CHAPTER 1

THE CANADIAN FINANCIAL REPORTING ENVIRONMENT

MULTIPLE CHOICE—Conceptual

Answer	No.	Description
d	1.	Accounting characteristics.
a	2.	Nature of financial accounting.
c	3.	Definition of financial accounting.
a	4.	Financial reporting entity.
d	5.	Efficient use of resources.
d	6.	Capital allocation process.
c	7.	Assessing management stewardship.
c	8.	Objectives of financial reporting.
a	9.	Role of AcSB.
c	10.	Body responsible for setting GAAP.
b	11.	Preparation of biased information.
d	12.	Parties instrumental in development of reporting standards.
d	13.	Stakeholders in the financial reporting environment..
a	14.	“Due process”.
d	15.	Causes of subprime lending crisis.
d	16.	Management bias.
b	17.	Adoption of IFRS.
c	18.	Role of OSC.
d	19.	Definition of GAAP.
b	20.	Changing nature of the economy.
d	21.	Exercise of professional judgement.
c	22.	Major factors in the reporting environment.
a	23.	Impact of technology on financial reporting.
b	24.	Nature of the “Balanced Scorecard”.
a	25.	Responsibility for financial statements.
d	26.	GAAP for private enterprises.
d	27.	Reporting principles
b	28.	SOX.
a	29	AcSB’s standard setting process

EXERCISES

Item	Description
E1-30	Objectives of financial reporting.
E1-31	Role of securities commissions and stock exchanges.
E1-32	User needs.
E1-33	Sources of GAAP.
E1-34	Standard Setting.
E1-35	Challenges facing financial reporting.
E1-36	Stakeholders in the financial reporting environment.

MULTIPLE CHOICE—Conceptual

1. The essential characteristic(s) of accounting is (are)
   a. communication of financial information to interested persons.
   b. communication of financial information about economic entities.
   c. identification, measurement, and communication of financial information.
   d. all of these.

2. Financial accounting is concerned with the process that culminates in
   a. the preparation of financial reports.
   b. specialized reports for inventory management and control.
   c. specialized reports for income tax calculation and recognition.
   d. reports on changes in stock prices and future estimates of market position.

3. Financial accounting can be broadly defined as the area of accounting that prepares financial statements to be used
   a by parties internal to the business enterprise only.
   b. by investors only.
   c. by parties both internal and external to the business enterprise.
   d. primarily by management.

4. The information provided by financial reporting pertains to
   a. individual business enterprises, rather than to industries or an economy as a whole or to members of society as consumers.
   b. business industries, rather than to individual enterprises or an economy as a whole or to members of society as consumers.
   c. individual business enterprises, industries, and an economy as a whole, rather than to members of society as consumers.
   d. an economy as a whole and to members of society as consumers, rather than to individual enterprises or industries.

5. Whether a business is successful and thrives is determined by
   a. free enterprise.
   b. competition.
   c. markets.
   d. all of these.

6. An effective capital allocation process
   a. encourages innovation.
   b. promotes productivity.
   c. provides an efficient and liquid market for buying and selling securities.
   d. all of these.

7. In assessing management stewardship, users traditionally refer to
   a. non-financial measurements.
   b. forward-looking data.
   c. historical data .
   d. none of these.

8. Which of the following statements is *not* an objective of financial reporting?
   a. Provide information that is useful to users in making resource allocation decisions.
   b. Provide information about an entity's economic resources, obligations, and equity/net assets.
   c. Provide information on the liquidation value of an enterprise.
   d. Provide information about changes in an entity's economic resources, obligations, and equity/net assets.

9. The role of the Accounting Standards Board (AcSB) in the formulation of accounting principles in Canada can be best described as
   a. primary.
   b. secondary.
   c. sometimes primary and sometimes secondary.
   d. non-existent.

10. The body that has the responsibility to set generally accepted accounting principles in Canada is the
    a. FASB.
    b. IASB.
    c. AcSB.
    d. OSC.

11. The preparation by some companies of biased information is sometimes referred to as
    a. conservative financial reporting.
    b. aggressive financial reporting.
    c. full disclosure of all material facts.
    d. management stewardship.

12. Which of the following parties is *not* instrumental in the development of financial reporting standards in Canada?
    a. the Financial Accounting Standards Board (FASB)
    b. the Provincial Securities Commissions
    c. the International Accounting Standards Board (IASB)
    d. the American Institute of Certified Public Accountants

13. Which of the following is not a stakeholder in the Canadian Financial Reporting Environment?
    a. Investors
    b. Creditors
    c. Auditors
    d. All of these are stakeholders

14. In establishing financial accounting standards, “due process” refers to
    a. the process of giving interested parties ample opportunity to express their views.
    b. the practice of researching, creating a task force, issuing an exposure draft and establishing the new GAAP.
    c. the researching of the legal implications of proposed new accounting standards.
    d. the requirement that all accountants must receive a copy of financial standards.

15. The widely publicized subprime lending crisis was not caused by
    a. Capital market participants who acted in their own self-interest.
    b. A lack of transparency.
    c. A lack of investor understanding of the investment's true risk.
    d. The practice of securitizing assets.

16. Which of the following describes one of the causes of management bias?
    a. The need to comply with contracts, such as debt covenants.
    b. The desire to meet financial analyst's expectations.
    c. The tendency to emphasize positive events only.
    d. All of these

17. The adoption of International Financial Reporting Standards is an example of
    a. The impact of technology on user's needs.
    b. The impact of globalization on capital markets
    c. Ethical behaviour.
    d. None of the above

18. Which of the following statements does *not* describe the activities and authority of the Ontario Securities Commission (OSC)?
    a. The OSC reviews and monitors the financial statements of companies whose shares are listed on the Toronto Stock Exchange
    b. The OSC issues its own disclosure requirements for listed companies.
    c. The OSC has the ability to fine or delist companies.
    d. The OSC issues financial accounting standards for Canadian companies.

19. Generally accepted accounting principles include
    a. specific rules, practices and procedures.
    b. broad principles and conventions of general applications including underlying concepts.
    c. pronouncements by the Emerging Issues Committee.
    d. all of these.

20. Which of the following aspects is often described as one of the main issues of measuring performance in the “knowledge-based” economy?
    a. "Knowledge-based" assets are mostly linked to physical assets.
    b. The success of "knowledge-based" companies includes non-financial components.
    c. "Knowledge-based" companies are dominating the market.
    d. All of these.

21. The exercise of professional judgement does *not* involve which of the following:
    a. the use of knowledge gained through education.
    b. the application of knowledge gained through experience.
    c. the use of ethical decision making.
    d. none of these.

22. Which of the following are major factors in the rapidly changing financial reporting environment in Canada?
    a. Increased demand for accountants and the impact of technology
    b. Globalization and the unethical actions of accountants
    c. The growing number of institutional investors and the knowledge based economy
    d. All of these

23. Which of the following is NOT likely a drawback of the dramatic advancement of technology on financial reporting?
    a. Users of financial information have access to more information.
    b. Quality and reliability may be compromised
    c. Equal and fair access may be at issue.
    d. None of these are drawbacks

24. The business strategy model called the “Balanced Scorecard”
    a. ensures that all of the financial statements are accurate and balanced.
    b. views the company from the financial, customer, internal processes perspectives, and learning and growth perspectives.
    c. begins each reporting period with zero balances in all areas of measurement.
    d. views the financial statements as the major component of useful information for decision making within the company.

25. Financial statements are prepared for the user. Which of the following best describes the responsibility for the preparation of financial statements?
    a. They are the responsibility of management.
    b. They are the responsibility of external auditors.
    c. They are the responsibility of shareholders.
    d. They are the responsibility of standard setters.

26. Which of the following supports the use of "simplified GAAP" for private companies?
    a. Private companies usually have less complex business models.
    b. The financial statement users of private companies tend to have first-hand information.
    c. Private companies tend to have fewer users.
    d. All of these

27. Canada Customs and Revenue Agency does not require a corporation to use the same reporting principles for tax as for accounting. Which of the following accounting principles is most likely to be the same for accounting and tax purposes?
    a. Amortization expense
    b. Development costs
    c. Long-term leases
    d. Revenue Recognition

28. The Sarbanes-Oxley Act (SOX) was not enacted to
    a. Help prevent fraud and poor financial reporting practices.
    b. Ensure the act was applied internationally.
    c. Enable the SEC to increase its policing efforts.
    d. Introduce new independence rules for auditors

29. Which of the following does not describe a step in the AcSB's standard setting process?
    a. Issue an emerging Issues Abstract
    b. Develop an Exposure Draft
    c. Write a project proposal
    d. Develop a Re-exposure Draft.

Multiple Choice Answers—Conceptual

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Item
1.	d	6.	d	11.	b	16.	d	21.	d	26.	d
2.	a	7.	c	12.	d	17.	b	22.	c	27.	d
3.	c	8.	c	13.	d	18.	d	23.	a	28.	b
4.	a	9.	a	14.	a	19.	d	24.	b	29.	a
5.	d	10.	c	15.	d	20.	b	25.	a		

EXERCISES

Ex. 1-30—Objectives of financial reporting.

What are the objectives of financial reporting by business enterprises?

Solution 1-30

The objectives of financial reporting are to provide information:

(a) that is useful to investors, members, contributors, creditors and other users in making their resource allocation decisions and/or assessing management stewardship.

(b) to help users in evaluating an entity's economic resources, obligations and equity/net assets and the changes to these items.

(c) to help users evaluate the economic performance of an entity.

Ex. 1-31—Role of Securities Commissions and Stock Exchanges.

Explain the role of securities commissions and stock exchanges in financial reporting.

Solution 1-31

The securities commissions and stock exchanges monitor the financial statements to ensure that they provide full and plain disclosure of material information and to ensure that the companies may continue to list shares on the stock exchanges. Securities commissions oversee and monitor the capital marketplace.

Ex. 1-32—User Needs.

Explain why providing information to users is a challenging task.

Solution 1-32

First, users have very different knowledge levels. Some users have accounting designations or have worked in the finance industry for several years. Others have limited knowledge of how the information is gathered and reported. Second, users have very different needs. Some users are institutional investors who hold a large percentage of equity share holdings and generally devote significant resources to managing their investment portfolios. Others are credit managers at banks or credit unions who deal mainly with small business or personal loans. Still others are labour negotiators whose knowledge of financial reporting is limited to periodic reviews of financial information for the purpose of negotiations.

Ex. 1-33—Sources of GAAP.

International Financial Reporting Standards (IFRS) are the primary source of GAAP for public companies in Canada. They are, however, insufficient to address all of the accounting issues facing accountants. Explain why this is so and outline some other sources of GAAP accountants use.

Solution 1-33

The standards outline the specific accounting treatment for a multitude of items but for some items the guidelines are very general. Also, the business environment is complex and constantly changing and, therefore, some items may not be discussed at all. Accountants must, therefore, use IFRS in concert with other sources like research studies, accounting textbooks, journals, studies and articles.

Ex. 1-34—Standard setting

Explain the relationship between Canadian GAAP and International Financial Reporting Standards (IFRS).

Solution 1-34

Since the decision to adopt IFRS was made, Canadian GAAP has been continuously adjusted (converged) to mirror IFRS. Even prior to that convergence, both standards were principles based (rather than rules-based).

Ex. 1-35—Challenges Facing Financial Reporting.

In North America, the financial reporting environment is changing at a very rapid pace. Briefly describe four things that are effecting this rapid change.

Solution 1-35

1) Globalization: Many companies today are trading internationally. To make this process more efficient, companies are seeking capital globally and many are listing their stock on several stock markets around the world. The move is to global markets and global investors. To effect this change, financial statements have to be more uniform around the world so that comparisons of investment decisions can be more effectively made.

2) Technology: Accountants identify, measure and communicate information to users. Technology affects this process in profound ways. The use of networks and the convergence of computers and telecommunications enable companies to connect electronically to their banks, their suppliers, their customers and regulatory agencies. Users need access to information more rapidly—beyond the quarterly and annual financial statements.

3) Changing nature of the economy: North America has moved from a traditional manufacturing and resource extraction economy to a ‘knowledge based economy’. This provides a real challenge to accountants because users need more relevant models for measuring and reporting value creating assets. Many of the assets in this new economy represent knowledge and expertise of people. Measuring such items has been very difficult because of their subjective nature.

4) Increased requirement for accountability: The growing number of institutional investors and their more sophisticated knowledge levels means that there is an increased demand by institutional investors for accountability. Such investors become more involved in how companies are run. Accountants are going to have to move beyond the financial reporting model to more all-inclusive models of business reporting. These new models will need to include key indicators/measurements that will help predict value creation and monitor organizational performance.

Ex. 1-36— Stakeholders in the financial reporting environment

Briefly describe the much-publicized subprime lending crisis in the United States, identify the stakeholders and how they were affected.

Solution 1-36

At the center of this issue were securitized mortgage assets that were sold to investors. These assets were based on mortgages that had been extended to high-risk borrowers who could no longer afford their mortgage payments once interest rates rose. This led to a flooding of the housing market as borrowers walked away from their houses (and debt). The primary stakeholders were the lenders, investors, borrowers and standard setters. Lenders (acting in their own self-interest) sold these investments to investors who may not have fully understood the high-risk nature of their investment. Borrowers lost their homes they could no longer afford, and standard setters were faced with a major blow to the public's confidence in the existing standards.

LEGAL NOTICE

CHAPTER 2

CONCEPTUAL FRAMEWORK UNDERLYING FINANCIAL REPORTING

MULTIPLE CHOICE—Conceptual

Answer	No.	Description
c	1.	GAAP defined.
d	2.	Purpose of conceptual framework.
d	3.	Objectives of financial reporting.
c	4.	Purpose of understandable information.
a	5.	Decision-usefulness criterion.
c	6.	Full disclosure principle.
b	7.	Definition of relevance.
b	8.	Comparability characteristic.
a	9.	Timeliness characteristic.
c	10.	Economic entity.
d	11.	Fair value principle
a	12.	Definition of a liability.
c	13.	Definition of a loss.
c	14.	Materiality constraint.
b	15.	Full disclosure principle.
c	16.	Quality of representational faithfulness.
d	17.	Comparability.
b	18.	Comparability.
a	19.	Principles based GAAP.
c	20.	Definition of an asset.
d	21.	Elements of financial statements.
c	22.	Distinction between revenues and gains.
c	23.	Definition of a loss.
b	24.	Principles-based GAAP.
b	25.	Components of comprehensive income.
d	26.	Economic entity assumption.
a	27.	Economic entity assumption.
b	28.	Periodicity assumption.
a	29.	Going concern assumption.
d	30.	Going concern assumption.
d	31.	Implications of going concern assumption.
a	32.	Historical cost principle.
d	33.	Historical cost principle.
d	34	Valuation model.
c	35.	Revenue recognition principle.
d	36.	Revenue recognition principle.

MULTIPLE CHOICE—Conceptual (cont.)

Answer	No.	Description
d	37.	Revenue recognition principle.
d	38.	Timing of revenue recognition.
a	39.	Definition of an asset.
a	40.	Matching principle.
b	41.	Matching principle.
b	42.	Matching principle.
b	43.	Expense recognition.
c	44.	Full-disclosure principle.
b	45.	Uncertainty constraint.
c	46.	Full disclosure.
b	47.	Full disclosure principle.
c	48.	Materiality constraint.
d	49.	Materiality.
c	50.	Fraudulent financial reporting.
d	51.	Representational faithfulness.
a	52.	Qualitative characteristics.
a	53.	Comparability characteristic
a	54.	Timeliness characteristic.
a	55.	Recognition of gains and losses.

EXERCISES

Item	Description
E2-56	Foundational principles.
E2-57	Fair value measurement.
E2-58	Accounting concepts—identification.
E2-59	Accounting concepts—identification.
E2-60	Accounting concepts—matching.
E2-61	Accounting concepts—fill in the blanks.
E2-62	Matching concept.
E2-63	Examination of the conceptual framework.
E2-64	Principles vs. rules based GAAP.
E2-65	Financial engineering.
E2-66	Fraudulent financial reporting

MULTIPLE CHOICE—Conceptual

1. Generally accepted accounting principles
   a. are fundamental truths or axioms that can be derived from laws of nature.
   b. derive their authority from legal court proceedings.
   c. derive their credibility and authority from general recognition and acceptance by the accounting profession.
   d. have been specified in detail in the CICA conceptual framework.

2. A soundly developed conceptual framework of concepts and objectives should
   a. increase financial statement users' understanding of and confidence in financial reporting.
   b. enhance comparability among companies' financial statements.
   c. allow new and emerging practical problems to be more quickly solvable.
   d. all of these.

3. Which of the following is *not* an objective of financial reporting?
   a. To provide information about an entity's economic resources, obligations and equity/net assets.
   b. To provide information that is helpful to investors and creditors and other users in making resource allocation decisions and/or assessing management stewardship.
   c. To provide information that is useful in assessing the economic performance of the entity.
   d. All of these are objectives of financial reporting.

4. Decision makers vary widely in the types of decisions they make, the methods of decision making they employ, the information they already possess or can obtain from other sources, and their ability to process information. Consequently, for information to be useful there must be a linkage between these users and the decisions they make. This link is
   a. relevance.
   b. reliability.
   c. understandability.
   d. materiality.

5. The overriding criterion by which accounting information can be judged is that of
   a. usefulness for decision making.
   b. freedom from bias.
   c. timeliness.
   d. comparability.

6. During a major renovation project of its head office, a worker was seriously injured. While the company believes that it was not at fault, it does include the incident in the notes to its financial statements. This is consistent with which of the following principles:
   a. Economic entity
   b. Control
   c. Full disclosure
   d. Periodicity

7. Accounting information is considered to be relevant when it
   a. can be depended on to represent the economic conditions and events that it is intended to represent.
   b. is capable of making a difference in a decision.
   c. is understandable by reasonably informed users of accounting information.
   d. is verifiable and neutral.

8. The adoption of international GAAP can be seen as an application of which of the following quality enhancing characteristics:
   a. Verifiability
   b. Comparability
   c. Understandability
   d. Timeliness

9. Enhancing qualitative characteristics are an essential part of the conceptual framework of accounting. These include, among others, timeliness. Which of the items below would be *most* indicative of timeliness?
   a. The preparation of quarterly financial statements
   b. The preparation of annual financial statements
   c. The large volume of data to be included.
   d. The choice of the best accounting principle

10. A local business man owns several different companies. His accountant prepares separate annual financial statements for each of these businesses. This is an application of which of the following principles:
   a. Full disclosure
   b. Periodicity
   c. Economic entity
   d. Matching

11. To measure the fair value of an asset, an entity should determine
   a. The asset's nature, condition and location
   b. The asset's valuation premise
   c. The availability of data
   d. All of the above

12. Under the currently proposed definition of a liability, what is the *most* important aspect to consider when deciding whether the item should be recognized as a liability?
   a. The item represents an economic obligation for which a present obligation exists
   b. The item is shown on the balance sheet
   c. The transaction underlying the obligation has occurred
   d. The item is measurable

13. Which of the following independent business transactions would *most* likely be recorded as an accounting loss?
    a. A decrease in a retail store's sales
    b. A decrease of a bank's interest income
    c. A decrease in net assets from a company's incidental transactions.
    d. All of the above

14. MAX Auto Repair has implemented a policy that requires all expenditures below $10 to be expensed. This is an application of
    a. The full disclosure principle
    b. The matching principle
    c. The materiality constraint
    d. Representational faithfulness

15. A severe cold snap may affect this year's crop of Florida's citrus growers. The potentially adverse affect is disclosed in the financial statements of the citrus growers. This practice can be *best* described as an application of
    a. The derecognition of financial statement elements
    b. The full disclosure principle
    c. The going concern assumption
    d. The economic entity assumption

16. Representational faithfulness is an ingredient of the primary quality of

	Reliability	Relevance
a.	Yes	Yes
b.	No	Yes
c.	Yes	No
d.	No	No

17. Financial information does *not* demonstrate comparability when
    a. firms in the same industry use different accounting methods to account for the same type of transaction.
    b. a company changes its estimate of the residual value of a fixed asset.
    c. a company fails to adjust its financial statements for changes in the value of the measuring unit.
    d. none of these.

18. Financial information exhibits the characteristic of comparability when
    a. expenses are reported as charges against revenue in the period in which they are paid.
    b. accounting entities give accountable events the same accounting treatment from period to period.
    c. extraordinary gains and losses are not included on the income statement.
    d. accounting procedures are adopted which give a consistent rate of net income.

19. A principles based approach to financial reporting standards generally does *not* exhibit ` the following:
    a. Specific rules
    b. Flexibility
    c. General guidance
    d. Room for a large degree of professional judgement

20. Which of the following items below does *not* meet the definition of an asset?
    a. A building owned and used by a company
    b. Equipment that is owned and used by a company
    c. Publicly available water used by a farm to water its crops
    d. None of the above

21. The elements of financial statements include investments by owners. These are increases in an entity's net assets resulting from owners'
    a. transfers of assets to the entity.
    b. rendering services to the entity.
    c. satisfaction of liabilities of the entity.
    d. all of these.

22. In classifying the elements of financial statements, the primary distinction between revenues and gains is
    a. the materiality of the amounts involved.
    b. the likelihood that the transactions involved will recur in the future.
    c. the nature of the activities that gave rise to the transactions involved.
    d. the costs versus the benefits of the alternative methods of disclosing the transactions involved.

23. A decrease in net assets arising from peripheral or incidental transactions is called a(n)
    a. capital expenditure.
    b. cost.
    c. loss.
    d. expense.

24. Principles-based GAAP is sometimes criticized for being
    a. Too *in*flexible.
    b. Too flexible
    c. Too inconsistent
    d. None of these

25. Which of the following elements of financial statements is *not* a component of comprehensive income?
    a. Revenues
    b. Distributions to owners
    c. Losses
    d. Expenses

26. The economic entity assumption
    a. is inapplicable to unincorporated businesses.
    b. recognizes the legal aspects of business organizations.
    c. requires periodic income measurement.
    d. is applicable to all forms of business organizations.

27. Preparation of consolidated financial statements when a parent-subsidiary relationship exists is an example of the
    a. economic entity assumption.
    b. relevance characteristic.
    c. comparability characteristic.
    d. neutrality characteristic.

28. During the lifetime of an entity, accountants produce financial statements at arbitrary points in time in accordance with which basic accounting concept?
    a. Cost/benefit relationship
    b. Periodicity assumption
    c. Conservatism constraint
    d. Matching principle

29. What accounting concept justifies the usage of accruals and deferrals?
    a. Going concern assumption
    b. Materiality constraint
    c. Consistency characteristic
    d. Monetary unit assumption

30. The assumption that a business enterprise will not be sold or liquidated in the near future is known as the
    a. economic entity assumption.
    b. monetary unit assumption.
    c. conservatism assumption.
    d. none of these.

