thus, the assumption is that the company will be in business in the future to benefit from the insurance.

2. Historic cost principle (the assumption that assets and liabilities are recorded at the acquisition price) is as follows:

    - The equipment is valued at cost less accumulated depreciation, and not at replacement cost.

3. Matching principle (the assumption that an expense is recorded when it contributes to revenue) is as follows:

    - Tax expense is recognized in the period in which the related revenue was earned, rather than in the period in which it will be paid.

Essay Answer 6

A. A leased asset should be capitalized if it meets any one of the following four criteria:

- The lease agreement transfers title of the property to the lessee at the end of the lease term.
- The lease agreement contains a bargain purchase option, which permits the lessee to purchase the leased property for a price significantly lower than the property's expected fair value at that date.
- The lease term is equal to 75 percent or more of the estimated economic life of the leased asset. In effect, the lessee bears most of the risks and rewards of ownership.
- The present value of the minimum lease payments equals or exceeds 90 percent of the fair value of the leased asset. In

effect, the lessee has essentially purchased the property.

B. The residual value of a leased asset is the expected fair value of the asset at the end of the lease term. The guaranteed residual value is that portion of the residual value that the lessor expects to receive at the end of the lease term, either guaranteed directly by the lessee or indirectly by a third party unrelated to the lessor. The unguaranteed residual value is the uncommitted residual value, even if it is zero.

C. If the lease were a capital lease, Kimpton would be required to disclose the terms of the lease including the following:

- The gross amount of leased assets at each balance sheet date listed and categorized by function.
- Future annual, minimum lease payments as of the latest balance sheet date for each of the next five years and also in total over the life of the leases.
- Total noncancelable minimum sublease rentals to be received in the future, as of the latest balance sheet date.
- Total contingent rentals.
- Separate identification of the amount capitalized (liability), including related depreciation, obligations under capital leases recorded as debt, and any renewal or purchase options.

Essay Answer 7

A. 1. The last-in, first-out (LIFO) method of cost flow assumes that the latest unit costs in inventory are the first unit costs to flow to cost of goods sold. It matches the latest costs against current sales.

2. The average cost method of cost flow assumes that the unit costs are averaged, and that average cost is used to cost inventory and cost of goods sold. If the perpetual method is used, a moving-weighted-average amount is computed each time purchases are made. If the periodic method is used, the average cost is not computed until the end of the accounting period.

3. The first-in, first-out (FIFO) method of cost flow assumes that goods are used in the order they are purchased, and, therefore, the earliest unit costs in the inventory are the first unit costs to flow to cost of goods sold. It matches the earliest unit costs against current sales.

B. In periods of moderate levels of inflation, the LIFO method will result in both net income and balance sheet amounts that are lower than would be the case if the FIFO method were used (inventory quantities remain constant).

The change from FIFO to LIFO is generally handled as an exception to the rule for accounting changes; the change is handled prospectively. Beginning with the year of the change and into the future, income will be lower than it would have been if FIFO had been continued, since the higher current costs would be transferred to income.

The direct effect on working capital would be to lower the ratio. The ending inventory under LIFO would be lower than FIFO, which would lower working capital. However, future taxes would also be lower, which means that cash paid for taxes would be reduced. The result would be increased available cash, thus increasing working capital and partially offsetting the decrease attributable to the decreased inventory value.

C. The reasons for using LIFO in an inflationary economy include the following:

- LIFO matches current costs to current revenues.
- Using LIFO temporarily defers tax payments by matching current higher costs against current revenue producing a lower income and lower tax, resulting in improved cash flow.
- If future prices decline, a company using LIFO may not have to write down inventory, or at least not as much. The inventory value represents the earliest costs from the time when LIFO was adopted.

CMA PART 1 – CHAPTER 1

EXTERNAL FINANCIAL REPORTING DECISIONS

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