31. Which of the following is an implication of the going concern assumption?
    a. The historical cost principle is credible.
    b. Amortization and amortization policies are justifiable and appropriate.
    c. The current-noncurrent classification of assets and liabilities is justifiable and significant.
    d. All of these.

32. Proponents of historical cost ordinarily maintain that in comparison with all other valuation alternatives for general purpose financial reporting, statements prepared using historical costs are more:
    a. reliable.
    b. relevant.
    c. indicative of the entity's purchasing power.
    d. conservative.

33. Valuing assets at their liquidation values rather than their cost is inconsistent with the
    a. periodicity assumption.
    b. matching principle.
    c. materiality constraint.
    d. historical cost principle.

34. The current mixed valuation model primarily ties the basis of valuation to
    a. the level of uncertainty.
    b. measurement reliability.
    c. the age of the asset.
    d. management intent with respect to the asset.

35. Revenue is generally recognized when performance is achieved and it is measurable and collectible. This statement describes the
    a. consistency characteristic.
    b. matching principle.
    c. revenue recognition principle.
    d. relevance characteristic.

36. Generally, revenue from sales should be recognized at a point when
    a. management decides it is appropriate to do so.
    b. the product is available for sale to the ultimate consumer.
    c. the entire amount receivable has been collected from the customer and there remains no further warranty liability.
    d. none of these.

37. Revenue generally should be recognized
    a. at the end of production.
    b. at the time of cash collection.
    c. when performance is achieved.
    d. when performance is achieved and the amount earned is measurable and collectible.

38. Which of the following is *not* a time when revenue may be recognized?
    a. At time of sale
    b. At receipt of cash
    c. During production
    d. All of these are possible times of revenue recognition.

39. Under the currently proposed definition of an asset, what is the most important aspect to consider when deciding whether the item should be recognized as an asset?
    a. The item represents a present economic resource to which the entity has a right
    b. The item is shown on the balance sheet
    c. The transaction underlying the resource has occurred
    d. The item is measurable

40. One of the principles of the conceptual framework is the matching principle. Which of the following is *not* a good example of that principle?
    a. A machine that produces certain goods is amortized over its useful life. The resulting amortization expense is matched with the proceeds from the sale of those goods.
    b. The entire two-year insurance premium is expensed in the first year.
    c. The write-off an uncollectible receivable in the year that the sale was made.
    d. The recognition of revenue for which associated expenses can not yet be determined is delayed until such determination can be made.

41. The allowance for doubtful accounts, which appears as a deduction from accounts receivable on a balance sheet and which is based on an estimate of bad debts, is an application of the
    a. consistency characteristic.
    b. matching principle.
    c. materiality constraint.
    d. revenue recognition principle.

42. The accounting principle of matching is best demonstrated by
    a. not recognizing any expense unless some revenue is realized.
    b. associating effort (expense) with accomplishment (revenue).
    c. recognizing prepaid rent received as revenue.
    d. establishing an Appropriation for Contingencies account.

43. Which of the following serves as the justification for the periodic recording of amortization expense?
    a. Association of efforts (expense) with accomplishments (revenue)
    b. Systematic and rational allocation of cost over the periods benefited
    c. Immediate recognition of an expense
    d. Minimization of income tax liability

44. Application of the full disclosure principle
    a. is theoretically desirable but not practical because the costs of complete disclosure exceed the benefits.
    b. is violated when important financial information is buried in the notes to the financial statements.
    c. is demonstrated by the inclusion of information such as information about contingencies.
    d. requires that the financial statements be consistent and comparable.

45. Where there is a significant uncertainty with respect to the measurement of an item
    a. do not record anything in the financial statements.
    b. recognize the item in the financial statements and disclose the measurement uncertainty in the notes to the financial statements.
    c. do not record anything in the financial statements and disclose the measurement uncertainty in the notes to the financial statements.
    d. record the maximum amount in the financial statements.

46. Management Discussion and Analysis (MD&A) is
   a. notes on meetings between management and auditors.
   b. internal documents not released to shareholders.
   c. supplementary information included in the annual report.
   d. supplementary information included in the notes to the financial statements.

47. The operations of a resource company's oil sands operations results in environmental damage. While the extent of the damage can not yet be determined, the situation is disclosed in its financial statements. This *best* demonstrates
   a. The application of professional judgement
   b. The full disclosure principle
   c. Representational faithfulness
   d. Good management stewardship

48. Charging off the cost of a wastebasket with an estimated useful life of 10 years as an expense of the period when purchased is an example of the application of the
   a. consistency characteristic.
   b. matching principle.
   c. materiality constraint.
   d. historical cost principle.

49. Which of the following statements about materiality is *not* correct?
   a. An item must make a difference or it need not be disclosed.
   b. Materiality is a matter of relative size or importance.
   c. An item is material if its inclusion or omission would influence or change the judgement of a reasonable person.
   d. All of these are correct statements about materiality.

50. Fraudulent financial reporting is a business reality. While it cannot be eliminated, the risk of fraudulent reporting can be decreased. Which of the following considerations is *least* likely to lessen that risk?
   a. An independent audit committee
   b. An internal audit function
   c. An increased focus on tying bonuses to short-term company performance
   d. Vigilant management

51. Information that is representationally faithful is
   a. Complete
   b. Neutral
   c. Free from material error or bias
   d. All of these

52. Which of the following *best* describes the importance of qualitative characteristics as part of the conceptual framework of financial reporting?
   a. Relevance and representational faithfulness must always be present.
   b. Representational faithfulness may be traded off.
   c. Timeliness is a fundamental qualitative characteristic.
   d. All of these

53. Schmidt Ltd. aims to improve the qualitative characteristics of its financial statements. Your assistant has presented you with options shown below. Which of those options would *most* likely improve the *comparability* of your company's financial statements?
    a. The restatement of its financial statements from Canadian GAAP to US GAAP for its American investors
    b. The preparation of monthly financial statements
    c. The introduction of a policy that specifies how Schmidt's capital assets should be amortized
    d. The use of foreign-trained accountants

54. You want to improve the qualitative characteristics of your firm's financial statements. Which of the following options would *most* likely improve the *timeliness* of your company's financial statements?
    a. To increase the frequency of issue from annually to quarterly
    b. To increase the number of disclosures
    c. To increase the amortization period for capital assets from 5 to years.
    d. To change the timing of when revenues are recognized

55. Gains and losses are based on whether they are related to an entity's major ongoing or central operations. These gains or losses may be related to

	Peripheral Activities	Use by Others of Resources
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

Multiple Choice Answers—Conceptual

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.
1.	c	9.	a	17.	d	25.	b	33.	d	41.	b	49.	d
2.	d	10.	c	18.	b	26.	d	34.	d	42.	b	50.	c
3.	d	11.	d	19.	a	27.	a	35.	c	43.	b	51.	d
4.	c	12.	a	20.	c	28.	b	36.	d	44.	c	52.	a
5.	a	13.	c	21.	d	29.	a	37.	d	45.	b	53.	a
6.	c	14.	c	22.	c	30.	d	38.	d	46.	c	54.	a
7.	b	15.	b	23.	c	31.	d	39.	a	47.	b	55.	a
8.	b	16.	c	24.	b	32.	a	40.	a	48.	c		

Solutions to those Multiple Choice questions for which the answer is "none of these."

17. a company changes its inventory method every few years in order to maximize reported income (other answers are possible).
20. comparability.
30. going concern assumption.
36. an exchange has taken place and the earnings process is virtually complete.

EXERCISES

Ex. 2-56 – Foundational principles.

Briefly explain the foundational principals of recognition, measurement and presentation/disclosure that underlie financial accounting.

Solution 2-56
These concepts help explain which, when, and how financial elements and events should be disclosed.
Recognition focuses on whether something should be included in a company's financial statements. It includes the principles of economic entity, control, revenue recognition and matching. Measurement relates to the "conversion" of information into numbers. It includes the principles of periodicity, monetary unit, going concern, historical cost and fair value. Presentation relates to the way of how (and how much) information is conveyed to the user. It includes the general practice of providing information that is important enough to influence an informed user's judgement and decisions.

Ex. 2-57- Fair Value Measurement
The ongoing trend toward using fair value has both critics and advocates. State and briefly explain arguments in favour and against the use of fair value.

Solution 2-57
Arguments in favour:
Fair values are current and therefore more relevant. The cost at which an asset is carried (using the cost at which was acquired, say, twenty years ago) may bear little resemblance to its current replacement cost.
Arguments against:
Fair values may be difficult to ascertain, especially when markets for the underlying assets do not exist. Fair values may subject financial statements to a significant degree of variability in volatile markets.

Ex. 2-58- Accounting principles - identification

State the accounting principle that is most applicable in the following situations:
1. A company prepares consolidated financial statements for a subsidiary company it owns.
2.The decision to remove an asset from the balance sheet.
3. A large sale on account is not recognized as revenue because collectability is at issue.
4. The disclosure of the liability from a lawsuit in the financial statements.
5. The preparation of monthly financial statements.
6. The use of the Canadian Dollar in the financial statements.
7. An energy company includes detailed information about its reserves in its notes to the financial statements.

Solution 2-58

1. Control or economic entity.
2. Derecognition.
3. Revenue recognition.
4. Full disclosure.
5. Periodicity.
6. Monetary unit
7. Full disclosure

Ex. 2-59—Accounting concepts—identification.

Presented below are a number of accounting procedures and practices in McEvoy Inc. For each of these items, list the assumption, principle, information characteristic, or modifying convention that is violated.

1. Because the company's income is low this year, a switch from accelerated amortization to straight-line amortization is made for the period.
2. The president of McEvoy Inc. believes it is foolish to report financial information on a yearly basis. Instead, the president believes that financial information should be disclosed only when significant new information is available related to the company's operations.
3. McEvoy Inc. decides to establish a large loss and related liability this year because of the possibility that it may lose a pending patent infringement lawsuit. The possibility of loss is considered remote by its attorneys.
4. An officer of McEvoy Inc. purchased a new home computer for personal use with company money, charging miscellaneous expense.
5. The company receives a payment that does *not* relate to its ordinary revenue-generating activities and records it as revenue.

Solution 2-59

1. Neutrality.
2. Periodicity.
3. Matching (also, conservatism).
4. Economic entity.
5. Financial Statement Elements

Ex. 2-60—Accounting concepts—matching.

Listed below are several information characteristics and accounting principles and assumptions. Match the letter of each with the appropriate phrase that states its application. (Items *a* through *k* may be used more than once or not at all.)

a. Economic entity assumption
b. Going concern assumption
c. Monetary unit assumption
d. Periodicity assumption
e. Historical cost principle
f. Revenue recognition principle
g. Matching principle
h. Full disclosure principle
i. Relevance characteristic
j. Reliability characteristic
k. Comparability characteristic

____ 1. Stable-dollar assumption (do not use historical cost principle).
____ 2. Earning process completed and realized or realizable.
____ 3. Presentation of error-free information with representational faithfulness.
____ 4. Yearly financial reports.
____ 5. Accruals and deferrals in adjusting and closing process. (Do not use going concern.)
____ 6. Useful standard measuring unit for business transactions.
____ 7. Notes as part of necessary information to a fair presentation.
____ 8. Affairs of the business distinguished from those of its owners.
____ 9. Business enterprise assumed to have a long life.
____10. Valuing assets at amounts originally paid for them.
____11. Application of the same accounting principles as in the preceding year.
____12. Summarizing significant accounting policies.
____13. Presentation of timely information with predictive and feedback value.

Solution 2-60

1. c	4. d	7. h	10. e	13. i
2. f	5. g	8. a	11. k	
3. j	6. c	9. b	12. h	

Ex. 2-61-Accounting concepts-fill in the blanks

Fill in the blanks below with the accounting term(s) that best completes each sentence.

1. A soundly developed conceptual framework is a __________ set of standards and rules. ____________ and ____________________ are the fundamental qualities that make accounting information useful for decision-making.

2. Enhancing qualitative characteristics include __________________________ and ____________________.

3. Liabilities have two essential characteristics. 1. They represent an __________________ and 2. the entity has a _______________________.

4. While consolidated financial statements are prepared from the perspective of the _____________, taxes are paid from the perspective of the _______________.

5. Collectability is one of the three conditions of the revenue recognition principle. Assuming the other two conditions are met, revenue should only be recognized if collectability is ______________________.

6. The __________________ stipulates that anything that is relevant to decisions should be included in the financial statements.

7. A company's Management Discussion and Analysis (MD&A) is an example of ____________________________.

8. A ____________- based approach as used in Canadian GAAP and IFRS is sometimes criticized for being too ________.

9. Under the _____________ principle, ___________ incurred during a particular period are matched with ___________ earned during that same period.

10. The ___________________ is based on the assumption that a business enterprise will continue to operate for the foreseeable future.

11. One of the assumptions of the ____________________ is the valuation at a particular point in time.

12. ______________ is defined as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

13. Standard setters have given companies the option to use ___________ instead of historical costs.

14. Good financial reporting should be based on ____________ and _______________analysis.

Solution 2-61

1. Coherent, relevance, representational faithfulness
2. Comparability, verifiability, timeliness, understandability
3. Economic burden or obligation, present enforceable obligation
4. Economic entity, legal entity
5. Reasonably assured
6. Full disclosure principle
7. Supplementary information
8. Principles, Flexible
9. Matching, expenses, revenues
10. Going concern assumption
11. Historical cost principle
12. Fair value
13. Fair value
14. Well-reasoned, supported

Ex. 2-62—Matching concept.

A concept is a group of related ideas. Matching could be considered a concept because it includes ideas related to both revenue recognition and expense recognition. Briefly explain the ideas in (a) revenue recognition and (b) expense recognition.

Solution 2-62

(a) The ideas in revenue recognition include the following:

1. Revenues are inflows of net assets from delivering or producing goods or services or other earning activities that are the major operations of an enterprise during a period.
2. Recognition is recording and reporting in the financial statements.
3. Revenues are *realized* when goods or services are exchanged for cash or claims to cash.
4. Revenues are *earned* when the earnings process is complete or virtually complete.

The revenue recognition principle is that revenue is recognized when performance is achieved (earned) and measurability and collectability are reasonably assured (realized/realizable).

Solution 2-62 (Continued)

(b) The ideas in expense recognition include "expense" and "matching":

1. Expenses are outflows of net assets during a period from delivering or producing goods or services or other activities that are the major operations of the entity.
2. Expenses are recognized when the goods or services (efforts) make their contribution to revenue.

The matching principle is that expenses are matched with revenues. Expenses are matched three ways:

1. When there is an association with revenue, expenses are matched with revenues in the period the revenues are recognized.
2. When no association with revenue is evident, expenses are allocated on some systematic and rational basis.
3. When no association with revenue is evident and no future benefits are expected, expenses are recognized immediately.

Ex. 2-63-Conceptual framework
Financial accounting and reporting is based on a conceptual framework. Discuss the purpose and usefulness of that framework.

Solution 2-63
To be useful, standard setting should be built on an established body of concepts and objectives. Having a soundly developed conceptual framework as their starting point, standard setters are then able to issue additional and consistent standards over time.

In the meantime, until additional standards have been issued, accountants can use the framework to solve new and emerging practical problems.

Ex. 2-64—Principles vs. rules based GAAP.

There has been much discussion about principles based standards versus rules based standards. Discuss the advantages and disadvantages of a principles based approach.

Solution 2-64

Advantages of a principles based approach:

a) decisions are based on the conceptual framework – so they should be consistent

b) flexibility – allows for making decisions about new or unusual transactions based on principles

c) allows accountants to use their professional expertise – professional judgement

Disadvantages of a principles based approach:

a) flexibility may result in reduced comparability between different firms

b) flexibility may be abused and bias may creep into decisions

Ex. 2-65—Financial Engineering.

Explain the practice of financial engineering and how it relates to fraudulent financial reporting.

Solution 2-65

Financial engineering is a process whereby a business arrangement or transaction is structured legally such that it meets the company's financial reporting objective within GAAP. This is often done by using complex legal arrangements and financial instruments. This produces a transaction or item that may have the form of one kind of transaction or item when the substance is something different. Enron was involved in many transactions of this type. Since the substance of these arrangements is to obscure the real nature of the transactions or items involved, they are potentially fraudulent.

Ex. 2-66 – Fraudulent financial reporting.

Identify several factors that contribute to fraudulent financial reporting.

Solution 2-66

1. Unrealistic internal budgets and financial statement focal points arising from contractual, regulatory, or capital market expectations.
2. Weak internal control and governance
3. Worsening economic conditions or industry.

LEGAL NOTICE

CHAPTER 3

THE ACCOUNTING INFORMATION SYSTEM

MULTIPLE CHOICE—Conceptual

Answer	No.	Description
d	1.	Purpose of an accounting system.
d	2.	Criteria for recording events.
c	3.	Purpose of trial balance.
b	4.	Trial balance
d	5.	Book of original entry.
a	6.	Transaction analysis.
a	7.	Definition of transaction.
c	8.	Event recording.
d	9.	Purpose of income summary account.
c	10.	Purpose of adjusting entries.
d	11.	Limitations of trial balance.
d	12.	Purpose of adjusting entries.
c	13.	Matching principle.
c	14.	Special journals.
b	15.	Special journals.
b	16.	Cash-basis of accounting.
d	17.	Definition of accrued expense.
c	18.	Adjusting entry for accrued expense.
d	19.	Factors to consider in estimating depreciation.
c	20.	Timing of financial statements.
d	21.	Effect of adjusting entries.
b	22.	Prepaid expense and the matching principle.
c	23.	Accrued revenue and the matching principle.
b	24.	Unearned revenue and the matching principle.
d	25.	Identification of a real account.
b	26.	Identification of a temporary account.
c	27.	Effect of understating ending inventory.
c	28.	Recordable transactions.
d	29.	Limitations of trial balance.
d	*30.	Identification of reversing entries.
d	*31.	Identification of reversing entries.

MULTIPLE CHOICE—Computational

Answer	No.	Description
b	32.	Determine adjusting entry.
a	33.	Determine adjusting entry.
d	34.	Determine adjusting entry.
c	35.	Adjusting entry for bad debts.
b	36.	Adjusting entry for bad debts.
b	37.	Unearned rent adjustment.
b	38.	Calculate cash received for interest.
b	39.	Calculate cash paid for salaries.
d	40.	Calculate cash paid for insurance.
c	41.	Calculate insurance expense.
c	42.	Calculate interest revenue.
c	43.	Calculate salary expense.
c	44.	Adjusting entry for interest receivable.
d	45.	Calculate property tax adjustment.
a	*46.	Determine reversing entry.
a	*47.	Determine year-end adjustment.

MULTIPLE CHOICE—CPA Adapted

Answer	No.	Description
c	48.	Determine accrued interest payable.
b	49.	Determine balance of unearned revenues.
b	50.	Calculate prepaid insurance.
c	51.	Determine interest receivable.
a	52.	Calculate sales adjustment.
b	53.	Calculate accrued salaries.
a	54.	Calculate royalty revenue.
a	55.	Calculate payroll adjustment.

*This topic is dealt with in an Appendix to the chapter.

EXERCISES

Item	Description
E3-56	Definitions.
E3-57	Terminology.
E3-58	Accrued and deferred items.
E3-59	Adjusting entries.
E3-60	Adjusting entries.
E3-61	Accrual basis.
E3-62	Accrual basis.
E3-63	Accrual basis.

PROBLEMS

Item	Description
*P3-64	Adjusting and reversing entries.
P3-65	Closing entries.
P3-66	Adjusting entries.
P3-67	Adjusting entries and account classifications.
P3-68	Adjusting entries.
P3-69	Adjusting and closing entries.
P3-70	Eight-column work sheet.
P3-71	Cash to accrual accounting.
P3-72	Accrual accounting.
P3-73	Multi step income statement
P3-74	Adjusting and closing entries
P3-75	Journal entry
P3-76	Trial balance correction

MULTIPLE CHOICE—Conceptual

1. Factors that shape an accounting information system include the
   a. nature of the business.
   b. size of the firm.
   c. volume of data to be handled.
   d. all of these.

2. Which of the following criteria must be met before an event or item should be recorded for accounting purposes?
   a. The event or item can be measured objectively in financial terms.
   b. The event or item is relevant and reliable.
   c. The event or item is an element.
   d. All of these must be met.

3. A trial balance
   a. is a list of accounts at a specific point in time.
   b. can be used for the preparation of financial statements.
   c. is best described by (a.) and (b.)
   d. is none of the above.

4. A *post*-closing trial balance.
   a. includes temporary accounts only.
   b. includes permanent accounts only.
   c. includes both temporary and permanent accounts.
   d. may include expenses.

5. An accounting record into which the essential facts and figures in connection with all transactions are initially recorded is called the
   a. ledger.
   b. account.
   c. trial balance.
   d. none of these.

6. The debit and credit analysis of a transaction normally takes place
   a. before an entry is recorded in a journal.
   b. when the entry is posted to the ledger.
   c. when the trial balance is prepared.
   d. at some other point in the accounting cycle.

7. An example of a transaction is
   a. the receipt of cash from a customer prior to performing the service.
   b. the recording of depreciation.
   c. the accrual of salaries owed.
   d. all of these.

8. Some events are *not* recorded in the accounting information system because
   a. the amounts are not material.
   b. the service has not been provided yet although the cash has been received.
   c. the problems measuring them are too complex.
   d. all of these.

9. The income summary account
   a. is used only at year-end.
   b. is used to record dividends.
   c. is used to bring temporary accounts to zero.
   d. is best described by (a) and (c).

10. Which of the following *best* describes adjustments:
    a. adjustments ensure proper matching.
    b. they are used to record external events.
    c. (a) and (d).
    d. they are usually prepared at the end of the accounting period.

11. A trial balance may prove that debits and credits are equal, but
    a. an amount could be entered in the wrong account.
    b. a transaction could have been entered twice.
    c. a transaction could have been omitted.
    d. all of these.

12. Adjusting entries are necessary to
    a. obtain a proper matching of revenue and expense.
    b. achieve an accurate statement of assets and equities.
    c. adjust assets and liabilities to their fair market value.
    d. both a and b.

13. Why are certain costs of doing business capitalized when incurred and then amortized over subsequent accounting cycles?
    a. To reduce the income tax liability
    b. To aid management in cash-flow analysis
    c. To match the costs of production with revenues as earned
    d. To adhere to the accounting constraint of conservatism

14. A payment that is *received* would most likely be recorded directly in that company's:
    a. general ledger.
    b. cash disbursements journal.
    c. cash receipts journal.
    d. trial balance.

15. A cheque that is *issued* would most likely be recorded directly in that company's:
    a. expense journal.
    b. cash disbursements journal.
    c. cash receipts journal.
    d. none of the above.

16. Consider a cheque received in payment for revenues that have not yet been earned. Assuming that company uses the *cash*-basis of accounting, how would that payment be recorded?
    a. it would be recorded as unearned revenue until it is actually earned.
    b. the entire amount would be recognized as revenue in the current period.
    c. it would be recorded as a prepaid expense.
    d. none of the above.

17. An accrued expense can best be described as an amount
    a. paid and currently matched with earnings.
    b. paid and not currently matched with earnings.
    c. not paid and not currently matched with earnings.
    d. not paid and currently matched with earnings.

18. If, during an accounting period, an expense item has been incurred and consumed but not yet paid for or recorded, then the end-of-period adjusting entry would involve
    a. a liability account and an asset account.
    b. an asset or contra-asset and an expense account.
    c. a liability account and an expense account.
    d. a receivable account and a revenue account.

19. Which of the following must be considered in estimating depreciation on an asset for an accounting period?
    a. The original cost of the asset
    b. Its useful life
    c. The decline of its fair market value
    d. Both the original cost of the asset and its useful life.

20. Which of the following statements *best* describes the frequency of when financial statements are issued?
    a. financial statements should only be issued at the end of the year.
    b. financial statements should only be issued quarterly.
    c. financial can be issued anytime during the year.
    d. none of the above.

21. Year-end net assets would be overstated and current expenses would be understated as a result of failure to record which of the following adjusting entries?
    a. Expiration of prepaid insurance
    b. Depreciation of long-lived assets
    c. Accrued wages payable
    d. All of these

22. A prepaid expense can best be described as an amount
    a. paid and currently matched with revenues.
    b. paid and not currently matched with revenues.
    c. not paid and currently matched with revenues.
    d. not paid and not currently matched with revenues.

23. An accrued revenue can best be described as an amount
   a. collected and currently matched with expenses.
   b. collected and not currently matched with expenses.
   c. not collected and currently matched with expenses.
   d. not collected and not currently matched with expenses.

24. An unearned revenue can best be described as an amount
   a. collected and currently matched with expenses.
   b. collected and not currently matched with expenses.
   c. not collected and currently matched with expenses.
   d. not collected and not currently matched with expenses.

25. Which of the following is a real (permanent) account?
   a. Goodwill
   b. Sales
   c. Accounts Receivable
   d. Both Goodwill and Accounts Receivable

26. Which of the following is a nominal (temporary) account?
   a. Unearned Revenue
   b. Salary Expense
   c. Inventory
   d. Retained Earnings

27. If the inventory account at the end of the year is understated, the effect will be to
   a. overstate the gross profit on sales.
   b. understate the net purchases.
   c. overstate the cost of goods sold.
   d. overstate the goods available for sale.

28. Which of the following items should be journalized?
   a. a letter advising an employee of a pay raise.
   b. a customer's pending bankruptcy (assuming an adequate allowance for doubtful accounts has already been set up).
   c. a customer's pending bankruptcy (assuming an adequate allowance for doubtful accounts has *not* already been set up).
   d. (a) and (b).

29. Below are several statements about the trial balance. Which of these statements is *not* correct?
   a. debits and credits must balance.
   b. the equality of credits and debits ensures that no errors were made.
   c. the post-closing trial balance includes temporary accounts only.
   d. (b) and (c).

*30. Adjusting entries that should be reversed include those for prepaid or unearned items that
   a. create an asset or a liability account.
   b. were originally entered in a revenue or expense account.
   c. were originally entered in an asset or liability account.
   d. create an asset or a liability account and were originally entered in a revenue or expense account.

*31. Adjusting entries that should be reversed include
   a. all accrued revenues.
   b. all accrued expenses.
   c. those that debit an asset or credit a liability.
   d. all of these.

Multiple Choice Answers—Conceptual

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.
1.	d	6.	a	11.	d	16.	b	21.	d	26.	b	*31.	d
2.	d	*7.	a	12.	d	17.	d	22.	b	27.	c		
3.	c	*8.	c	13.	c	18.	c	23.	c	28.	c		
4.	b	*9.	d	14.	c	19.	d	24.	b	*29.	d		
5.	d	10.	c	15.	b	20.	c	25.	d	*30.	d		

Solutions to those Multiple Choice questions for which the answer is “none of these.”

5. journal.

MULTIPLE CHOICE—Computational

32. Jackson Company made the annual lease payment of $9,000 for its fleet of delivery trucks. The payment was made on September 1, 2010 and covered the period September 1, 2010 to August 31, 2011. Assuming the entire amount had originally been charged to lease expense, the required adjustment on December 31, 2010 is
    a. debit lease expense and credit prepaid lease $6,000.
    b. debit prepaid lease and credit lease expense $6,000.
    c. debit prepaid lease and credit lease expense $9,000.
    d. debit lease expense and credit prepaid lease $9,000.

33. Penny Resources determines that it has not yet recorded the accrual for 2010 interest revenue to be received in 2011. Assuming the amount to be recorded for 2010 is $8,000, the required adjustment on December 31, 2010 is
    a. debit interest receivable and credit interest revenue $8,000.
    b. debit interest revenue and credit interest receivable $8,000.
    c. debit interest payable and credit interest revenue $8,000.
    d. no entry required.

34. Scott Company purchased equipment on November 1, 2010 and gave a 3-month, 9 percent note with a face value of $50,000. The December 31, 2010 adjusting entry is
    a. debit Interest Expense and credit Interest Payable, $4,500.
    b. debit Interest Expense and credit Interest Payable, $3,750.
    c. debit Interest Expense and credit Cash, $750.
    d. debit Interest Expense and credit Interest Payable, $750.

35. Blue Company's account balances at December 31, 2010 for Accounts Receivable and the related Allowance for Doubtful Accounts are $284,000 debit and $1,000 credit, respectively. From an aging of accounts receivable, it is estimated that $10,000 of the December 31 receivables will be uncollectible. The necessary adjusting entry would include a credit to the allowance account for
    a. $8,500.
    b. $10,000.
    c. $9,000.
    d. $1,000.

36. Breg Company's account balances at December 31, 2010 for Accounts Receivable and the Allowance for Doubtful Accounts are $860,000 debit and $1,200 credit. Sales during 2010 were $3,000,000. It is estimated that 2 percent of sales will be uncollectible. The adjusting entry would include a credit to the allowance account for
    a. $17,176
    b. $60,000.
    c. $17,200.
    d. $18,000.

37. Perez Corporation received cash of $12,000 on August 1, 2010 for one year's rent in advance and recorded the transaction with a credit to Rent Revenue. The December 31, 2010 adjusting entry is
    a. debit Rent Revenue and credit Unearned Rent, $5,000.
    b. debit Rent Revenue and credit Unearned Rent, $7,000.
    c. debit Unearned Rent and credit Rent Revenue, $5,000.
    d. debit Cash and credit Unearned Rent, $7,000.

Use the following information for questions 38 through 40:

The income statement of Carsen Corporation for 2010 included the following items:

Interest revenue	$75,500
Salaries expense	65,000
Insurance expense	9,600

The following balances have been excerpted from Carsen Corporation's balance sheets:

	December 31, 2010	December 31, 2009
Accrued interest receivable	$9,100	$7,500
Accrued salaries payable	8,900	4,200
Prepaid insurance	1,100	1,500

38. The cash received for interest during 2010 was
    a. $66,400.
    b. $73,900.
    c. $75,500.
    d. $77,100.
39. The cash paid for salaries during 2010 was
    a. $69,700.
    b. $60,300.
    c. $60,800.
    d. $73,900.

40. The cash paid for insurance premiums during 2010 was
    a. $8,500.
    b. $8,100.
    c. $10,000.
    d. $9,200.

Use the following information for questions 41 through 43:

Poole Company paid or collected during 2010 the following items:

Insurance premiums paid	$ 12,400
Interest collected	25,900
Salaries paid	125,200

The following balances have been excerpted from Poole's balance sheets:

	December 31, 2010	December 31, 2009
Prepaid insurance	$ 1,200	$ 1,500
Interest receivable	3,700	2,900
Salaries payable	12,300	10,600

41. The insurance expense on the income statement for 2010 was
    a. $9,700.
    b. $12,100.
    c. $12,700.
    d. $15,100.

42. The interest revenue on the income statement for 2010 was
    a. $19,300.
    b. $25,100.
    c. $26,700.
    d. $32,500.

43. The salary expense on the income statement for 2010 was
    a. $102,300.
    b. $123,500.
    c. $126,900.
    d. $148,100.

44. Perry Corporation loaned $78,000 to another corporation on December 1, 2010 and received a three-month, 9 percent interest-bearing note with a face value of $78,000. What adjusting entry should Rice make on December 31, 2010?
    a. Debit Interest Receivable and credit Interest Revenue, $900.
    b. Debit Cash and credit Interest Revenue, $585.
    c. Debit Interest Receivable and credit Interest Revenue, $585.
    d. Debit Cash and credit Interest Receivable, $1,755.

*45. Digger Oil & Gas has received its invoice in the amount of $85,000 for property taxes for the year 2010. The invoice was received and paid in June 2010 and the entire amount was debited to property tax expense. Assuming Digger does NOT prepare interim financial statements, the required adjustment on December 31, 2010 is
    a. debit property tax expense and credit prepaid property tax $49,583.
    b. debit prepaid property tax and credit property tax expense $49,583.
    c. debit property tax expense and credit prepaid property tax $35,417.
    d. no entry required.

46. At December 31, 2010, Patula Corporation has not yet received its December invoice for utilities. On December 31, 2010 it accrues an estimate of $10,000. On January 15, 2011 Patula receives the invoice in the amount of $11,000. Assuming the accrual had already been reversed, the entry on January 15, 2011 is
   a. debit utilities expense and credit cash $11,000.
   b. debit cash and credit utilities expense $11,000.
   c. debit utilities expense and credit cash $1,000.
   d. debit cash and credit utilities expense $1,000.

*47. On December 10, 2010 Copeta Inc. received a cheque in the amount of $50,000 from a customer for services that Copeta had yet to perform. By December 31, 2010 it had earned $20,000 of that amount. Assuming the appropriate year end adjustments were made, the 2010 balance in Copeta's unearned revenue account will be
   a. $30,000.
   b. $20,000.
   c. $50,000.
   d. Zero.

Multiple Choice Answers—Computational

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.
32.	b	35.	c	38.	b	41.	c	44.	c	47.	a
33.	a	36.	b	39.	b	42.	c	45.	d		
34.	d	37.	b	40.	d	43.	c	46.	a		

MULTIPLE CHOICE—CPA Adapted

48. On September 1, 2009 Calmex Corp. issued a note payable to National Bank in the amount of $900,000, bearing interest at 8 percent, and payable in three equal annual principal payments of $300,000. On this date, the bank's prime rate was 7 percent. The first payment for interest and principal was made on September 1, 2010. At December 31, 2010, Calmex should record accrued interest payable of
    a. $24,000.
    b. $21,000.
    c. $16,000.
    d. $14,000.

49. Denny Co. sells major household appliance service contracts for cash. The service contracts are for a one-year, two-year, or three-year period. Cash receipts from contracts are credited to Unearned Service Revenues. This account had a balance of $1,100,000 at December 31, 2010 before year-end adjustment. Service contract costs are charged as incurred to the Service Contract Expense account, which had a balance of $325,000 at December 31, 2010.

    Service contracts still outstanding at December 31, 2010 expire as follows:

During 2011	$170,000
During 2012	250,000
During 2013	110,000

    What amount should be reported as Unearned Service Revenues in Denny's December 31, 2010 balance sheet?
    a. $775,000.
    b. $530,000.
    c. $250,000.
    d. $325,000.

50. Fischer Consulting paid $18,000 on December 1, 2010 for a three-year insurance policy (December 1, 2010 to November 30, 2013) and recorded the entire amount as prepaid insurance. The December 31, 2010 adjustment should be recorded as follows:
    a. debit prepaid insurance and credit insurance expense $500.
    b. debit insurance expense and credit prepaid insurance $500.
    c. debit insurance expense and credit prepaid insurance $17,500.
    d. debit prepaid insurance and credit insurance expense $17,500.

51. On June 1, 2010, Mays Corp. loaned Farr $500,000 on a 12% note, payable in five annual instalments of $100,000 beginning January 2, 2011. In connection with this loan, Farr was required to deposit $6,000 in a non-interest-bearing escrow account. The amount held in escrow is to be returned to Farr after all principal and interest payments have been made. Interest on the note is payable on the first day of each month beginning July 1, 2010. Farr made timely payments through November 1, 2010. On January 2, 2011, Mays received payment of the first principal instalment plus all interest due. At December 31, 2010, Mays' interest receivable on the loan to Farr should be
a. $0.
b. $5,000.
c. $10,000.
d. $15,000.

52. Moreno Inc. reviews its December 31, 2010 unadjusted trial balance and determines that a sale in the amount of $15,000 had been incorrectly recorded as a debit to sales and a credit to receivables. The adjusting entry at December 31, 2010 is:
a. debit receivables and credit sales $30,000.
b. credit receivables and debit sales $30,000.
c. debit receivables and credit sales $15,000.
d. credit receivables and debit sales $15,000.

53. Cole Co. pays all salaried employees on a biweekly basis. Overtime pay, however, is paid in the next biweekly period. Cole accrues salaries expense only at its December 31 year end. Data relating to salaries earned in December 2010 are as follows:

Last payroll was paid on Dec/26/2010, for the two-week period ended Dec/26/2010.
Overtime pay earned in the two-week period ended Dec/26/2010 was $5,000.
Remaining work days in 2010 were December 29, 30, 31, on which days there was no overtime.
The recurring biweekly salaries total $80,000. Assuming a five-day work week, Cole should record a liability at December 31, 2010 for accrued salaries of
a. $24,000.
b. $29,000.
c. $48,000.
d. $53,000.

54. Meswell Corp.'s trademark was licensed to McCall Co. for royalties of 12 percent of sales of the trademarked items. Royalties are payable semi-annually on March 15 for sales in July through December of the prior year, and on September 15 for sales in January through June of the same year. Meswell received the following royalties from McCall:

	March 15	September 15
2009	$6,000	$8,000
2010	7,000	9,000

McCall estimated that sales of the trademarked items would total $75,000 for July through December 2010. In Meswell's 2010 income statement, the royalty revenue should be
a. $18,000.
b. $16,000.
c. $9,000.
d. $20,000.

55. The Controller of Cavendish Financial is reviewing her payroll accruals for December 2010. Salaries for the month of December amounted to $165,000 and will be paid on January 14, 2011. Assuming year end accruals were reversed on January 1, the entry to record the January 14 payment to employees is:
    a. debit salaries expense and credit cash $165,000.
    b. debit cash and credit salaries expense $165,000.
    c. debit accrued payables and credit cash $165,000.
    d. none of the above.

Multiple Choice Answers—CPA Adapted

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.
48.	c	50.	b	52.	a	54.	a
49.	b	51.	c	53.	b	55.	a

DERIVATIONS — Computational

No.	Answer	Derivation
32.	b	\$9,000 – (9,000 x 4/12) = \$6,000.
33.	a	
34.	d	2/12 × 9% × 50,000 = \$750.
35.	c	\$10,000 – \$1,000= \$9,000.
36.	b	\$3,000,000 × 2% = \$60,000.
37.	b	7/12 × \$12,000 = \$7,000.
38.	b	\$7,500 + \$75,500 – \$9,100 = \$73,900.
39.	b	\$4,200 + \$65,000 – \$8,900 = \$60,300.
40.	d	\$9,600 – \$1,500 + \$1,100 = \$9,200.
41.	c	\$12,400 + \$300 = \$12,700.
42.	c	\$25,900 – \$2,900 + \$3,700 = \$26,700.
43.	c	\$125,200 – \$10,600 + \$12,300 = \$126,900.
44.	c	1/12 × 9% × \$78,000 = \$585.
*45.	d	
46.	a	
*47.	a	\$50,000 - \$20,000 = \$30,000.

DERIVATIONS — CPA Adapted

No.	Answer	Derivation
48.	c	(\$900,000 – \$300,000) × 8% × 4/12 = \$16,000.
49.	b	\$170,000 + \$250,000 + \$110,000 = \$530,000.
50.	b	\$18,000 x 1/36 = \$500
51.	c	\$500,000 × 12% × 2/12 = \$10,000.
52.	a	\$15,000 + \$15,000 = \$30,000.
53.	b	\$5,000 + (\$80,000 ÷ 10 × 3) = \$29,000.
54.	a	\$9,000 + (\$75,000 × 12%) = \$18,000.
55.	a	

EXERCISES

Ex. 3-56—Definitions.

Define the following terms:

1. Special Journal
2. Work sheet
3. Permanent accounts
4. Temporary accounts
5. Income summary
6. General ledger

Solution 3-56

1. Special journals are used to record transactions that have similar characteristics. Examples include the cash receipts journal and the cash disbursements journal.
2. Work sheets are used as informal tools to help accountants prepare financial statements.
3. Permanent accounts (also called real accounts) are assets, liability and equity accounts. Unlike temporary accounts, permanent accounts are NOT closed.
4. Temporary accounts are revenue and expense accounts. Unlike permanent accounts, they are periodically closed.
5. The income summary is an account that is used as part of the closing process. It facilitates the closing of the temporary accounts at year end.
6. A general ledger is a collection of all accounts and may include subsidiary ledgers for specific accounts

Ex. 3-57 - The accounting cycle

Summarize the steps in the accounting cycle

Solution 3-57

The accounting cycle may be summarized in 9 steps as follows:

1. Journalization of current period's entries into journals
2. Posting of journals to the general ledger
3. Preparation of trial balance (unadjusted)
4. Preparation and posting of adjusting entries
5. Preparation of trial balance (adjusted)
6. Preparation of financial statements
7. Preparation and posting of closing entries
8. Preparation of trial balance (post-closing)
9. Preparation and posting of reversing entries

Ex. 3-58 - Recordable events

Before transactions are entered into a company's accounting system, the underlying event must be analyzed, to determine how (and if at all), it should be recorded. The situations below relate to Maxwell Corporation.

Required: indicate whether the items below are recordable events.

1. A new mortgage contract for its new factory building is signed.
2. The first mortgage payment is made.
3. Wages for the current month are paid.
4. A new secretary is hired.
5. Property taxes are paid.
6. GST collections for the current month are forwarded to the CRA.

Solution 3-58

1. Not recordable
2. Recordable
3. Recordable
4. Not recordable
5. Recordable
6. Recordable

Ex. 3-59—Adjusting entries.

Present, in journal form, the adjustments that would be made on July 31, 2010, the end of the fiscal year, for each of the following.

1. The supplies inventory on August 1, 2009 was $8,350. Supplies costing $16,650 were acquired during the year and charged to the supplies inventory. A count on July 31, 2010 indicated supplies on hand of $6,810.
2. On April 30, a ten-month, 8 percent note for $20,000 was received from a customer.
3. On March 1, $8,400 was collected as rent for one year and a nominal account was credited.

Solution 3-59

1.	Supplies Expense	18,190	
	Supplies Inventory		18,190
2.	Interest Receivable	400	
	Interest Revenue		400
3.	Rent Revenue	4,900	
	Unearned Revenue		4,900

Ex. 3-60—Adjusting entries.

Yago Co. wishes to enter receipts and payments in such a manner that adjustments at the end of the period will not require reversing entries at the beginning of the next period.

Instructions
Record the following transactions in the desired manner and give the adjusting entry on December 31, 2010. (Two entries for each part.)
1. An insurance policy for two years was acquired on April 1, 2010 for $4,800.
2. Rent of $4,200 for six months for a portion of the building was received on November 1, 2010.

Solution 3-60

1.	Unexpired Insurance	4,800	
	Cash		4,800
	Insurance Expense	1,800	
	Unexpired Insurance		1,800
2.	Cash	4,200	
	Unearned Rent		4,200
	Unearned Rent	1,400	
	Rent Revenue		1,400

Ex. 3-61—Accrual basis.

Sales salaries paid during 2010 were $90,000. Advances to salesmen were $1,300 on January 1, 2010, and $800 on December 31, 2010. Sales salaries accrued were $1,300 on January 1, 2010, and $1,400 on December 31, 2010.

Instructions
Show the calculation of sales salaries on an accrual basis for 2010.

Solution 3-61

$90,000 + $1,300 – $800 – $1,300 + $1,400 = $90,600.

Ex. 3-62—Accrual basis.

The records for Jay Inc. showed the following for 2010:

	Jan. 1	Dec. 31
Accrued expenses	$2,000	$3,600
Prepaid expenses	900	800

Cash paid during the year for expenses, $55,000.

Instructions
Show the calculation of the amount of expense that should be reported on the income statement.

Solution 3-62

$55,000 – $2,000 + $3,600 + $900 – $800 = $56,700.

Ex. 3-63—Accrual basis.

The records for Hanibal Company showed the following for 2010:

	Jan. 1	Dec. 31
Unearned revenue	$3,000	$3,400
Accrued revenue	1,400	1,100

Cash collected during the year for revenue, $85,000.

Instructions
Show the calculation of the amount of revenue that should be reported on the income statement.

Solution 3-63

$85,000 + $3,000 – $3,400 – $1,400 + $1,100 = $84,300

PROBLEMS

Pr. 3-64 - Adjusting entries.

The information shown below relates to Flegel Corporation. At December 31, 2010 Flegel's general ledger shows the following balances:

Prepaid lease	$6,000 Debit
Prepaid insurance	$900 Debit
Unearned revenue	$78,000 Credit

In addition, the following information is available:
1. The entire amount shown as prepaid lease has expired.
2. One third of the amount shown as prepaid insurance has expired.
3. Half of the amount shown as unearned revenue has now been earned.

Instructions
Prepare all adjusting entries that are required at December 31, 2010

Solution 3-64

	Debit	Credit
1. Lease Expense	6,000	
Prepaid Lease		6,000
2. Insurance Expense	300	
Prepaid Insurance		300
($900 x 1/3 = $300)		
3. Unearned Revenue	39,000	
Revenue		39,000
($78,000 x 1/2 = $39,000)		

Pr. 3-65 - Closing Entries

Below is a selection of account balances for Hausman Ltd. at December 31, 2010:

Sales	$856,000
Sales returns	$20,000
Cost of goods sold	$456,000
Advertising expense	$42,000
Salaries expense	$112,000
Depreciation expense	$29,000
Insurance expense	$9,000
Administrative expense	$10,000

Instructions

Prepare all necessary closing entries at December 31, 2010

Solution 3-65

Sales			856,000
Income summary		178,000	
Administrative expense		10,000	
Advertising expense		42,000	
Depreciation expense		29,000	
Cost of goods sold		456,000	
Insurance expense		9,000	
Salaries expense		112,000	
Sales returns		20,000	
Income summary	178,000		
Retained earnings		178,000	

Pr. 3-66—Adjusting entries.

Part I – The Maison Company has reported income of $400,000 for 2010, before considering the 5 items below. Prepare the adjusting entries needed at December 31, 2010 in order to correctly state the 2010 net income. If no entry is needed, write NONE.

1. Interest on a $19,500, 8 percent, six-year note payable was last paid on September 1, 2010.
2. On May 31, 2010, Maison entered into a contract to provide services to a customer for eighteen months beginning June 1. The customer paid the $16,000 fee in full on June 1 and Maison credited it to Service Revenue.
3. On August 1, 2010, Maison paid a year's rent in advance on a warehouse, and debited the $38,000 payment to Prepaid Rent.
4. Depreciation on office equipment for 2010 is $11,000.
5. On December 18, 2010, Maison paid the local newspaper $600 for an advertisement to be run in January of 2011, charging it to Prepaid Advertising.

Pr. 3-66—Adjusting entries (continued)

Part II – Show the effect of each adjusting entry in Part I on reported net income, and indicate the correct amount of net income.

Reported 2010 net income		$400,000
Add (deduct) Item	(1)	
	(2)	
	(3)	
	(4)	
	(5)	________
Correct 2010 net income		$______

Solution 3-66

Part I	1.	Interest Expense	520	
		Interest Payable		520
	2.	Service Revenue	9,778	
		Unearned Service Fees..........		9,778
	3.	Rent Expense..........	15,833	
		Prepaid Rent		15,833
	4.	Depreciation Expense	11,000	
		Accumulated Depreciation		11,000
	5.	None.		

Part II

Reported 2010 net income		$400,000
Add (deduct) Item	(1)	(520)
	(2)	(9,778)
	(3)	(15,833)
	(4)	(11,000)
	(5)	________
Correct 2010 net income		$362,869

Pr. 3-67—Adjusting entries and account classification.

Selected amounts from Edgemont Company's trial balance of Dec/31/2010 appear below:

1.	Accounts Payable	$ 180,000
2.	Accounts Receivable	160,000
3.	Accumulated Depreciation —Equipment	230,000
4.	Allowance for Doubtful Accounts	21,000
5.	Bonds Payable	550,000
6.	Cash	155,000
7.	Common Stock	63,000
8.	Equipment	850,000
9.	Insurance Expense	31,000
10.	Interest Expense	12,000
11.	Merchandise Inventory	290,000
12.	Notes Payable (due Jun/1/2011)	230,000
13.	Prepaid Rent	130,000
14.	Retained Earnings	120,000
15.	Salaries and Wages Expense	338,000

(All of the above accounts have their standard or normal debit or credit balance.)

<u>Part A.</u> Prepare adjusting journal entries at the year end, December 31, 2010, based on the following supplemental information.

a. The equipment has a useful life of ten years with no salvage value. (Straight-line method being used.)

b. Interest accrued on the bonds payable is $16,000 as of Dec/31/2010

c. Unexpired insurance at Dec/31/2010 is $9,000.

d. The rent payment of $130,000 covered the four months from November 30, 2010 through March 31, 2011.

e. Salaries and wages earned but unpaid at Dec/31/2010, $24,000.

<u>Part B.</u> Indicate the proper balance sheet classification of each of the 15 numbered accounts in the Dec/31/2010 trial balance *before adjustments* by placing appropriate numbers after each of the following classifications. If the account title would appear on the income statement, do not put the number in any of the classifications.

a. Current assets
b. Property, plant, and equipment
c. Current liabilities
d. Long-term liabilities
e. Shareholders' equity

Solution 3-67

Part A.

a. Depreciation Expense—Equipment	85,000	
Accumulated Depreciation —Equipment		85,000
b. Interest Expense	16,000	
Interest Payable		16,000
c. Prepaid (or Unexpired) Insurance	9,000	
Insurance Expense		9,000
d. Rent Expense	32,500	
Prepaid Rent		32,500
e. Salaries and Wages Expense	24,000	
Salaries and Wages Payable		24,000

Part B.

a. Current assets—2, 4, 6, 11, 13
b. Property, plant, and equipment—3, 8
c. Current liabilities—1, 12
d. Long-term liabilities—5
e. Shareholders' equity—7, 14

Pr. 3-68—Adjusting entries.

Data relating to the balances of various accounts affected by adjusting or closing entries appear below. (The entries, which caused the changes in the balances are not given.) You are asked to supply the missing journal entries, which would logically account for the changes in the account balances.

1. Interest receivable at Jan/1/2010 was $1,000. During 2010, cash received from debtors for interest on outstanding notes receivable amounted to $5,800. The 2010 income statement showed interest revenue in the amount of $4,900. You are to provide the missing adjusting entry that must have been made, assuming reversing entries are not made.

2. Unearned rent at Jan/1/2010 was $5,300 and at Dec/31/2010 was $6,000. The records indicate cash receipts from rental sources during 2010 amounted to $45,000, all of which was credited to the Unearned Rent Account. You are to prepare the missing adjusting entry.

3. Accumulated Depreciation —Equipment at Jan/1/2010 was $230,000. At Dec/31/010 the balance of the account was $280,000. During 2010, one piece of equipment was sold. The equipment had an original cost of $40,000 and was 3/4 depreciated when sold. You are to prepare the missing adjusting entry.

4. Allowance for doubtful accounts on Jan/1/2010 was $50,000. The balance in the allowance account on Dec/31/2010 after making the annual adjusting entry was $65,000 and during 2010 bad debts written off amounted to $30,000. You are to provide the missing adjusting entry.

5. Prepaid rent at Jan/1/2010 was $9,000. During 2010 rent payments of $110,000 were made and charged to "rent expense." The 2010 income statement shows as a general expense the item "rent expense" in the amount of $120,000. You are to prepare the missing adjusting entry that must have been made, assuming reversing entries are not made.

6. Retained earnings at Jan/1/2010 was $150,000 and at Dec/31/2010 it was $210,000. During 2010, cash dividends of $50,000 were paid and a stock dividend of $40,000 was issued. Both dividends were properly charged to retained earnings. You are to provide the missing closing entry.

Solution 3-68

1. Interest Receivable			100	
Interest Revenue				100
Interest revenue per books		$4,900		
Interest revenue received related to 2010 ($5,800 – $1,000)		4,800		
Interest accrued		$ 100		
2. Unearned Rent Revenue....................................			44,300	
Rent Revenue....................................				44,300
Cash receipts		$45,000		
Beginning balance		5,300		
Ending balance		(6,000)		
Rent revenue		$44,300		
3. Depreciation Expense			80,000	
Accumulated Depreciation —Equipment....................				80,000
Ending balance		$280,000		
Beginning balance		230,000		
Difference		50,000		
Write-off at time of sale 3/4 × $40,000		30,000		
		$ 80,000		
4. Bad Debt Expense			45,000	
Allowance for Doubtful Accounts				45,000
Ending balance		$65,000		
Beginning balance		50,000		
Difference		15,000		
Written off		30,000		
		$45,000		
5. Rent Expense....................................			10,000	
Prepaid Rent....................................				10,000
Rent expense		$120,000		
Less cash paid		110,000		
Reduction in prepaid rent account		$ 10,000		
6. Income Summary			150,000	
Retained Earnings				150,000
Ending balance		$210,000		
Beginning balance		150,000		
Difference		60,000		
Cash dividends	$50,000			
Stock dividends	40,000	90,000		
		$150,000		

Pr. 3-69—Adjusting and closing entries.

The following trial balance was taken from the books of Caslup Corporation on December 31, 2010.

Account	Debit	Credit
Cash	$ 40,000	
Accounts Receivable	108,000	
Note Receivable	8,000	
Allowance for Doubtful Accounts		$ 1,800
Merchandise Inventory	54,000	
Unexpired Insurance	4,800	
Furniture and Equipment	138,000	
Accumulated Depreciation of F. & E.		15,000
Accounts Payable		10,800
Common Stock		44,000
Retained Earnings		65,000
Sales		410,000
Cost of Goods Sold	128,000	
Salaries Expense	53,000	
Rent Expense	12,800	
Totals	$546,600	$546,600

At year end, the following items have not yet been recorded.

a. Insurance expired during the year, $3,000.
b. Estimated bad debts, 1 percent of gross sales.
c. Depreciation on furniture and equipment, 10% per year.
d. Interest at 9 percent is receivable on the note for one full year.
e. Rent paid in advance at December 31, $6,800 (originally charged to expense).
f. Accrued salaries at December 31, $6,200.

Instructions

(a) Prepare the necessary adjusting entries.
(b) Prepare the necessary closing entries.

Solution 3-69

(a) Adjusting Entries

		Debit	Credit
a.	Insurance Expense	3,000	
	Unexpired Insurance		3,000
b.	Bad Debt Expense	4,100	
	Allowance for Doubtful Accounts		4,100
c.	Depreciation Expense	13,800	
	Accumulated Depreciation of F. & E.		13,800
d.	Interest Receivable	720	
	Interest Revenue		720
e.	Prepaid Rent	6,800	
	Rent Expense		6,800
f.	Salaries Expense	6,200	
	Salaries Payable		6,200

Solution 3-69 (Continued)

(b) Closing Entries

Sales	410,000	
Interest Revenue	720	
Income Summary		410,720
Income Summary	214,100	
Salaries Expense		59,200
Rent Expense		6,000
Depreciation Expense		13,800
Bad Debt Expense		4,100
Insurance Expense		3,000
Cost of Goods Sold		128,000
Income Summary	196,620	
Retained Earnings		196,620

Pr. 3-70—Eight-column work sheet.

The trial balance of Santos Corporation is reproduced on the following page. The information below is relevant to the preparation of adjusting entries needed to both properly match revenues and expenses for the period and reflect the proper balances in the real and nominal accounts.

Instructions

As the accountant for Santos Corporation, you are to prepare adjusting entries based on the following data, entering the adjustments on the work sheet and completing the additional columns with respect to the income statement and balance sheet. Carefully key your adjustments and label all items. (Due to time constraints, an adjusted trial balance is not required.) Round all calculations to the nearest dollar.

(a) After an aging of accounts receivable, it was determined that three percent of the accounts will become uncollectible.

(b) Depreciation is calculated using the straight-line method, with an eight-year life and $1,000 salvage value.

(c) Salesmen are paid commissions of 11 percent of sales. Commissions on sales for the last week of December have not been paid.

(d) The note was issued on October 1, bearing interest at 8 percent, due Feb. 1, 2011.

(e) A physical inventory of supplies indicated $280 of supplies currently in stock.

(f) Provisions of a lease contract specify payments must be made one month in advance, with monthly payments at $900/mo. This provision has been complied with as of Dec. 31, 2010.

Santos Corporation
Work Sheet
December 31, 2010

	Trial Balance		Adjustments		Income Statement		Balance Sheet	
Accounts	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Cash	5,400							
Marketable Securities	4,050							
Accounts Receivable	40,000							
Allow. for D. A.		420						
Mdse. Inventory	16,800							
Supplies	1,040							
Equipment	49,000							
Accum. Depr.–Equip.		9,500						
Accounts Payable		4,400						
Notes Payable		4,250						
Common Stock		40,000						
Retained Earnings		25,340						
Cost of Goods Sold	238,520							
Office Salaries	20,800							
Sales Commissions	29,000							
Rent Expense	7,200							
Misc. Expense	2,200							
Sales		330,100						
Totals	414,010	414,010						

Solution 3-70

Santos Corporation
Work Sheet
December 31, 2010

Accounts	Trial Balance Dr.	Trial Balance Cr.	Adjustments Dr.	Adjustments Cr.	Income Statement Dr.	Income Statement Cr.	Balance Sheet Dr.	Balance Sheet Cr.
Cash	5,400						5,400	
Marketable Securities	4,050						4,050	
Accounts Receivable	40,000						40,000	
Allow. for D. A.		420		(a) 780				1,200
Mdse. Inventory	16,800						16,800	
Supplies	1,040			(e) 760			280	
Equipment	49,000						49,000	
Accum. Depr.–Equip.		9,500		(b) 6,000				15,500
Accounts Payable		4,400						4,400
Notes Payable		4,250						4,250
Common Stock		40,000						40,000
Retained Earnings		25,340						25,340
Cost of Goods Sold	238,520				238,520			
Office Salaries	20,800				20,800			
Sales Commissions	29,000		(c) 7,311		36,311			
Rent Expense	7,200			(f) 900	6,300			
Misc. Expense	2,200				2,200			
Sales		330,100				330,100		
Totals	414,010	414,010						
Bad Debt Expense			(a) 780		780			
Depr. Expense			(b) 6,000		6,000			
Sales Com. Payable				(c) 7,311				7,311
Interest Expense			(d) 85		85			
Interest Payable				(d) 85				85
Supplies Expense			(e) 760		760			
Prepaid Rent			(f) 900				900	
Totals			15,836	15,836	311,756	330,100	116,430	98,086
Net Income					18,344			18,344
Totals					330,100	330,100	116,430	116,430

Adjusting entries and explanations

(a) Bad Debt Expense	780	
Allowance for Doubtful Accounts		780

(3% of accounts receivable is 3% × $40,000, which is $1,200. Since the allowance account has a credit balance of $420 before adjustment, $780 must be added to the allowance account.)

(b) Depreciation Expense	6,000	
Accumulated Depreciation—Equipment		6,000

($49,000 – $1,000 is $48,000. One-eighth of $48,000 is $6,000.)

Solution 3-70 (Continued)

(c) Sales Commissions	7,311	
Sales Commissions Payable		7,311
(11% of sales is 11% × \$330,100, which is \$36,311. The balance in the Sales Commissions account is \$29,000 before adjustment, indicating that \$7,311 of commissions are accrued but unpaid.)		
(d) Interest Expense	85	
Interest Payable		85
(\$4,250 × .08 × 3/12 = \$85)		
(e) Supplies Expense	760	
Supplies		760
(The balance of \$1,040 in the Supplies account before adjustment less the correct ending balance of \$280 is \$760.)		
(f) Prepaid Rent	900	
Rent Expense		900
(Since the trial balance contains no account for prepaid rent, the \$900 lease payment has apparently been debited to Rent Expense. An account must be set up for the Prepaid Rent.)		

Pr. 3-71—Cash to accrual accounting.

The following information is available for Wand Corporation's first year of operations:

Payment for merchandise purchases	\$300,000
Ending merchandise inventory	105,000
Accounts payable (balance at end of year)	60,000
Collections from customers	270,000

The balance in accounts payable relates only to merchandise purchases. All merchandise items were marked to sell at 40 percent above cost. What should be the ending balance in accounts receivable, assuming all accounts are deemed collectible?

Solution 3-71

Since this is the first year of operations and there were $270,000 of accounts receivable collected, one must calculate total sales to determine the ending balance in accounts receivable. Cost of goods sold is $255,000 assuming the accounts payable are for inventory (the $300,000 constitutes only payments made for purchases). Since the markup is 40 percent on cost, the sales are $357,000 ($255,000 × 140%). Sales of $357,000 less collections of $270,000 results in an ending accounts receivable balance of $87,000 as calculated below.

Cash purchases	$300,000
A/P balance	60,000
Total purchases	360,000
Ending inventory	105,000
Cost of goods sold	255,000
	× 140%
Sales	357,000
Less collections	270,000
Ending A/R	$ 87,000

Pr. 3-72—Accrual accounting.

Andros Company's records provide the following information concerning certain account balances and changes in these account balances during the current year. Transaction information is missing from each item below.

Instructions
Prepare the *entry* to record the missing information for each account. (Consider each independently.)

1. Accounts Receivable: Jan. 1, balance $40,000, Dec. 31, balance $45,000, uncollectible accounts written off during the year, $6,000; accounts receivable collected during the year, $134,000. Prepare the entry to record sales.
2. Allowance for Doubtful Accounts: Jan. 1, balance $2,400, Dec. 31, balance $7,500, uncollectible accounts written off during the year, $30,000. Prepare the entry to record bad debt expense.
3. Accounts Payable: Jan. 1, balance $20,000, Dec. 31, balance $33,000, purchases on account for the year, $110,000. Prepare the entry to record payments on account.
4. Interest Receivable: Jan. 1 accrued, $1,000, Dec. 31 accrued, $2,100, earned for the year, $20,000. Prepare the entry to record cash interest received.

Solution 3-72

1.

Ending balance	$ 45,000		Ending balance	$ 45,000
Beginning balance	40,000		Plus: Rec. collected	134,000
Difference	5,000		Write-offs	6,000
Uncollectible accounts	6,000	OR		185,000
Receivables collected	134,000		Less: Beginning balance	40,000
Sales for period	$145,000		Sales for period	$145,000

Accounts Receivable	145,000	
Sales		145,000

2.

Ending balance	$ 7,500		Ending balance	$ 7,500
Beginning balance	2,400		Write-off	30,000
Difference	5,100	OR		37,500
Write-off	30,000		Beginning balance	2,400
Adjusting entry	$35,100		Adjusting entry	$35,100

Bad Debts Expense	35,100	
Allowance for Doubtful Accounts		35,100

3.

Ending balance	$ 33,000		Beginning balance	$ 20,000
Beginning balance	20,000		Plus purchases	110,000
Difference	13,000	OR		130,000
Purchases	110,000		Less ending balance	33,000
Payments	$ 97,000		Payments	$ 97,000

Accounts Payable	97,000	
Cash		97,000

4.

Revenue Earned	$20,000		Beginning balance	$ 1,000
Less: Dec. 31 accrual	(2,100)		Plus revenue earned	20,000
Plus: Jan. 1 accrual	1,000	OR		21,000
Cash received	$18,900		Less ending balance	2,100
			Cash received	$18,900

Cash	18,900	
Interest Receivable		18,900

(This entry assumes that the $20,000 interest earned was first recorded as a receivable.)

Pr. 3-73 Multi-step Income Statement

Use the following information to prepare a Multi-step Income Statement, a statement of retained earnings and a classified balance sheet as of December 31, 2010.

Adjusted Trial Balance

Trimaine Charles Corporation
Adjusted Trial Balance
December 31st, 2010

	Debit	Credit
Cash	$ 33,400	
Accounts Receivable	87,400	
Merchandise Inventory	90,000	
Store Supplies	7,000	
Store Equipment	170,000	
Accumulated Depreciation – Store Equipment		54,000
Delivery Equipment	96,000	
Accumulated Depreciation -Delivery Equipment		26,000
Notes Payable		82,000
Accounts Payable		117,000
Common Shares		200,000
Retained Earnings		16,000
Sales		1,494,400
Sales Return and Allowances	8,400	
Cost of Goods Sold	994,800	
Salaries Expense	280,000	
Advertising Expense	52,800	
Utilities Expense	28,000	
Repair Expense	24,200	
Delivery Expense	33,400	
Rent Expense	48,000	
Store Supplies Expense	4,000	
Depreciation Expense Store Equipment	18,000	
Depreciation Expense Delivery Equipment	14,000	
Interest Expense	22,000	
Interest Payable		22,000
Totals	2,011,400	2,011,400

Other Data:

1. Salaries expense is 70% selling and 30% administrative.
2. Rent expense and utilities expense are 80% selling and 20% administrative.
3. $60,000 of notes payable are due for payment next year.
4. Repair expense is 100% administrative.

Solutions 3-73

TRIMAINE CHARLES CORPORATION.
Income Statement
For the Year Ended December 31, 2010

Sales revenue			
Sales			$1,494,400
Less: Sales returns and allowances			8,400
Net sales			1,486,000
Cost of goods sold			994,800
Gross profit			491,200
Operating expenses			
Selling expenses			
Salaries expense ($280,000 x 70%)	$196,000		
Advertising expense	52,800		
Rent expense ($48,000 x 80%)	38,400		
Delivery expense	33,400		
Utilities expense ($28,000 x 80%)	22,400		
Depr. exp.—store equipment	18,000		
Depr. exp.—delivery equipment	14,000		
Stores supplies expense	4,000		
Total selling expenses		$379,000	
Administrative expenses			
Salaries expense ($280,000 x 30%)	84,000		
Repair expense	24,200		
Rent expense ($48,000 x 20%)	9,600		
Utilities expense ($28,000 x 20%)	5,600		
Total admin. expenses		123,400	
Total operating. expenses			502,400
Loss from operations			11,200
Other expenses and losses			
Interest expense			22,000
Net loss			$33,200

Solution 3-73 (Continued)

TRIMAINE CHARLES CORPORATION.
Retained Earnings Statement
For the Year Ended December 31, 2010

Retained Earnings, January 1, 2010	$16,000
Less: Net loss	33,200
Deficit, December 31, 2010	($17,200)

TRIMAINE CHARLES CORPORATION.
Balance Sheet
December 31, 2010

Assets

Current assets			
Cash			$ 33,400
Accounts receivable			87,400
Merchandise inventory			90,000
Store supplies			7,000
Total current assets			217,800
Property, plant, and equipment			
Store equipment	$170,000		
Accumulated depreciation—store equipment	54,000	$116,000	
Delivery equipment	96,000		
Accumulated depreciation—delivery equipment	26,000	70,000	186,000
Total assets			$403,800

Liabilities and Shareholders' Equity

Current liabilities		
Current portion of notes payable		$ 60,000
Accounts payable		117,000
Interest payable		22,000
Total current liabilities		199,000
Long-term liabilities		
Notes payable		22,000
Total liabilities		221,000
Shareholders' equity		
Common Shares	$200,000	
Deficit	(17,200)	182,800
Total liabilities and shareholders' equity		$403,800

Pr. 3-74 Adjusting and Closing Entries

(i) Using the adjusted Trial Balance of Trimaine Charles Corporation above, journalize the adjustments that were made.

(ii) Using the adjusted Trial Balance of Trimaine Charles Corporation above, journalize the closing entries that are necessary.

Solutions 3-74

(i)	Store Supplies Expense	4,000	
	Store Supplies		4,000
	Depr. Expense—Store Equipment	18,000	
	Accumulated Depreciation—Store Equipment		18,000
	Depr. Expense—Delivery Equipment	14,000	
	Accumulated Depreciation—Delivery Equipment		14,000
	Interest Expense	22,000	
	Interest Payable		22,000
(ii)	Sales	1,494,400	
	Income Summary		1,494,400
	Income Summary	1,527,600	
	Sales Returns and Allowances		8,400
	Cost of Goods Sold		994,800
	Salaries Expense		280,000
	Advertising Expense		52,800
	Utilities Expense		28,000
	Repair Expense		24,200
	Delivery Expense		33,400
	Rent Expense		48,000
	Store Supplies Expense		4,000
	Depreciation Expense—Store Equipment		18,000
	Depreciation Expense—Delivery Equipment		14,000
	Interest Expense		22,000
	Retained Earnings	33,200	
	Income Summary		33,200

Pr. 3-75 Journal Entries

Jonathan Green owns Green Palms, a gardening centre (as a sole proprietorship). His first year of operations included the following selected events and transactions:

January:
1. He invested $400,000 in his business.
2. He buys a greenhouse for $200,000 cash.

May:

3. He hires a greenhouse supervisor at an annual salary of $40,000.

June:

4. He orders and pays for a shipment of plants in the amount of $110,000.
5. He sells plants in the amount of $50,000. Half of these sales are made on account.

August:

6. He receives a deposit in the amount of $7,000 from a customer to put merchandise "on hold".
7. He pays current month's salaries in the amount of $4,000.

Instructions
Prepare all required journal entries.

Solution 3-75

		Debit	Credit
1.	Cash	400,000	
	Jonathan Green, Capital		400,000
2.	Building	200,000	
	Cash		200,000
3.	No entry required.		
4.	Inventories	110,000	
	Cash		110,000
5.	Cash	25,000	
	Accounts Receivable	25,000	
	Sales		50,000
6.	Cash	7,000	
	Unearned Revenue		7,000
7.	Salaries Expense	4,000	
	Cash		4,000

Pr. 3-76 - Trial balance correction

James, the Controller of SHD Corporation, asks his assistant to correct the company's December 31, 2010 trial balance.

The preliminary trial balance, which does not balance, is reproduced below:

SHD Corporation
Trial Balance
December 31, 2010

	Debit	Credit
Cash	10,000	
Accounts Receivable	15,000	
Prepaid Insurance	600	
Equipment	40,000	
Inventories	9,000	
Accounts Payable		11,590
Common Shares		110,000
Sales		17,100
Salaries	64,000	
Office Supplies	2,150	
Depreciation Expense	2,550	
	143,300	138,690

The assistant's review uncovered the following errors:

1. The accounts payable for the purchase of inventories in the amount of $6,560 was recorded as $5,650 in error.
2. Depreciation expense was understated by $450
3. Office supplies were overstated by $150
4. A collection from a customer in the amount of $4,000 was not posted to the receivable ledger

Instructions
Prepare a corrected trial balance:

Solution 3-76

SHD Corporation
Trial Balance
December 31, 2010

	Debit	Credit
Cash	10,000	
Accounts Receivable ($15,000 - $4,000)	11,000	
Prepaid Insurance	600	
Equipment	40,000	
Inventories	9,000	
Accounts Payable		12,500
Common Shares ($11,590 + $6,560 - $5,650)		110,000
Sales		17,100
Salaries	64,000	
Office Supplies ($2,150 - $150)	2,000	
Depreciation Expense ($2,550 + $450)	3,000	
	139,600	139,600

LEGAL NOTICE

CHAPTER 4

REPORTING FINANCIAL PERFORMANCE

MULTIPLE CHOICE—Conceptual

Answer	No.	Description
c	1.	Business model activities
d	2.	Business model activities and the income statement
a	3.	Transparency concept
b	4.	Soft numbers concept
d	5.	Earnings management
c	6.	Elements of the income statement.
d	7.	Usefulness of the income statement.
d	8.	Methods of preparing income statements.
b	9.	Single-step income statement.
b	10.	Limitations of the income statement.
a	11.	Income statement presentation.
b	12.	Event with no income statement effect.
d	13.	Reporting of irregular items.
d	14.	Intraperiod tax allocation.
a	15.	Presentation of expenses.
d	16.	Presentation of expenses.
b	17.	The concept of comprehensive income.
b	18.	Balance sheet items.
d	19.	Identification of a change in accounting principle.
d	20.	Disclosure of a change in accounting principle.
c	21.	EPS disclosures on income statement.
c	22.	Reporting discontinued operations.
d	23.	Comprehensive income and equity changes
d	24.	Intraperiod tax allocation.
d	25.	Purpose of intraperiod tax allocation.
c	26.	Retained earnings statement.
d	27.	Prior period adjustment.
d	28.	Identification of a prior period adjustment.
c	29.	Comprehensive income items.
b	30.	Planned IASB changes to financial statement presentation.
c	31.	Identification of separate segment for discontinued operations
c	32.	Other comprehensive income
a	33.	Accumulated other comprehensive income
d	34.	Classification of assets.
a	35.	The statement of changes in shareholder’s equity.

MULTIPLE CHOICE—Computational

Answer	No.	Description
d	36.	Calculation of net sales.
c	37.	Adjustment of income for loss.
c	38.	Calculate income using retained earnings.
a	39.	Effect of prior period adjustments on income.
c	40.	Effects of accounting errors.
a	41.	Effects of accounting errors.
a	42.	Effect of ending inventory and depreciation overstatement.
c	43.	Calculate error in retained earnings.
b	44.	Calculate error in current assets.
a	45.	Change in depreciation method.
d	46.	Events affecting income from continuing operations.
c	47.	Calculation of events affecting net income.
a	48.	Calculate balance of retained earnings.
c	49.	Disposal of a major business segment.
c	50.	Calculate other income on multiple step income statement.
d	51.	Calculate loss on discontinued operation.
b	52.	Calculate total purchases.
d	53.	Calculate cost of goods sold.

MULTIPLE CHOICE—CPA Adapted

Answer	No.	Description
d	54.	Calculate selling expenses.
a	55.	Calculate general and administrative expenses.
a	56.	Calculate selling expenses.
c	57.	Calculate general and administrative expenses.
b	58.	Calculate cost of goods manufactured.
d	59.	Calculate income from continued operations
b	60.	Calculate income from discontinued operations.
a	61.	Calculate net income.
a	62.	Determine infrequent losses not extraordinary.
b	63.	Identification of prior period adjustment.
b	64.	Difference between cash basis and accrual method.
b	65.	Determine cash basis revenue.
b	66.	Determine accrual basis revenue.
d	67.	Calculate cost of goods sold.

EXERCISES

Item	Description
E4-68	Definitions.
E4-69	Terminology.
E4-70	Income statement disclosures.
E4-71	Calculate net income from change in shareholders' equity.
E4-72	Calculate net income from change in shareholders' equity.
E4-73	Income statement classifications.
E4-74	Income statement relationships.
E4-75	Multiple-step income statement.
E4-76	Effects of accounting errors.
E4-77	Classification of income and retained earnings statement items.
E4-78	Cash basis.
E4-79	Characteristics of high quality earnings

PROBLEMS

Item	Description
P4-80	Income statement form.
P4-81	Multiple-step income statement.
P4-82	Multiple-step income statement.
P4-83	Single-step income statement.
P4-84	Income statement and retained earnings statement.
P4-85	Multiple-step income statement.
P4-86	Accrual accounting.
P4-87	Discontinued Operations

MULTIPLE CHOICE—Conceptual

1. The business model may be broken up into three activities:
   a. investing, operating, allocating.
   b. balance sheet, income statement, cash flow statement.
   c. investing, operating, financing.
   d. balance sheet, income statement, retained earnings statement.

2. The income statement strives to capture the
   a. financing activities.
   b. investing activities.
   c. interrelationship between the activities.
   d. operating activities.

3. The concept of transparency mandates that the financial statements
   a. reflect the economic reality of running a business.
   b. reflect everything no matter how small.
   c. reflect the biases of the managers.
   d. all of the above.

4. The concept of 'soft numbers' reflects that
   a. financial statement numbers may be manipulated.
   b. sometimes significant measurement uncertainty exists.
   c. sometimes significant errors exist.
   c. earnings numbers may not be sustainable.

5. Earnings management is
   a. the process of managing a business.
   b. the process of profit maximization.
   c. always fraudulent.
   d. manipulating income to meet a targeted earnings level.

6. The major elements of the income statement are
   a. revenue, cost of goods sold, selling expenses, and general expense.
   b. operating section, non-operating section and discontinued operations.
   c. revenues, expenses, gains, and losses.
   d. all of these.

7. Information in the income statement helps users to
   a. evaluate the past performance of the enterprise.
   b. provide a basis for predicting future performance.
   c. help assess the risk or uncertainty of achieving future cash flows.
   d. all of these.

8. Which of the following is an acceptable method of presenting the income statement?
   a. A single-step income statement
   b. A multiple-step income statement
   c. A consolidated statement of income
   d. All of these

9. The single-step income statement emphasizes
   a. the gross profit figure.
   b. total revenues and total expenses.
   c. extraordinary items and accounting changes more than these are emphasized in the multiple-step income statement.
   d. the various components of income from continuing operations.

10. Limitations of the income statement include all of the following except
   a. items that cannot be measured reliably are not reported.
   b. only actual amounts are reported in determining net income.
   c. income measurement involves judgement.
   d. income numbers are affected by the accounting methods employed.

11. Which of the following is *not* a generally practiced method of presenting the income statement?
   a. Including corrections of errors made in a prior period
   b. The single-step income statement
   c. The consolidated statement of income
   d. Including gains and losses from discontinued operations of a segment of a business in determining net income

12. The occurrence which most likely would have no effect on 2011 net income (assuming that all amounts involved are material) is the
   a. sale in 2011 of an office building contributed by a stockholder in 1987.
   b. collection in 2011 of a receivable from a customer whose account was written off in 2010 by a charge to the allowance account.
   c. settlement based on litigation in 2011 of previously unrecognized damages from a serious accident which occurred in 2008.
   d. worthlessness determined in 2011 of stock purchased on a speculative basis in 2007.

13. Irregular or unusual gains or losses that don't relate to discontinued operations
   a. may be reported separately if they are material in amount.
   b. are generally combined with other gains and losses if they are immaterial.
   c. must be shown above "income before discontinued operations" and before the provision for income tax.
   d. All of these

14. The concept of intraperiod tax allocation is used for
   a. income from continuing operations
   b. income from discontinued operations
   c. other comprehensive income
   d. All of these

15. Expenses may be presented in the income statement
    a. by nature or by function
    b. by amount or in alphabetical order
    c. by geographical area or by the single-step method
    d. by current or non-current

16. When expenses are presented by function in the income statement
    a. Their breakdown should be disclosed.
    b. They should be reported as part of other comprehensive income.
    c. Their cash flow predictive value is decreased
    d. (a) and (c)

17. The concept of comprehensive income
    a. Is not relevant under IFRS
    b. Is not relevant under private entity GAAP
    c. Can be replaced with the concept of discontinued operations under private entity GAAP
    d. None of these

18. A company's balance sheet
    a. Would never include accumulated other comprehensive income (because it is an income statement item).
    b. May include accumulated other comprehensive income if the company follows IFRS
    c. May include accumulated other comprehensive income if the company follows private entity GAAP
    d. None of these

19. Which of the following is a change in accounting principle?
    a. A change in the estimated service life of machinery
    b. A change estimated allowance for bad debts
    c. A change in the estimated future warranty expense
    d. A change from FIFO to weighted average for inventory

20. Which of the following is a required disclosure in the income statement when reporting a change in accounting principle?
    a. A per share amount for the cumulative effect of the change.
    b. The cumulative effect on prior years net of tax.
    c. The cumulative effect should be disclosed immediately after discontinued operations.
    d. None of these.

21. Which of the following is a required disclosure in the income statement when reporting the disposal of a segment of the business?
    a. The gain or loss on disposal should be reported as an extraordinary item.
    b. Results of operations of a discontinued segment should be disclosed immediately below other irregular items.
    c. Earnings per share from both continuing operations and net income should be disclosed on the face of the statement or in the notes.
    d. The gain or loss on disposal should not be segregated, but should be reported together with the results of continuing operations.

22. When a company disposes of a discontinued operation (segment), the transaction should be included in the income statement as a gain or loss on disposal reported as
    a. a prior period adjustment.
    b. other comprehensive income.
    c. an amount after continuing operations.
    d. a bulk sale of plant assets included in income from continuing operations.

23. For purposes of discontinued operations, the key elements in determining that a separate segment exists are
    a. the component is a separate business and a separate legal entity.
    b. the component is a separate legal entity and generates its own net cash flows.
    c. the component is in a separate geographic region and can be sold.
    d. the component is a separate business and generates its own cash flow.

24. Income taxes are allocated to
    a. correction of errors reported in prior periods.
    b. discontinued operations.
    c. irregular items.
    d. all of these.

25. Which of the following is true about intraperiod tax allocation?
    a. It arises because certain revenue and expense items appear in the income statement either before or after they are included in the tax return.
    b. It is required for the cumulative effect of changes in accounting principles but not for discontinued operations.
    c. Its purpose is to allocate income tax expense evenly over a number of accounting periods.
    d. Its purpose is to relate the income tax expense to the items which affect the amount of tax.

26. Which of the following items will *not* appear in the retained earnings statement?
    a. Net loss
    b. Correction of an error
    c. Change in accounting estimates
    d. Stock dividends

27. Which one of the following types of losses is excluded from the determination of net income in income statements?
    a. Material losses resulting from transactions in the company's investments account.
    b. Material losses resulting from unusual sales of assets not acquired for resale.
    c. Material losses resulting from the write-off of intangibles.
    d. Material losses resulting from correction of errors related to prior periods.

28. Sure Corporation made a very large arithmetical error in the preparation of its year-end financial statements by improper placement of a decimal point in the calculation of amortization. The error caused the net income to be reported at almost double the proper amount. Correction of the error when discovered in the next year should be treated as
    a. an increase in amortization expense for the year in which the error is discovered.
    b. a component of income for the year in which the error is discovered, but separately listed on the income statement and fully explained in a note to the financial statements.
    c. a gain for the year in which the error was made.
    d. an adjustment to beginning retained earnings, net of tax.

29. All-inclusive income includes all of the following except
    a. dividend revenue.
    b. losses on disposal of assets.
    c. investments by owners.
    d. gains on the expropriation of property by the government.

30. The IASB is planning significant changes to the presentation of financial statements. These changes will result in financial statements that are classified according to
    a. cash flows from operating, investing and financing activities.
    b. business and financing activities.
    c. assets, liabilities and equity.
    d. the nature and function of expenses.

31. Comprehensive income includes all changes in equity during a period *except*
    a. gains and losses from discontinued operations.
    b. unrealized gains and losses on available for sale securities.
    c. those resulting from investments by owners and distributions to owners.
    d. gains and losses from irregular items.

32. Other comprehensive income is
    a. income from unusual activities.
    b. income that is not related to normal earnings activities.
    c. income items that bypass the income statement.
    d. included in income from continuing operations.

33. Accumulated other comprehensive income would be reported
    a. in the shareholders' equity section.
    b. in the retained earnings section.
    c. in net income.
    d. in net income from continuing operations.

34. An asset can be classified as held for sale when
    a. It is probable that the assets will be sold within one year
    b. The sale has been authorized by the company's management
    c. The asset is available for immediate sale
    d. All of these

35. The statement of changes in shareholder's equity
  a. Is a required statement under IFRS
  b. Is a required statement under private entity GAAP
  c. Is a required statement under either standard
  d. None of these

Multiple Choice Answers—Conceptual

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.
1.	c	6.	c	11.	a	16.	d	21.	c	26.	c	31.	c
2.	d	7.	d	12.	b	17.	b	22.	c	27.	d	32.	c
3.	a	8.	d	13.	d	18.	b	23.	d	28.	d	33.	a
4.	b	9.	b	14.	d	19.	d	24.	d	29.	c	34	d
5.	d	10.	b	15.	a	20.	d	25.	d	30.	b	35	a

Solution to Multiple Choice question for which the answer is "none of these."

20. A change in accounting principles is not reported on the income statement.

MULTIPLE CHOICE—Computational

36. A manufacturing firm sold goods during its normal course of business. The pre-tax income attributable to this sale is $137,500. Assuming an income tax rate of 30%, the sale would be reported in the company's income statement as
    a. income of $96,250 included in after-tax net income from continuing operations
    b. income of $137,500 included in *pre*-tax income from continuing operations
    c. a gain of $137,500 with a separate disclosure of the income tax effect.
    d. (a) and (b)

37. Pearson Company reported net income of $450,000. This amount included a pre-tax loss of $15,000 that was considered material and pertained to its continuing operations. Assuming an income tax rate of 35%, Pearson's net income *without* this loss would have been
    a. $444,750
    b. $435,000
    c. $440,250
    d. $410,250

38. Markete Company has 100,000 common shares outstanding and has a policy of paying a $1.20 dividend for each of these shares. Markete has an income tax rate of 40%. Its retained earnings statement for 2011 had a closing balance of $1,346,000. Assuming an opening balance of zero, dividend payments according to its usual policy and no other adjustments, Markete's 2011 net income was
    a. $1,418,000
    b. $1,394,000
    c. $1,466,000
    d. $1,451,000

39. Lockenberg Company changed the amortization method (a change in accounting principle) for its fleet of delivery trucks. The accumulated net after-tax effect was an increase of *prior period's* net income by $84,300. This adjustment will have the following effect on Lockenberg's current year net income:
    a. Current year's net income will be unaffected
    b. Current year's net income will increase by $84,300
    c. Current year's net income will increase by $84,300 minus the income tax effect
    d. Current year's net income will decrease by $84,300

Use the following information for questions 40 and 41.

The financial statements of Bahr, Inc. for 2010 and 2011 contained the following errors:

	2010	2011
Ending inventory	$5,000 overstated	$8,000 understated
Insurance expense	2,400 understated	1,300 overstated

40. Assuming that none of the errors was detected or corrected, by what amount will 2010 income before taxes be overstated or understated?
    a. $2,600 understated
    b. $2,600 overstated
    c. $7,400 overstated
    d. $7,400 understated

41. Assuming that none of the errors was detected or corrected, by what amount will 2011 income before taxes be overstated or understated?
    a. $14,300 understated
    b. $11,900 understated
    c. $6,700 understated
    d. $6,700 overstated

Use the following information for questions 42 through 44. Ignore taxes.

Morat, Inc. is a calendar-year corporation. Its financial statements for the years 2010 and 2011 contained errors as follows:

	2010	2011
Ending Inventory	$ 6,000 understated	$10,000 overstated
Amortization Expense	11,000 overstated	7,000 overstated

42. Assuming that the errors made in 2010 were corrected, but that the errors made in 2011 were not detected, by what amount will 2011 income before taxes be overstated or understated?
    a. $3,000 overstated
    b. $10,000 overstated
    c. $17,000 overstated
    d. $3,000 understated

43. Assuming that *none* of the errors was detected or corrected, by what amount will retained earnings at December 31, 2011 be overstated or understated?
    a. $23,000 understated
    b. $17,000 understated
    c. $8,000 understated
    d. $10,000 overstated

44. Assuming that *none* of the errors was detected or corrected, and that no additional errors were made in 2012, by what amount will current assets at December 31, 2012 be overstated or understated?
    a. $10,000 overstated
    b. $0
    c. $4,000 overstated
    d. $10,000 understated

45. In 2011 Roswell Company changed from straight-line to double declining-balance amortization. The total difference in amortization for all years through 2010 was $52,000 and for 2011 the difference was $5,000. The tax rate is 30 percent. The amount that should be reported in the statement of retained earnings for 2011 as a change in accounting principle is
    a. $36,400 debit.
    b. $36,400 credit.
    c. $39,900 debit.
    d. $39,900 credit.

Use the following information for questions 46 and 47.

At Iserlohn Company, events and transactions during 2011 included the following. The tax rate for all items is 30 percent.

(1) Amortization for 2009 was found to be understated by $30,000.

(2) A strike by the employees of a supplier resulted in a loss of $20,000.

(3) The inventory at December 31, 2009 was overstated by $40,000.

(4) A flood destroyed a building that had a book value of $400,000. Floods are very uncommon in that area.

46. The effect of these events and transactions on 2011 income from continuing operations net of tax would be
    a. $14,000.
    b. $35,000.
    c. $63,000.
    d. $294,000.

47. The effect of these events and transactions on the beginning balance of 2011 retained earnings would be
    a. $14,000.
    b. $294,000.
    c. $21,000.
    d. $343,000.

48. The following information was extracted from the accounts of Colaw Corporation at December 31, 2011:

	CR(DR)
Total reported income since incorporation	$1,500,000
Total cash dividends paid	(800,000)
Cumulative effect of changes in accounting principle	(120,000)
Total stock dividends distributed	(200,000)
Correction of an error, recorded January 1, 2011	66,000

What should be the balance of retained earnings at December 31, 2011?
a. $446,000.
b. $500,000.
c. $380,000.
d. $566,000.

49. During 2011, Post Corporation disposed of Real Division, a major segment of its business. Post realized a gain of $1,500,000, net of taxes, on the sale of Real's assets. Real's operating losses, net of taxes, were $1,800,000 in 2011. How should these facts be reported in Post's income statement for 2011?

	Total Amount to be Included in	
	Income from Continuing Operations	Results of Discontinued Operations
a.	$1,800,000 loss	$1,500,000 gain
b.	300,000 loss	0
c.	0	300,000 loss
d.	1,500,000 gain	1,800,000 loss

50. Quorum Company reported the following information for 2011:

Sales revenue	$520,000
Cost of goods sold	350,000
Operating expenses	55,000
Gain on the sale of capital assets	50,000
Cash dividends received on investment securities	2,000

For 2011, on a multiple-step income statement, Quorum would report other income of
a. $167,000.
b. $165,000.
c. $52,000.
d. $50,000.

51. Stober, Ltd. decided on January 1, 2011 to discontinue its plastic making division. The division, considered a reportable segment, was sold on June 1, 2011. Division assets with a carrying value of $650,000 were sold for $500,000. Operating income from January 1, to May 30, 2011 for the division amounted to $80,000. Ignoring taxes, what amount should be reported on Stober's income statement for the year ended December 31, 2011, under the caption "discontinued operations"?
   a. $230,000 gain
   b. $80,000 gain
   c. $150,000 loss
   d. $70,000 loss

52. The following information is available concerning the accounts of Fischer Company:

Accounts payable, January 1, 2011	$16,000
Cash payments on account during 2011	69,000
Purchase discounts taken during 2011 on 2011 purchases	1,400
Accounts payable, December 31, 2011	9,000

   Assuming the company records purchases at the gross amounts, the total purchases for 2011 would be
   a. $62,000.
   b. $63,400.
   c. $58,100.
   d. $57,800.

53. The following information is available for Kress Company:

Payment for goods during 2011	$64,000
Accounts payable, January 1, 2011	8,000
Inventory, January 1, 2011	11,000
Accounts payable, December 31, 2011	7,400
Inventory, December 31, 2011	9,100

   Cost of goods sold for 2011 is
   a. $59,800
   b. $60,150
   c. $64,320
   d. $65,300.

Multiple Choice Answers—Computational

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.
36.	d	39.	a	42.	a	45.	a	48.	a	51.	d
37.	c	40.	c	43.	c	46.	d	49.	c	52.	b
38.	c	41.	a	44.	b	47.	c	50.	c	53.	d

MULTIPLE CHOICE—CPA Adapted

Use the following information for questions 54 and 55.

Oskar Corp. reports operating expenses in two categories: (1) selling and (2) general and administrative. The adjusted trial balance at December 31, 2011, included the following expense accounts:

Accounting and legal fees	$120,000
Advertising	150,000
Freight-out	75,000
Interest	60,000
Loss on sale of long-term investments	30,000
Officers' salaries	180,000
Rent for office space	160,000
Sales salaries and commissions	110,000

One-half of the rented premises is occupied by the sales department.

54. How much of the expenses listed above should be included in Oskar's selling expenses for 2011?
    a. $260,000.
    b. $335,000.
    c. $340,000.
    d. $415,000.

55. How much of the expenses listed above should be included in Oskar's general and administrative expenses for 2011?
    a. $380,000.
    b. $410,000.
    c. $440,000.
    d. $470,000.

56. Coil Corp. reports operating expenses in two categories: (1) selling and (2) general and administrative. The adjusted trial balance at December 31, 2011 included the following expense and loss accounts:

Accounting and legal fees	$140,000
Advertising	160,000
Freight-out	80,000
Interest	70,000
Loss on sale of long-term investment	30,000
Officers' salaries	225,000
Rent for office space	220,000
Sales salaries and commissions	150,000

One-half of the rented premises is occupied by the sales department. Coil's total selling expenses for 2011 are

a. $500,000.
b. $420,000.
c. $390,000.
d. $350,000.

57. The following items were among those that were reported on Gare Co.'s income statement for the year ended December 31, 2011:

Legal and audit fees	$180,000
Rent for office space	235,000
Interest on inventory floor plan	248,000
Loss on abandoned equipment used in operations	41,000

The office space is used equally by Gare's sales and accounting departments. What amount of the above-listed items should be classified as general and administrative expenses in Gare's multiple-step income statement?

a. $415,000.
b. $160,000.
c. $297,500.
d. $180,000.

Use the following information for questions 58 through 61.

Matlin Corp.'s trial balance of income statement accounts for the year ended December 31, 2011 included the following:

	Debit	Credit
Sales		$170,000
Cost of goods sold	$ 70,000	
Administrative expenses	28,000	
Loss on sale of equipment	11,000	
Sales commissions	9,000	
Interest revenue		6,000
Freight-out	2,000	
Loss of warehouse due to flood	13,000	
Loss from operation of discontinued division	25,000	
Bad debt expense	4,000	
Totals	$162,000	$176,000

Other information:

Matlin's income tax rate is 30%.

Finished goods inventory:

January 1, 2011	$86,000
December 31, 2011	98,000

On Matlin's multiple-step income statement for 2011,

58. Cost of goods manufactured is
    a. $70,000.
    b. $82,000.
    c. $53,000.
    d. $50,000.

59. Income from continued operations is
    a. $17,500.
    b. $52,800.
    c. $24,500.
    d. $27,300.

60. Income from discontinued operations is
    a. $10,500.
    b. $17,500.
    c. $16,800.
    d. $24,000.

61. Net income is
    a. $9,800.
    b. $15,000.
    c. $16,800.
    d. $24,000.

62. Lex, Inc. incurred the following infrequent losses during 2011:

    A $90,000 write-down of equipment leased to others (net of tax)
    A $40,000 adjustment of accruals on long-term contracts (net of tax)
    A $60,000 write-off of obsolete inventory (net of tax)

    Of those losses, what amount should be included in Lex's 2011 income from continuing operations?
    a. $190,000.
    b. $150,000.
    c. $130,000.
    d. $100,000.

63. Which of the following should be reported as an adjustment to retained earnings?

	Change in Estimated Lives of Depreciable Assets	Change from Unaccepted Principle to Accepted Principle
a.	Yes	Yes
b.	No	Yes
c.	Yes	No
d.	No	No

64. Compared to the accrual basis of accounting, the cash basis of accounting overstates income by the net increase during the accounting period of the

	Accounts Receivable	Accrued Expenses Payable
a.	No	No
b.	No	Yes
c.	Yes	No
d.	Yes	Yes

65. Hegel Corp. reported revenue of $0.9 million in its accrual basis income statement for the year ended June 30, 2011. Additional information was as follows:

Accounts receivable June 30, 2010	$230,000
Accounts receivable June 30, 2011	490,000
Uncollectible accounts written off during the fiscal year	10,000

    Under the cash basis, Hegel should report revenue of
    a. $640,000.
    b. $630,000.
    c. $650,000.
    d. $600,000.

66. Gerald Bone, M.D., keeps his accounting records on the cash basis. During 2011, Dr. Bone collected $150,000 from his patients. At December 31, 2010, Dr. Bone had accounts receivable of $25,000. At December 31, 2011, Dr. Bone had accounts receivable of $35,000 and unearned revenue of $5,000. On the accrual basis, how much was Dr. Bone's patient service revenue for 2011?
   a. $125,000.
   b. $155,000.
   c. $160,000.
   d. $165,000.

67. The following information is available for Rice Company for 2011:

Disbursements for purchases	$650,000
Increase in trade accounts payable	58,000
Decrease in merchandise inventory	28,000

   Costs of goods sold for 2011 was
   a. $650,000.
   b. $708,000.
   c. $700,000.
   d. $736,000.

Multiple Choice Answers—CPA Adapted

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.
54.	d	56.	a	58.	b	60.	b	62.	a	64.	b	66.	d
55.	a	57.	c	59.	d	61.	a	63.	b	65.	b	67.	d

DERIVATIONS — Computational

No.	Answer	Derivation
36.	d	$137,500 x (1 – 0.3) = $96,250
37.	c	$450,000 – [15,000 x (1-0.35)] = $440,250
38.	c	$1,346,000 + ($1.20 x 100,000) = $1,466,000.
39.	a	
40.	c	$5,000 + $2,400 = $7,400.
41.	a	$5,000 + $8,000 + $1,300 = $14,300.
42.	a	$10,000 – $7,000 = $3,000.
43.	c	$11,000 + $7,000 – $10,000 = $8,000.
44.	b	$0.
45.	a	$52,000 – $15,600 = $36,400.
46.	d	$20,000 x (1-0.3) + $400,000 x (1-0.3) = $294,000.
47.	c	$30,000 x (1-0.3) = $21,000.
48.	a	$1,500,000 – $800,000 – $120,000 - $200,000 + $66,000 = $446,000.
49.	c	$1,800,000 – $1,500,000 = $300,000.
50.	c	Other income = $50,000 + $2,000 = $52,000.
51.	d	$150,000 – $80,000 = $70,000.
52.	b	$69,000 + $1,400 - $16,000 + $9,000 = $63,400.
53.	d	$64,000 – $8,000 + $7,400 = $63,400 (purchases). $11,000 + $63,400 – $9,100 = $65,300.

DERIVATIONS — CPA Adapted

No.	Answer	Derivation
54.	d	\$150,000 + \$75,000 + \$110,000 + \$80,000 = \$415,000.
55.	a	\$120,000 + \$180,000 + \$80,000 = \$380,000.
56.	a	\$160,000 + \$80,000 + \$110,000 + \$150,000 = \$500,000.
57.	c	\$180,000 + (\$235,000/2) = \$297,500.
58.	b	\$70,000 + \$98,000 - \$86,000 = \$82,000.
59.	d	(\$176,000 - \$162,000 + \$25,000) x (1-0.3) = \$27,300.
60.	b	\$25,000 x (1 – 0.3) = \$17,500
61.	a	(\$176,000 - \$162,000) x (1-0.3) = \$9,800.
62.	a	\$90,000 + \$40,000 + \$60,000 = \$190,000.
63.	b	Conceptual.
64.	b	Conceptual.
65.	b	\$900,000 + \$230,000 – \$490,000 – \$10,000 = \$630,000.
66.	b	\$150,000 – \$25,000 + \$35,000 – \$5,000 = \$155,000.
67.	d	\$650,000 + \$58,000 + \$28,000 = \$736,000.

EXERCISES

Ex. 4-68—Definitions.

Provide clear, concise answers for the following.

1. What are revenues?
2. What are expenses?
3. What are gains?
4. What are losses?
5. How should unusual gains and losses be disclosed in the income statement?
6. When does a discontinued segment qualify as discontinued operations?
7. Indicate how earnings per share is calculated.
8. State two examples of adjustments to a prior years' retained earnings and indicate how they are reported in the financial statements.
9. The IASB is planning significant changes regarding the presentation of financial statements. How did these changes evolve and how will financial statements likely be impacted?

Solution 4-68

1. Revenues are increases in economic resources either by way of inflows or enhancements of assets of an entity or settlements of liabilities resulting from the ordinary activities of an entity.
2. Expenses are the decrease in economic resources, either by outflows or reductions of assets or incurrence of liabilities, resulting from an entity's ordinary revenue generating activities.
3. Gains are increases in equity (net assets) from peripheral or incidental transactions of an entity from all other transactions and other events and circumstances affecting the entity during a period except those that result from revenues or investment by owners.
4. Losses are decreases in equity (net assets) from peripheral or incidental transactions, of an entity from all other transactions and other events and circumstances affecting the entity during a period except those that result from revenues or investment by owners.
5. If they are material, they are disclosed separately but must be shown above "income(loss) before discontinued operations" and above the income tax provision. If they are immaterial, they are combined with other gains and losses of the period. Either way, they are included in the company's income from continued operations.
6. In order for a segment to be a discontinued operation it must be a distinguishable component of an entity, the activities of which represent a line of business significant to the entity as a whole and/or that are directed to a significant particular class of customer. There must be a formal plan of disposal.
7. The calculation of earnings per share is: Net income minus preferred dividends divided by the weighted average of common shares outstanding.
8. Adjustments to a prior year's retained earnings include correction of an error in the financial statements of a prior period and retroactively applied changes in accounting principles. The adjustment should be charged or credited to the opening balance of retained earnings.

Solution 4-68 (cont.)

9. The project was originally started in 2001 and consists of three phases. These phases are currently at various stages of completion. One of the key principles that underlie the proposed changes is a separation of an entity's financing activities from other activities. Therefore, the changes are expected to result in financial statements that are classified according to financing and business activities.

Ex. 4-69—Terminology.

In the space provided, write the word or phrase that is defined or indicated.

1. Net income minus preferred dividends divided by the weighted average of shares outstanding. 1. ______________________
2. A correction of an error is reported as 2. ______________________
3. An income statement that includes only two groupings (revenues and expenses) was prepared under the 3. ______________________
4. The income statement category for a disposal of a segment of a business. 4. ______________________
5. Relating tax expense to specific items on the income statement. 5. ______________________

Solution 4-69

1. Earnings per share.
2. An adjustment to beginning retained earnings.
3. Single-step method.
4. Discontinued operations.
5. Intraperiod tax allocation.

Ex. 4-70 - Income statement - limitations

Briefly discuss the limitations of the income statement.

Solution 4-70

The results disclosed in the income statement are based on the use of estimates and assumptions and may also be affected by the accounting methods used. Furthermore, some important items may, for lack of measurability, not be disclosed at all. Finally, the results depend on differing views on how income should be measured (such as the differing views under private entity GAAP and IFRS for example).

Ex. 4-71—Calculation of net income from the change in shareholders' equity.

Presented below is certain information pertaining to Pollock Company.

Assets, January 1	$300,000
Assets, December 31	280,000
Liabilities, January 1	130,000
Common stock, December 31	70,000
Retained earnings, December 31	30,000
Common stock issued during the year	8,000
Dividends declared during the year	13,000

Instructions

Calculate the net income for the year.

Solution 4-71

	January 1	December 31
Assets	$300,000	
Liabilities	130,000	
Shareholders' equity	$ 170,000	$100,000*

Calculation of net income:	
Shareholders' equity December 31	$100,000
Shareholders' equity January 1	170,000
Decrease	(70,000)
Add: Dividend declared	13,000
Less: Common stock issued	(8,000)
Net income(Loss)	$ (65,000)

*$70,000 + $30,000

Ex. 4-72—Calculation of net income from the change in shareholders' equity.

Presented below are changes in the account balances of Perot Company during the year, except for retained earnings.

	Increase (Decrease)		Increase (Decrease)
Cash	$25,000	Accounts payable	$35,000
Accounts receivable (net)	(13,000)	Bonds payable	(20,000)
Inventory	52,000	Common stock	72,000
Plant Assets (net)	37,000	Paid-in capital	16,000

The only entries in Retained Earnings were for net income and a dividend declaration of $10,000.

Instructions

Calculate the net income for the current year.

Solution 4-72

Calculation of net income

Change in assets ($114,000 – $13,000)	$101,000	Increase
Change in liabilities ($35,000 – $20,000)	15,000	Increase
Change in shareholders' equity	86,000	Increase
Add: Dividend declared	10,000	
Less: Investment by shareholders	(88,000)	
Net income	$ 8,000	

Ex. 4-73—Income statement classifications.

Indicate the major section or subsection of a multiple-step income statement in which each of the following items would usually appear:

a. Advertising
b. Depletion
c. Dividend revenue
d. Freight-in
e. Loss on disposal of a segment of the business, net of tax
f. Income taxes on income
g. Major casualty loss, net of tax
h. Purchase discounts
i. Sales discounts
j. Officers' salaries
k. Freight-out
l. Sinking fund income

Solution 4-73

a. Selling expense.
b. Cost of goods sold.
c. Other revenue.
d. Cost of goods sold as an addition to purchases.
e. Disclosed separately, but must be shown above "income (loss) before discontinued operations" and before the income tax provision.
f. Income taxes; subtracted from income before income taxes in arriving at net income.
g. Extraordinary items.
h. Cost of goods sold as a subtraction from purchases.
i. Subtracted from gross revenues.
j. Administrative or general expenses.
k. Selling expense.
l. Other revenue.

Ex 4-74 Comprehensive Income

Lazorko Corporation completed its first year of operations. Its results and other information for that year (2011) included the following:

Sales:	$900,000
Cost of goods sold:	$430,000
Operating expenses:	$80,000
Unrealized holding gains from investments (accounted for under the fair value through comprehensive income model):	$25,000

Instructions:

Based on the information provided, prepare a combined statement of income and comprehensive income. Ignore income taxes and EPS.

Solution 4-74

LAZORKO CORPORATION
Statement of Income and Comprehensive Income
For the Year Ended December 31, 2011

Sales	900,000
Cost of goods sold	430,000
Gross profit	470,000
Operating expenses	80,000
Net income	390,000
Other comprehensive income	
Unrealized holding gain	25,000
Comprehensive income	$415,000

Ex. 4-75 Statement of changes in equity

Ponoka Ltd. had the following balances at January 1, 2010:
Common shares: $420,000
Retained earnings: $30,000
Accumulated other comprehensive income: $58,000

During the year the company earned net income of $200,000 and generated other comprehensive income of $70,000.

Instructions

Prepare a statement of changes in shareholder's equity for the year ended December 31, 2010

Solution 4-75

PONOKA LTD.
Statement of Shareholder's Equity
For the Year Ended December 31, 2010

	Total	Common Shares	Comprehensive Income	Retained Earnings	Accumulated Other Comprehensive Income
Beginning balance	$508,000	$420,000		$30,000	$58,000
Net income	$200,000		$200,000	$200,000	
Other comprehensive income	$70,000		$70,000		$70,000
Comprehensive income			$270,000		
Ending balance	$778,000	$420,000		$230,000	$128,000

Ex. 4-76 - Discontinued Operations

Abacor Ltd, a private company based in Vancouver, decided to sell its Graphic Design Division. After two years of losses and heavy competition, a plan to dispose of the division was put in place. At the end of 2010, the plan was finalized and approved by the board of directors.

Other information:
Abacor's 2010 after-tax net income (excluding the results from the Graphic Design Division) was 230,000. During the year, the division reported an after-tax loss of $140,000 (revenues: $20,000 expenses: $160,000). Management estimates that after-tax legal and audit fees of $40,000 as well as severance payments of $55,000 will be required. A portion of these costs is expected to be offset by the after-tax proceeds of $50,000 from the sale of the division's assets.

Instructions

Assuming the division qualifies for treatment as a discontinued operation, prepare a partial income statement for Abacaor for 2010. The statement should begin with income from continuing operations and include an appropriate footnote pertaining to the disposal of the Graphics Division.

Solution 4-76

Partial income statement:

ABACOR LTD
PARTIAL Income Statement
For the Year Ended December 31, 2010

Net income from continuing operations		$230,000
Discontinued operations *		
Loss from operation of discontinued Graphic Design Division (net of tax)	$140,000	
Loss from disposal of Graphic Design Division (net of tax)	45,000	185,000
Net income		$45,000

* Footnote:
On December 31, due to continued losses, the board of directors unanimously approved management's plan to dispose of the Graphics Design Division. The sale is anticipated to be completed by June 30, 2011.

The after-tax operating results for the current year are as follows:

Revenues	$20,000
Expenses	$160,000
Net loss	($140,000)

The estimated after-tax loss relating to the disposal of the division is comprised of the following items:

Proceeds from sale of assets:	$50,000
Legal and audit fees	$40,000
Severance payments to staff	$55,000
	$45,000

Ex. 4-77—Classification of income statement and retained earnings statement items.

For each of the items listed below, indicate how it should be treated in the financial statements. Use the following letter code for your selections:

a. Ordinary item on the income statement
b. Discontinued operations
c. Unusual item on the income statement
d. Adjustment to prior year's retained earnings

_____ 1. The bad debt rate was increased from 1 percent to 2 percent, thus increasing bad debt expense.

_____ 2. Obsolete inventory was written off. This was the first loss of this type in the company's history (but immaterial).

_____ 3. An uninsured casualty loss was incurred by the company. This was the first loss of this type in the company's 50-year history.

_____ 4. Recognition of income earned last year which was inadvertently omitted from last year's income statement.

_____ 5. The company sold one of its warehouses at a loss.

_____ 6. Settlement of litigation with federal government related to income taxes of three years ago. The company is continually involved in various adjustments with the federal government related to its taxes.

_____ 7. A loss incurred from expropriation (the company owned resources in South America which were taken over by a dictator unsympathetic to Canadian business).

_____ 8. The company neglected to record its amortization in the previous year.

_____ 9. Discontinuance of all production in Canada. The manufacturing operations were relocated in Mexico.

_____ 10. Loss on sale of investments. The company last sold some of its investments two years ago.

_____ 11. Loss on the disposal of a segment of the business.

Solution 4-77

1. a	4. d	7. c	10. a
2. a	5. a	8. d	11. b
3. c	6. a	9. a	

Ex. 4-78—Cash basis.

Revenue on the income statement was $125,800. Accounts receivable were $4,500 on January 1 and $5,540 on December 31. Unearned revenue was $1,050 on January 1 and $1,670 on December 31.

Instructions
Show the calculation of revenue for the year on a cash basis.

Solution 4-78

$125,800 + $4,500 – $5,540 – $1,050 + $1,670 = $125,380.

Ex. 4-79—Characteristics of high quality earnings

Describe the characteristics of high quality earnings.

Solution 4-79

Information content: unbiased/objectively determined; reflect economic reality; sustainable—reflect primary earnings generated from ongoing core business activities, closely correlated with cash flows from operations, based on a sound business strategy/business model.

Presentation: transparent and understandable.

PROBLEMS

Pr. 4-80—Income Statement Form.

Hauser Corporation had income from continuing operations of $800,000 (after taxes) in 2010. In addition, the following information, which has not been considered, is as follows.

1. In 2010, Hauser adopted the double declining-balance method of amortizing equipment. Prior to 2010, Hauser had used the straight-line method. The change decreases income for 2010 by $50,000 (pre-tax) and the cumulative effect of the change on prior years' income was a $200,000 (pre-tax) decrease.
2. A machine was sold for $140,000 cash during the year at a time when its book value was $100,000. (Amortization has been properly recorded.) The company often sells machinery of this type.
3. Hauser decided to discontinue its stereo division in 2010. During the current year, the loss on the disposal of the segment of the business was $150,000 less applicable taxes.

Instructions
Present in good form the income statement of Hauser Corporation for 2010 starting with "income from continuing operations." Assume that Hauser's tax rate is 20% and 100,000 shares of common stock were outstanding during the year.

Solution 4-80

Hauser Corporation
Partial Income Statement
For the Year Ended December 31, 2010

Income from continuing operations			$792,000*
Discontinued operations			
Loss on disposal of a segment of a business,			
$150,000, less applicable income taxes, $30,000			(120,000)
Net income			$672,000
Earnings per share—Income from cont. operations		$7.92	
Discontinued operations, net of tax		(1.20)	
Net income		$6.72	
*Income from cont. operations (unadjusted)	$800,000		
Gain on sale of machinery (after tax)	32,000		
Current effect of change in accounting principle (net)	(40,000)		
Income from cont. operations (adjusted)	$792,000		

Pr. 4-81—Multiple-step income statement.

Presented below is information related to the Masur Company.

Retained earnings, December 31, 2010	$ 650,000
Sales	1,400,000
Selling and administrative expenses	240,000
Hurricane loss (pre-tax) on plant	250,000
Cash dividends declared on common stock	33,600
Cost of goods sold	820,000
Gain resulting from calculation error on amortization charge in 2010 (pre-tax)	520,000
Other revenue	60,000
Other expenses	50,000

Instructions
Prepare in good form a multiple-step income statement for the year 2011. Assume a 20 percent tax rate and that 50,000 shares of common stock were outstanding during the year. Masur is a private Corporation following private entity GAAP.

Solution 4-81

Masur Company
INCOME STATEMENT
For the Year Ended December 31, 2011

Sales	$1,400,000
Cost of goods sold	820,000
Gross profit	580,000
Selling and administrative expenses	240,000
Income from operations	340,000
Other revenue	60,000
Other expenses	(50,000)
Loss from hurricane	(250,000)
Income before taxes	100,000
Income taxes	(20,000)
Net income	$ 80,000

Pr. 4-82—Multiple-step income statement.

Shown below is an income statement for 2010 that was prepared by a junior accountant of Parasoft Corporation.

Parasoft Corporation
INCOME STATEMENT
December 31, 2010

Sales revenue	$975,000
Investment revenue	19,500
Cost of merchandise sold	(408,500)
Selling expenses	(155,000)
Administrative expense	(215,000)
Interest expense	(13,000)
Income before special items	203,000
Special items	
Loss on disposal of a segment of the business	(30,000)
Major casualty loss	(80,000)
Net income tax liability	(27,900)
Net income	$ 65,100

Instructions

Prepare a multiple-step income statement for 2010 for Parasoft Corporation that is presented in accordance with generally accepted accounting principles (including format and terminology). Parasoft Corporation has 50,000 shares of common stock outstanding and has a 20 percent income tax rate on all tax related items. As a private corporation, Parasoft does not disclose earnings per share information.

Solution 4-82

Parasoft Corporation
INCOME STATEMENT
For the Year Ended December 31, 2010

Sales		$975,000
Cost of goods sold		408,500
Gross profit		566,500
Selling expenses	$155,000	
Administrative expenses	215,000	370,000
Income from operations		196,500
Other revenue		19,500
		216,000
Other expenses		13,000
Casualty loss		80,000
Income from continuing operations before taxes		123,000
Income taxes		24,600
Income from continuing operations		98,400
Discontinued operations:		
Loss from discontinued operations, net of applicable income tax of $6,000		24,000
Net income		$ 74,400

Pr. 4-83 - Income statement adjustments

You have been hired by the CFO of Perez Corporation, a public company. As new senior accountant you have been asked to help with the preparation of the 2010 income statement. In 2010, Perez reported pre-tax income from continuing operations of $3,150,000. However, you have been advised that the following transaction have NOT yet been considered in that amount.

1. A review of the company's depreciation policies for its computer equipment revealed that depreciation expense relating to 2009 was overstated by $19,000.

2. During the year, the company wrote off receivables for which no allowance for doubtful accounts had been set up. The amount of the receivable was $62,500.

3. In 2010, the company sold old equipment for $160,000. The equipment had a net book value of $120,000. The associated gain or loss is not considered unusual.

4. During the year, Perez disposed of one its subsidiaries. The CFO told you that the transaction meets the criteria for discontinued operations. The after-tax losses on the subsidiaries operations and from disposal were $120,000 and $290,000 respectively.

5. The company made a payment in the amount of $400,000 to settle a lawsuit. The lawsuit related to a 2008 event which the company's lawyers had been working on since that time. Based on the lawyer's advice, no payable had been set up.

Instructions

Prepare the 2010 income statement for Perez taking into account the effects (if any) of the above items. The statement should start with income from continuing operations before income taxes. Unless otherwise stated, you may assume an income tax rate of 40% for all items. Note disclosure and earnings per share calculations are not required.

Solution 4-83

Perez Corporation
PARTIAL INCOME STATEMENT
For the Year Ended December 31, 2010

Income from continuing operations – before tax		$2,727,500
Income taxes		(1091,000)
Income before discontinued operations		$1,636,500
Discontinued operations		
Loss from operations (net of tax)	($120,000)	
Loss from disposal (net of tax)	(290,000)	(410,000)
Net Income		$1,226,500

Calculations

Income from continuing operations (before adjustments)	$3,150,000
1. Would be credited directly to retained earnings	0
2. Expense	(62,500)
3. Gain $160,000 - $120,000	40,000
4. To be shown in discontinued operations section	0
5. Loss	(400,000)
Income from continuing operations (after adjustments)	$2,727,500

Pr. 4-84—Income statement and retained earnings statement.
Norman Corporation's capital structure consists of 20,000 shares of common stock. At December 31, 2010 an analysis of the accounts and discussions with company officials revealed the following information:

Sales	$1,200,000
Purchase discounts	18,000
Purchases	720,000
Earthquake loss (net of $18,000 tax)	42,000
Selling expenses	128,000
Cash	60,000
Accounts receivable	90,000
Common stock	200,000
Accumulated amortization	180,000
Dividend revenue	18,000
Inventory, January 1, 2010	152,000
Inventory, December 31, 2010	125,000
Unearned service revenue	4,400
Accrued interest payable	1,000
Land	370,000
Patents	100,000
Retained earnings, January 1, 2010	270,000
Interest expense	17,000
Cumulative effect of change from straight-line to accelerated amortization (net of $15,000 tax)	35,000
General and administrative expenses	160,000
Dividends declared	29,000
Allowance for doubtful accounts	5,000
Notes payable (maturity Jul/01/2013)	200,000
Machinery and equipment	450,000
Materials and supplies	40,000
Accounts payable	60,000

Unless indicated otherwise, you may assume an effective income tax rate of 30%.

Instructions
(a) Prepare a multiple-step income statement.
(b) Prepare a retained earnings statement.

Solution 4-84

Norman Corporation
INCOME STATEMENT
For the Year Ended December 31, 2010

Sales			$1,200,000
Cost of goods sold:			
Merchandise inventory, Jan. 1		$152,000	
Purchases	$720,000		
Less purchase discounts	18,000		
Net purchases		702,000	
Merchandise available for sale		854,000	
Less merchandise inventory, Dec. 31		125,000	
Cost of goods sold			729,000
Gross profit on sales			471,000
Operating expenses:			
Selling expenses		128,000	
General and administrative expenses		160,000	
Total operating expenses			288,000
Operating income			183,000
Other revenue and expense:			
Dividend revenue		18,000	
Interest expense		(17,000)	
Loss from earthquake		(60,000)	(59,000)
Income before taxes			124,000
Income taxes			55,200
Net income			$ 68,800
Earnings per share		$3.44	

Norman Corporation
RETAINED EARNINGS STATEMENT
For the Year Ended December 31, 2010

Retained earnings, January 1, 2010		$270,000
Cumulative effect of change in amortization methods, net of applicable taxes of $15,000		(35,000)
Adjusted beginning retained earnings		235,000
Add: Net income	$68,800	
Deduct: Dividends declared	29,000	39,800
Retained earnings, December 31, 2010		$274,800

Pr. 4-85—Multiple-step income statement.

Presented below is information which relates to LeGeyt Company for 2010.

Collections of credit sales	$1,100,000
Retained earnings, January 1, 2010	800,000
Sales	1,900,000
Selling and administrative expenses	290,000
Casualty loss (pre-tax)	350,000
Cash dividends declared on common stock	34,000
Cost of goods sold	1,100,000
Loss resulting from calculation error on amortization charge in 2008 (pre-tax)	460,000
Other revenues	180,000
Other expenses	120,000
Loss from early extinguishment of debt (pre-tax)	340,000
Gain from transactions in foreign currencies (pre-tax)	220,000
Proceeds from sale of Strathroy common stock	60,000

Additional information:

1. Early in 2010, LeGeyt changed amortization methods for its plant assets from the double declining-balance to the straight-line method. The affected assets were purchased at the beginning of 2008 for $200,000, had no residual value, and had useful lives of 10 years. Amortization expense of $20,000 is included in the "Selling and Administrative Expenses" of $290,000 above.

2. On September 1, 2010, LeGeyt sold one of its segments (product line) to Best Industries for a gain (pre-tax) of $550,000. During the period January 1 to August 31, the discontinued segment incurred an operating loss (pre-tax) of $480,000. This loss is not included in any of the numbers shown above.

3. Included in "Selling and Administrative Expenses" is "Bad Debts Expense" of $19,000. LeGeyt bases its bad debts expense upon a percentage of sales. In 2008 and 2009, the percentage was .5 percent. In 2010, the percentage was changed to 1 percent.

Instructions
Prepare in good form a multiple-step income statement for 2010. Assume a 20 percent tax rate and that 20,000 shares of common stock were outstanding during the year.

Solution 4-85

LeGeyt Company
INCOME STATEMENT
For the Year Ended December 31, 2010

Sales		$1,900,000
Cost of goods sold		1,100,000
Gross profit		800,000
Selling and administrative expenses		290,000
Operating income		510,000
Other revenues and gains:		
Other revenues		180,000
Gain from transactions in foreign currency		220,000
		910,000
Other expenses and losses:		
Other expenses	$120,000	
Early extinguishment of debt	340,000	
Casualty loss	350,000	810,000
Income from continuing operations before tax		100,000
Income tax		20,000
Income from continuing operations		80,000
Discontinued operations:		
Loss from operations (net of taxes of $96,000)	(384,000)	
Gain from sale of assets (net of taxes of $110,000)	440,000	56,000
Net income		$ 136,000

Earnings per share:	
Income from continuing operations	$4.00
Discontinued operations	2.80
Net income	$ 6.80

Pr. 4-86—Accrual accounting.

Moffat Corporation maintains its records on the cash basis. You have been engaged to convert its cash basis income statement to the accrual basis. The cash basis income statement, along with additional information, follows:

Moffat Corporation
Income Statement (Cash Basis)
For the Year Ended December 31, 2010

Cash receipts from customers		$380,000
Cash payments:		
Wages	$150,000	
Taxes	65,000	
Insurance	40,000	
Interest	25,000	280,000
Net income		$100,000

Additional information:

	Balances at 12/31	
	2010	2009
Accounts receivable	$50,000	$30,000
Wages payable	15,000	25,000
Taxes payable	14,000	19,000
Prepaid insurance	8,000	4,000
Accumulated amortization	95,000	80,000
Interest payable	3,000	9,000

No plant assets were sold during 2010.

Solution 4-86

Moffat Corporation
Income Statement (Accrual Basis)
For the Year Ended December 31, 2010

Revenue ($380,000 + $50,000 – $30,000)		$400,000
Expenses		
Wages ($150,000 + $15,000 – $25,000)	$140,000	
Taxes ($65,000 + $14,000 – $19,000)	60,000	
Insurance ($40,000 + $4,000 – $8,000)	36,000	
Depreciation ($95,000 – $80,000)	15,000	
Interest ($25,000 + $3,000 – $9,000)	19,000	
Total expenses		270,000
Net Income		$130,000

Pr. 4-87 Discontinued Operations

Maxwell Corporation operates several stores in Alberta (Calgary, Edmonton, Lethbridge and Medicine Hat). The restructuring of its organization in November 2010, has led to the decision of selling its Medicine Hat store. In preparing its financial statements of December 31, 2010, the following information was made available.

a. The Medicine Hat operation incurred a loss of $283,500. for the year ended December 31, 2010, including $225,000 for the period January 1, to November 20, 2010.
b. The estimated cost to sell is $300,000.
c. The fair value of the Medicine Hat operation's assets is estimated at $7 million and the carrying value is $7.3 million.
d. The combined provincial and federal income tax rate is 30%.
e. It is estimated that the operation will lose an additional $250,000 before it is sold.

Instructions:

(1) The Medicine Hat division qualifies for reporting as a discontinued operation. What amount should be reported in the discontinued operations section of Maxwell's 2010 income statement?
(2) In early 2011, the Medicine Hat operation is sold for $8.5 million and the actual cost to sell is $400,000. Additional income tax expense related to the sale is $500,000. The division lost an additional $150,000 before it was sold. What amount should be shown in Maxwell's 2011 income statement?

Solution 4-87

Instruction 1:

Loss from operations for 2010, before tax	$283,500
Reduction in carrying value of the asset estimated fair value ($7,300,000 – 7,000,000)	300,000
Estimated cost to sell	300,000
Estimated pre-tax amount	883,500
Recovery in respect to 30% tax of above amount	(265,050)
Total Loss on discontinued operations, net of 2010 tax	$618,450

Instruction 2:

Sale Price	$8,500,000
Minus Asset sold fair value	(7,000,000)
Additional cost to sell ($400,000-300,000)	(100,000)
Less additional loss from operations	(150,000)
Income tax expenses not previously recorded	(500,000)
Estimated pre tax amount	750,000
Applicable income tax @ 30%	(225,000)
Gain on discontinued operations	$525,000

LEGAL NOTICE

CHAPTER 5

FINANCIAL POSITION AND CASH FLOWS

MULTIPLE CHOICE—Conceptual

Answer	No.	Description
d	1.	Limitation of the balance sheet.
c	2.	Uses of the balance sheet.
a	3.	Definition of monetary asset.
a	4.	Disclosures under private entity GAAP.
c	5.	Disclosures under IFRS.
b	6.	Operating cycle.
d	7.	Operating cycle.
c	8.	Reclassification of current debt.
d	9.	Identification of current asset.
d	10.	Identification of current asset.
d	11.	Classification of marketable securities.
b	12.	Disclosures under private entity GAAP and IFRS.
d	13.	Disclosures under IFRS.
c	14.	Upcoming IASB changes to financial statement presentation.
b	15.	Identification of current liabilities.
d	16.	Definition of working capital.
b	17.	Identification of working capital items.
d	18.	Identification of long-term liabilities.
d	19.	Identification of long-term liabilities.
d	20.	Classification of treasury stock.
d	21.	Disclosures for common stock.
d	22.	Classification of investment in affiliate.
c	23.	Classification of owners' equity.
b	24.	Definition of liabilities.
d	25.	Methods of disclosure.
c	26.	Preparation of cash flow statement.
a	27.	Preparation of cash flow statement under private entity GAAP and IFRS.
a	28.	Preparation of cash flow statement.
d	29.	Classification as current asset.
c	30.	Purpose of the statement of cash flows.
b	31.	Identify an investing activity.
b	32.	Identify a financing activity.
c	33.	Cash flow from operating activities.
a	34.	Identify an investing activity.
d	35.	Preparing the statement of cash flows.
b	36.	Cash debt coverage ratio.
b	37.	Current cash debt coverage ratio.
d	38.	Financial flexibility measure.
c	39.	Calculation of free cash flow.

MULTIPLE CHOICE—CPA Adapted

Answer	No.	Description
c	40.	Calculate total current assets.
b	41.	Calculate total current assets.
d	42.	Calculate total current liabilities.
b	43.	Calculate retained earnings balance.
b	44.	Calculate current and long-term liabilities.
c	45.	Summary of significant accounting policies.
c	46.	Classification of investing activity.
a	47.	Classification of operating activity.
d	48.	Classification of financing activity.
b	49.	Classification of investing activity.

EXERCISES

Item	Description
E5-50	Definitions.
E5-51	Terminology.
E5-52	Current liabilities.
E5-53	Account classification.
E5-54	Valuation of balance sheet items.
E5-55	Balance sheet classifications.
E5-56	Balance sheet classifications.
E5-57	Balance sheet classifications.
E5-58	Statement of cash flows.
E5-59	Statement of cash flows ratios.

PROBLEMS

Item	Description
P5-60	Balance sheet format.
P5-61	Balance sheet presentation.
P5-62	Balance sheet preparation
P5-63	Balance sheet preparation
P5-64	Balance sheet preparation
P5-65	Balance sheet preparation
P5-66	Cash Flow Statement
P5-67	Cash Flow Statement – direct method
P5-68	Cash Flow Statement – indirect method

MULTIPLE CHOICE—Conceptual

1. Which of the following is a limitation of the balance sheet?
   a. Many items that are of financial value are omitted.
   b. Judgements and estimates are used.
   c. Current fair value is not reported.
   d. All of these

2. The balance sheet is useful for analysing all of the following *except*
   a. liquidity.
   b. solvency.
   c. profitability.
   d. financial flexibility.

3. Monetary assets are defined as assets that are convertible to
   a. known amounts of cash.
   b. cash within one operating cycle.
   c. cash within twelve months.
   d. cash within three months

4. A company that follows private entity GAAP
   a. must *not* disclose the cash flow per share
   b. can disclose the cash flow per share
   c. can disclose the cash flow per share if it makes a special election to do so
   d. None of these

5. A company that follows IFRS
   a. can disclose the cash flow per share if it makes a special election to do so
   b. must *not* disclose the cash flow per share
   c. is generally allowed to disclose the cash flow per share
   d. None of these

6. The basis for classifying assets as current or noncurrent is conversion to cash within
   a. the accounting cycle or one year, whichever is shorter.
   b. the operating cycle or one year, whichever is longer.
   c. the accounting cycle or one year, whichever is longer.
   d. the operating cycle or one year, whichever is shorter.

7. The basis for classifying assets as current or noncurrent is the period of time normally required by the accounting entity to convert cash invested in
   a. inventory back into cash, or twelve months, whichever is shorter.
   b. receivables back into cash, or twelve months, whichever is longer.
   c. tangible fixed assets back into cash, or twelve months, whichever is longer.
   d. inventory back into cash, or twelve months, whichever is longer.

8. When current debt is refinanced by the issue date of financial statements, it may generally be presented as *non*-current
   a. if the company follows IFRS
   b. under either private entity GAAP or IFRS
   c. if the company follows private entity GAAP
   d. None of these

9. Which of the following is a current asset?
   a. Cash surrender value of a life insurance policy of which the company is the beneficiary.
   b. Investment in equity securities for the purpose of controlling the issuing company.
   c. Cash designated for the purchase of tangible fixed assets.
   d. Trade instalment receivables normally collectible in eighteen months.

10. Which of the following should *not* be considered as a current asset in the balance sheet?
   a. Instalment notes receivable due over eighteen months in accordance with normal trade practice.
   b. Prepaid taxes which cover assessments of the following operating cycle of the business.
   c. Equity or debt securities purchased with cash available for current operations.
   d. The cash surrender value of a life insurance policy carried by a corporation, the beneficiary, on its president.

11. Equity or debt securities held to finance future construction of additional plants should be classified on a balance sheet as
   a. current assets.
   b. property, plant, and equipment.
   c. intangible assets.
   d. long-term investments.

12. Disclosure of the date that financial statements are authorized for issue is
   a. mandatory if the company follows private entity GAAP
   b. mandatory if the company follows IFRS
   c. mandatory under either private entity GAAP or IFRS
   d. None of these

13. Which of the following items would require special disclosure under IFRS?
   a. Investment property
   b. Biological assets
   c. Provisions
   d. All of these

14. Significant changes to the presentation of financial statements are currently being developed by the IASB and FASB. Which of the following statements best describes the focus of these changes?
   a. To better highlight the company's assets, liabilities and equity
   b. To segregate the company’s operating, financing and investing activities
   c. To highlight the company's major business and financing activities.
   d. To increase the number of notes to be attached to the company's financial statements.

15. Which item below is *not* a current liability?
    a. Unearned revenue
    b. Stock dividends distributable
    c. The currently maturing portion of long-term debt
    d. Trade accounts payable

16. Working capital is
    a. capital which has been reinvested in the business.
    b. unappropriated retained earnings.
    c. cash and receivables less current liabilities.
    d. none of these.

17. An example of an item which is not an element of working capital is
    a. accrued interest on notes receivable.
    b. goodwill.
    c. goods in process.
    d. short-term investments.

18. Long-term liabilities include
    a. obligations not expected to be liquidated within the operating cycle.
    b. obligations payable at some date beyond the operating cycle.
    c. future income taxes and most lease obligations.
    d. all of these.

19. Which of the following should be *excluded* from long-term liabilities?
    a. Obligations payable at some date beyond the operating cycle
    b. Most pension obligations
    c. Long-term liabilities that mature within the operating cycle and will be paid from a sinking fund
    d. None of these

20. Treasury stock should be reported as a(n)
    a. current asset.
    b. investment.
    c. other asset.
    d. reduction of shareholders' equity.

21. Which of the following should be reported for capital shares?
    a. The shares authorized
    b. The shares issued
    c. The shares outstanding
    d. All of these

22. Which of the following would be classified in a different major section of a balance sheet from the others?
    a. Capital stock
    b. Common stock subscribed
    c. Stock dividend distributable
    d. Stock investment in affiliate

23. The shareholders' equity section is usually divided into what four parts?
    a. Preferred stock, common stock, treasury stock, contributed surplus
    b. Preferred stock, common stock, retained earnings, other comprehensive income
    c. Capital shares, contributed surplus, retained earnings, accumulated other comprehensive income
    d. Capital stock, appropriated retained earnings, unappropriated retained earnings, contributed surplus

24. Which of the following best describes a liability?
    a. Any obligation, whether enforceable or not, is a liability
    b. A liability is an enforceable economic burden or obligation
    c. A liability is a legal economic benefit
    d. None of these

25. Which of the following is *not* a method of disclosing pertinent information?
    a. Supporting schedules
    b. Parenthetical explanations
    c. Cross reference and contra items
    d. All of these are methods of disclosing pertinent information.

26. A cash flow statement that is prepared under the *direct* method starts with:
    a. Net income
    b. Gross Profit
    c. None of these
    d. Income from operations

27. The standards for private entity GAAP and IFRS include numerous differences. Which of the following statements best describes the requirements for the preparation and presentation of the cash flow statement?
    a. Both standards allow the use of the indirect or direct method
    b. Private entity GAAP permits the use of the direct method only
    c. IFRS permits the use of the single-step method only
    d. (b) and (c)

28. A cash flow statement that is prepared under the *indirect* method adds and subtracts certain items to the base number. How would decreases in unearned revenues be shown? They would be shown as
    a. a deduction from net income
    b. an addition to net income
    c. a deduction from sales
    d. an addition to sales

29. A company's petty cash fund of $450 would generally be
    a. included as part of cash
    b. would not qualify as a current asset because the amount is below $1,000
    c. a current asset
    d. (a) and (c)

30. The financial statement which summarizes operating, investing, and financing activities of an entity for a period of time is the
    a. retained earnings statement.
    b. income statement.
    c. statement of cash flows.
    d. statement of financial position.

31. Making and collecting loans and disposing of property, plant, and equipment are
    a. operating activities.
    b. investing activities.
    c. financing activities.
    d. liquidity activities.

32. In preparing a statement of cash flows, repurchase of a company's own shares at an amount greater than cost would be classified as a(n)
    a. operating activity.
    b. financing activity.
    c. extraordinary activity.
    d. investing activity.

33. In preparing a statement of cash flows, cash flows from operating activities
    a. are always equal to accrual accounting income.
    b. are calculated as the difference between revenues and expenses.
    c. can be calculated by appropriately adding to or deducting from net income those items in the income statement that do not affect cash.
    d. can be calculated by appropriately adding to or deducting from net income those items in the income statement that do affect cash.

34. In preparing a statement of cash flows, which of the following transactions would be considered an investing activity?
    a. Sale of equipment at book value
    b. Sale of merchandise on credit
    c. Declaration of a cash dividend
    d. Issuance of bonds payable at a discount

35. Preparing the statement of cash flows involves all of the following except determining the
    a. cash provided by operations.
    b. cash provided by or used in investing and financing activities.
    c. change in cash during the period.
    d. cash collections from customers during the period.

36. The cash debt coverage ratio is computed by dividing net cash provided by operating activities by
    a. average long-term liabilities.
    b. average total liabilities.
    c. ending long-term liabilities.
    d. ending total liabilities.

37. The current cash debt coverage ratio is often used to assess
   a. financial flexibility.
   b. liquidity.
   c. profitability.
   d. solvency.

38. A measure of a company's financial flexibility is the
   a. cash debt coverage ratio.
   b. current cash debt coverage ratio.
   c. free cash flow.
   d. cash debt coverage ratio and free cash flow.

39. Free cash flow is calculated as net cash provided by operating activities less
   a. capital expenditures.
   b. dividends.
   c. capital expenditures and dividends.
   d. capital expenditures and amortization.

Multiple Choice Answers—Conceptual

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.
1.	d	7.	d	13.	d	19.	d	25.	d	31.	b	37.	b
2.	c	8.	c	14.	c	20.	d	26.	c	32.	b	38.	d
3.	a	9.	d	15.	b	21.	d	27.	a	33.	c	39.	c
4.	a	10.	d	16.	d	22.	d	28.	a	34.	a		
5.	c	11.	d	17.	b	23.	c	29.	d	35.	d		
6.	b	12.	b	18.	d	24.	b	30.	c	36.	b		

Solutions to those Multiple Choice questions for which the answer is "none of these."

16. Current assets less current liabilities.
19. Many answers are possible.
26. Cash received from customers.

MULTIPLE CHOICE—CPA Adapted

40. Wolanski Corp.'s trial balance reflected the following account balances at December 31, 2010:

Accounts receivable (net)	$41,000
Trading securities	7,000
Accumulated depreciation on equipment and furniture	15,000
Cash	10,000
Inventory	27,000
Equipment	25,000
Patent	4,000
Prepaid expenses	1,500
Land held for future business site	18,000

In Wolanski's December 31, 2010 balance sheet, the current assets total is
a. $104,500.
b. $90,500.
c. $86,500.
d. $73,500.

Use the following information for questions 41 through 43.

The following trial balance of Terracota Corp. at December 31, 2010 has been properly adjusted except for the income tax expense adjustment.

Terracota Corp.
Trial Balance
December 31, 2010

	Dr.	Cr.
Cash	$ 675,000	
Accounts receivable (net)	2,895,000	
Inventory	2,385,000	
Property, plant, and equipment (net)	8,366,000	
Accounts payable and accrued liabilities		$ 1,981,000
Income taxes payable		684,000
Future income tax liability		75,000
Common stock		3,350,000
Contributed surplus		2,680,000
Retained earnings, Jan/1/2010		4,650,000
Net sales and other revenues		12,360,000
Costs and expenses	10,080,000	
Income tax expenses	1,379,000	
	$25,780,000	$25,780,000

Other financial data for the year ended December 31, 2010:

- Included in accounts receivable is $720,000 due from a customer and payable in quarterly instalments of $90,000. The last payment is due December 29, 2012.
- The balance in the Future Income Tax Liability account pertains to a temporary difference that arose in a prior year, of which $30,000 is classified as a current liability.
- During the year, estimated tax payments of $465,000 were charged to income tax expense. The current and future tax rate on all types of income is 35 percent.

In Terracota's December 31, 2010 balance sheet,

41. The current assets total is
    a. $5,955,000.
    b. $5,595,000.
    c. $3,060,000.
    d. $4,495,000.

42. The current liabilities total is
    a. $2,435,000.
    b. $2,695,000.
    c. $2,200,000.
    d. $2,230,000.

43. The final retained earnings balance is
    a. $5,551,000.
    b. $6,016,000
    c. $5,135,000.
    d. $6,431,000.

44. On January 1, 2010, Kapp Co. leased a building to Duerr Corp. for a ten-year term at an annual rental of $80,000. At inception of the lease, Kapp received $320,000 covering the first two years' rent of $160,000 and a security deposit of $160,000. This deposit will not be returned to Duerr upon expiration of the lease but will be applied to payment of rent for the last two years of the lease. What portion of the $320,000 should be shown as a current and long-term liability in Kapp's December 31, 2010 balance sheet?

	Current Liability	Long-term Liability
a.	$0	$320,000
b.	$80,000	$160,000
c.	$160,000	$160,000
d.	$160,000	$80,000

45. Which of the following facts concerning depreciable assets should be included in the summary of significant accounting policies?

	Amortization Method	Composition
a.	No	Yes
b.	Yes	Yes
c.	Yes	No
d.	No	No

46. In a statement of cash flows, receipts from sales of property, plant, and equipment and other productive assets should generally be classified as cash inflows from
a. operating activities.
b. financing activities.
c. investing activities.
d. selling activities.

47. In a statement of cash flows, interest payments to lenders and other creditors should be classified as cash outflows for
a. operating activities.
b. borrowing activities.
c. lending activities.
d. financing activities.

48. In a statement of cash flows, proceeds from issuing equity instruments should be classified as cash inflows from
a. lending activities.
b. operating activities.
c. investing activities.
d. financing activities.

49. In a statement of cash flows, payments to acquire debt instruments of other entities (other than cash equivalents) should be classified as cash outflows for
a. operating activities.
b. investing activities.
c. financing activities.
d. lending activities.

Multiple Choice Answers—CPA Adapted

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.
40.	c	42.	d	44.	b	46.	c	48.	d
41.	b	43.	b	45.	c	47.	a	49.	b

DERIVATIONS — CPA Adapted

No.	Answer	Derivation
40.	c	$41,000 + $7,000 + $10,000 + $27,000 + $1,500 = $86,500
41.	b	$675,000 + [$2,895,000 - ($90,000 x 4)] + $2,385,000 = $5,595,000
42.	d	$1,981,000 + ($684,000 - $465,000) + $30,000 = $2,230,000
43.	b	$4,650,000 + $12,360,000 - $10,080,000 - ($1,379,000 - $465,000) = $6,016,000
44.	b	Conceptual.
45.	c	Conceptual.
46.	c	Conceptual.
47.	a	Conceptual.
48.	d	Conceptual.
49.	b	Conceptual.

EXERCISES

Ex. 5-50—Definitions.

Provide clear, concise answers for the following.

1. Explain the merits of classified financial statements.
2. What are financial instruments?
3. What are other assets?
4. What balance sheet information requires supplemental disclosure?
5. Explain the purpose of the cash flow statement.
6. Explain the concept of free cash flow.
7. What are inventories?

Solution 5-50

1. Classification in financial statements increases their information content. This is accomplished through the grouping of items with similar characteristics and separating items with different characteristics.

2. Financial instruments are contracts between two or more parties and include cash, the right to receive cash or another financial instrument, or investments in other companies.

3. This section includes assets that are not included anywhere else. They commonly include items such as noncurrent receivables and assets in special funds and require the disclosure of sufficient detail.

4. Supplemental disclosure is required for contingencies, accounting policies, contractual situations, and subsequent events. Additional information is also required for many individual balance sheet items.

5. The purpose of the cash flow statement is to allow users to assess an entity's capacity to generate cash and cash equivalents and its needs for cash resources. The statement identifies the sources of cash inflows and uses of cash during the period.

6. Free cash flow can be defined as a measure of a company's level of financial flexibility and is calculated as cash flow from operating activities less capital expenditures and dividends.

7. Inventories are assets that are held for sale in the ordinary course of business, in the process of production for such sale, or in the form of materials or supplies to be consumed in the production process or in the rendering of service.

Ex. 5-51—Terminology.

In the space provided at right, write the word or phrase that is defined or indicated.

1. A company's ability to take effective actions to alter the amounts and timing of cash flows so it can respond to unexpected needs and opportunities. 1. ______________________
2. Claims to future cash flows that are fixed and determinable. 2. ______________________
3. Short-term, highly liquid investments that are readily convertible into known amounts of cash. 3. ______________________
4. Assets that are held for sale in the ordinary course of business. 4. ______________________
5. Expenditures already made for benefits that will be received within one year or the operating cycle. 5. ______________________
6. Assets of physical substance that are used in ongoing business operations. 6. ______________________
7. Assets that have no physical substance. 7. ______________________
8. The excess of total current assets over total current liabilities. 8. ______________________
9. Unrealized gains and losses included as part of equity. 9. ______________________

Solution 5-51

1. Financial flexibility.
2. Monetary assets.
3. Cash equivalents
4. Inventories.
5. Prepaid expenses.
6. Property, plant, and equipment.
7. Intangible assets.
8. Working capital.
9. Accumulated other comprehensive income.

Ex. 5-52—Current liabilities.

Define current liabilities without using the word "liability."

Solution 5-52

Current liabilities are legally enforceable obligations that are due within the longer of: the date of the balance sheet or the operating cycle.

Ex. 5-53—Account classification.

ASSETS	LIABILITIES AND CAPITAL
a. Current assets	f. Current liabilities
b. Investments	g. Long-term liabilities
c. Plant and equipment	h. Preferred shares
d. Intangibles	i. Common shares
e. Other assets	j. Contributed surplus
	k. Retained earnings
	l. Items excluded from balance sheet

Using the letters above, classify the following accounts according to the preferred and ordinary balance sheet presentation.

____ 1. Bond sinking fund
____ 2. Common shares distributable
____ 3. Appropriation for plant expansion
____ 4. Bank overdraft
____ 5. Bonds payable (due 2019)
____ 6. Premium on common shares
____ 7. Securities owned by another company which are collateral for that company's note
____ 8. Trading securities
____ 9. Inventory
____ 10. Unamortized discount on bonds payable (due 2019)
____ 11. Patents
____ 12. Unearned revenue

Solution 5-53

1. b	5. g	9. a
2. i	6. j	10. g
3. k	7. l	11. d
4. f	8. a	12. f

Ex. 5-54—Valuation of Balance Sheet Items.

Use the code letters listed below (a – k) to indicate, for each balance sheet item (1 – 13) listed below the usual valuation reported on the balance sheet.

____	1. Common shares	____	8. Long-term bonds payable
____	2. Prepaid expenses	____	9. Land (in use)
____	3. Natural resources	____	10. Land (future plant site)
____	4. Property, plant, and equipment	____	11. Patents
____	5. Trade accounts receivable	____	12. Trading securities
____	6. Copyrights	____	13. Trade accounts payable
____	7. Merchandise inventory		

a. No par value
b. Current cost of replacement
c. Amount payable when due, less unamortized discount or plus unamortized premium
d. Amount payable when due
e. Fair value at balance sheet date
f. Net realizable value
g. Lower of cost or market
h. Original cost less accumulated depreciation
i. Original cost less accumulated depletion
j. Historical cost
k. Unexpired or unconsumed cost

Solution 5-54

1. a	6. h	11. h
2. k	7. g	12. e
3. i	8. c	13. d
4. h	9. j	
5. f	10. j	

Ex. 5-55—Balance sheet classifications.

Typical balance sheet classifications are as follows.

a. Current Assets
b. Investments
c. Plant Assets
d. Intangible Assets
e. Other Assets
f. Current Liabilities
g. Long-Term Liabilities
h. Capital Shares
i. Contributed Surplus
j. Retained Earnings
k. Notes to Financial Statements
l. Not Reported on Balance Sheet

Indicate by use of the above letters how each of the following items would be classified on a balance sheet prepared at December 31, 2010. If a contra account, or any amount that is negative or opposite the normal balance, put parentheses around the letter selected. A letter may be used more than once or not at all.

______ 1. Accrued salaries and wages	______16. Natural resources—timberlands
______ 2. Rental revenues for three months collected in advance	______17. Deficit (no income earned since beginning of company)
______ 3. Land used as plant site	______18. Goodwill
______ 4. Equity securities classified as short-term	______19. Ninety-day notes payable
______ 5. Cash	______20. Investment in bonds in another company; will be held to 2012 maturity
______ 6. Accrued interest payable due in thirty days	______21. Land held for speculation
______ 7. Premium on preferred shares issued	______22. Death of company president
______ 8. Dividends in arrears on preferred shares	______23. Current maturity of bonds payable
______ 9. Petty cash fund	______24. Investment in subsidiary; no plans to sell in the near future
______10. Unamortized discount on bonds payable due 2013	______25. Trade accounts payable
______11. Common shares at no par value	______26. Preferred shares, no par value
______12. Bond indenture covenants	______27. Prepaid expenses for next twelve months
______13. Unamortized premium on bonds payable due in 2018	______28. Copyright
______14. Allowance for doubtful accounts	______29. Accumulated depreciation
______15. Accumulated amortization	______30. Earnings, not distributed to shareholders

Solution 5-55

1. f	6. f	11. h	16. c	21. b	26. h
2. f	7. i	12. k	17. (j)	22. l	27. a
3. c	8. k	13. g	18. d	23. f	28. d
4. a	9. a	14. (a)	19. f	24. b	29. (c)
5. a	10. (g)	15. (c)	20. b	25. f	30. j

Ex. 5-56—Balance sheet classifications.

The various classifications listed below have been used in the past by Kimmel Company on its balance sheet. It asks your professional opinion concerning the appropriate classification of each of the items 1-14 below.

a. Current Assets
b. Investments
c. Plant and Equipment
d. Intangible Assets
e. Other Assets
f. Current Liabilities
g. Long-Term Liabilities
h. Capital Shares
i. Retained Earnings

Indicate by letter how each of the following items should be classified. If an item need not be reported on the balance sheet, use the letter "X." A letter may be used more than once or not at all. If an item can be classified in more than one category, choose the category most favoured by the authors of your textbook.

____ 1. Employees' payroll deductions.

____ 2. Cash in sinking fund.

____ 3. Rent revenue collected in advance.

____ 4. Factory building retired from use and held for sale.

____ 5. Patents.

____ 6. Payroll cash fund.

____ 7. Goods held on consignment.

____ 8. Accrued revenue on short-term investments.

____ 9. Advances to salespersons.

____10. Premium on bonds payable due two years from date.

____11. Bank overdraft.

____12. Salaries which company budget shows will be paid to employees within the next year.

____13. Work in process.

____14. Appropriation of retained earnings for bonded indebtedness.

Solution 5-56

1. f	5. d	9. a	13. a
2. b	6. a	10. g	14. i
3. f	7. x	11. f	
4. a or e	8. a	12. x	

Ex. 5-57—Balance sheet classifications.

The various classifications listed below have been used in the past by Dookes Company on its balance sheet.

a. Current Assets	e. Current Liabilities
b. Investments	f. Long-term Liabilities
c. Plant and Equipment	g. Common Shares
d. Intangible Assets	h. Retained Earnings

Instructions

Indicate by letter how each of the items below should be classified at December 31, 2010. If an item is not reported on the December 31, 2010 balance sheet, use the letter "X" for your answer. If the item is a contra account within the particular classification, place parentheses around the letter. A letter may be used more than once or not at all.

Sample question and answer:

__(a)__ Allowance for doubtful accounts.

_____ 1. Customers' accounts with credit balances.

_____ 2. Bond sinking fund.

_____ 3. Salaries which the company's cash budget shows will be paid to employees in 2011.

_____ 4. Accumulated depreciation.

_____ 5. Appropriation of retained earnings for plant expansion.

_____ 6. Impairment of goodwill for 2010.

_____ 7. On December 31, 2010, Dookes signed a purchase commitment to buy all of its raw materials from Peron Company for the next two years.

_____ 8. Discount on bonds payable due March 31, 2013.

_____ 9. Launching of Dookes' Internet retailing division in February, 2011.

_____ 10. Cash dividends declared on December 15, 2010 payable to shareholders on January 15, 2011.

Solution 5-57

1.	e	4.	(c)	7.	x	10.	e
2.	b	5.	h	8.	(f)		
3.	x	6.	x	9.	x		

Ex. 5-58—Statement of cash flows.

For each event listed below, select the appropriate category which describes the effect of the event on a statement of cash flows:

a. Cash provided/used by operating activities.
b. Cash provided/used by investing activities.
c. Cash provided/used by financing activities.
d. Not a cash flow.

____ 1. Payment on long-term debt

____ 2. Issuance of bonds at a premium

____ 3. Collection of accounts receivable

____ 4. Cash dividends declared

____ 5. Issuance of shares to acquire land

____ 6. Sale of marketable securities (long-term)

____ 7. Payment of employees' wages

____ 8. Issuance of common shares for cash

____ 9. Payment of income taxes payable

____10. Purchase of equipment

____11. Purchase of treasury stock (common)

____12. Sale of real estate held as a long-term investment

Solution 5-58

1.	c	4.	d	7.	a	10.	b
2.	c	5.	d	8.	c	11.	c
3.	a	6.	b	9.	a	12.	b

Ex. 5-59—Statement of cash flows ratios.

Financial statements for Sherban Company are presented below:

Sherban Company
Balance Sheet
December 31, 2010

Assets		Liabilities & Shareholders' Equity	
Cash	$ 44,000	Accounts payable	$ 28,000
Accounts receivable	39,000	Bonds payable	54,000
Buildings and equipment	154,000		
Accumulated depreciation— buildings and equipment	(46,000)	Common shares	69,000
Patents	24,000	Retained earnings	64,000
	$215,000		$215,000

Sherban Company
Statement of Cash Flows
For the Year Ended December 31, 2010

Cash flows from operating activities		
Net income		$ 60,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Increase in accounts receivable	$(19,000)	
Increase in accounts payable	7,000	
Depreciation—buildings and equipment	12,000	
Gain on sale of equipment	(7,000)	
Amortization of patents	3,000	(4,000)
Net cash provided by operating activities		56,000
Cash flows from investing activities		
Sale of equipment	14,000	
Purchase of land	(27,000)	
Purchase of buildings and equipment	(52,000)	
Net cash used by investing activities		(65,000)
Cash flows from financing activities		
Payment of cash dividend	(25,000)	
Sale of bonds	45,000	
Net cash provided by financing activities		20,000
Net increase in cash		11,000
Cash, January 1, 2010		33,000
Cash, December 31, 2010		$ 44,000

At the beginning of 2010, Accounts Payable amounted to $21,000 and Bonds Payable was $15,000.

Instructions

Calculate the following for Sherban Company:

a. Current cash debt coverage ratio
b. Cash debt coverage ratio
c. Free cash flow

Solution 5-59

a. Current cash debt coverage ratio $= \dfrac{\text{Net cash provided by operating activities}}{\text{Average current liabilities}}$

$$= \frac{\$56,000}{(\$21,000 + \$28,000) \div 2} = \frac{\$56,000}{\$24,500} = \underline{\underline{2.29 : 1}}$$

b. Cash debt coverage ratio $= \dfrac{\text{Net cash provided by operating activities}}{\text{Average total liabilities}}$

$$= \frac{\$56,000}{(\$36,000 + \$82,000) \div 2} = \frac{\$56,000}{\$59,000} = \underline{\underline{0.95 : 1}}$$

c. Free cash flow = Net cash provided by operating activities – capital expenditures and dividends

= \$56,000 – *\$79,000 – \$25,000 = $\underline{\underline{\$(48,000)}}$

*\$27,000 + \$52,000

PROBLEMS

Pr. 5-60—Balance sheet format.

The following balance sheet has been submitted to you by an inexperienced bookkeeper. List your suggestions for improvements in the format of the balance sheet. Consider both terminology deficiencies as well as classification inaccuracies.

Rowan Industries, Inc.
Balance Sheet
For the Period Ended December 31, 2010

Assets			
Fixed Assets—Tangible			
Equipment	$110,000		
Less: reserve for depreciation	(40,000)	$ 70,000	
Factory supplies		22,000	
Land and buildings	400,000		
Less: reserve for depreciation	(150,000)	250,000	
Plant site held for future use		90,000	$ 432,000
Current Assets			
Accounts receivable		175,000	
Cash		80,000	
Inventory		220,000	
Treasury stock (at cost)		20,000	495,000
Fixed Assets—Intangible			
Goodwill		80,000	
Notes receivable		40,000	
Patents		26,000	146,000
Deferred Charges			
Advances to salespersons		60,000	
Prepaid rent		27,000	
Returnable containers		75,000	162,000
TOTAL ASSETS			$1,235,000
Liabilities			
Current Liabilities			
Accounts payable		$140,000	
Allowance for doubtful accounts		8,000	
Common stock dividend distributable		35,000	
Income taxes payable		42,000	
Sales taxes payable		17,000	$ 242,000
Long-Term Liabilities, 5% debenture bonds, due 2016		500,000	
Reserve for contingencies		150,000	650,000
TOTAL LIABILITIES			892,000

Pr. 5-60—Balance sheet format. (Continued)

Equity		
Capital shares, no par value, issued 12,000 shares with		
60 shares held as treasury stock	$240,000	
Dividends paid	(20,000)	
Earned surplus	23,000	
Other accumulated past earnings	100,000	
TOTAL EQUITY		343,000
TOTAL LIABILITIES AND EQUITY		$1,235,000

Note 1. The reserve for contingencies has been created by charges to earned surplus and has been established to provide a cushion for future uncertainties.

Note 2. The inventory account includes only items physically present at the main plant and warehouse. Items located at the company's branch sales office, amounting to $30,000 are excluded since the company has consistently followed this procedure for many years.

Solution 5-60

1. The heading should be as of a specific date rather than for a period of time.
2. Reserve for Depreciation is poor terminology; the title Accumulated Depreciation is more appropriate.
3. Land and buildings should be segregated into two accounts. The Accumulated Depreciation account should only be reported for the buildings.
4. Plant site held for future use should be shown in the Investments section.
5. Current assets should be shown on the balance sheet first in most situations; current assets are listed usually in order of liquidity; factory supplies should be shown as a current asset.
6. Treasury stock is not an asset, but a contra account to shareholders' equity in most situations.
7. Notes receivable should be reported as a current asset or an investment.
8. The deferred charge items should be reclassified as follows in most situations:

    Advances to salespersons—current asset
    Prepaid rent—current asset
    Returnable containers—current asset

9. Allowance for doubtful accounts should be shown as a contra account to accounts receivable.
10. Common shares dividend distributable should be shown in shareholders' equity.
11. Five percent debenture bonds should be shown on a separate line.
12. Reserve for Contingencies should be shown as an appropriation of retained earnings. The authors prefer the term "appropriation" to the term "reserve."

Solution 5-60 (Continued)

13. Earned surplus is poor terminology. The term "retained earnings" is more appropriate.
14. Other Accumulated Past Earnings is poor terminology. Accumulated Other Comprehensive Income is the usual term.
15. The dividends paid title is a misnomer. It probably is a "dividends declared" item that should be closed to retained earnings.
16. No reference in the body of the statement is made to the notes. The order of the notes is wrong.
17. Note 2 indicates that the inventory account is understated by $30,000.
18. Specific identification and description of all significant accounting principles and methods that involve selection from among alternatives and/or those that are peculiar to a given industry should be disclosed in the annual report.

Pr. 5-61—Balance sheet presentation.

The following balance sheet was prepared by the bookkeeper for Bruin Company as of December 31, 2010.

Bruin Company
Balance Sheet
as of December 31, 2010

Cash	$ 90,000	Accounts payable	$ 75,000
Accounts receivable (net)	52,200	Long-term liabilities	110,000
Inventories	57,000	Shareholders' equity	208,500
Investments	76,300		
Equipment (net)	86,000		
Patents	32,000		
	$393,500		$393,500

The following additional information is provided:

1. Cash includes the cash surrender value of a life insurance policy $9,400, and a bank overdraft of $1,500 has been deducted.
2. The net accounts receivable balance includes:
   (a) accounts receivable—debit balances $62,000;
   (b) accounts receivable—credit balances $5,000;
   (c) allowance for doubtful accounts $4,800.
3. Inventories do not include goods costing $5,000 shipped out on consignment. Receivables of $5,000 were recorded on these goods.
4. Investments include investments in common shares, trading $24,000 and long-term $43,300, and franchises $9,000.
5. Equipment costing $8,000 with accumulated depreciation $6,000 is no longer used and is held for sale. Accumulated depreciation on the other equipment is $40,000.

Instructions
Prepare a balance sheet in good form (shareholders' equity details can be omitted.)

Solution 5-61

Bruin Company
Balance Sheet
As of December 31, 2010

		Assets		
Current assets				
Cash			$ 82,100	(1)
Trading securities			24,000	
Accounts receivable	$ 57,000	(2)		
Less: Allowance for doubtful accounts	4,800		52,200	
Inventories			62,000	(3)
*Equipment held for sale			2,000	(4)
Total current assets			222,300	
Investments				
Long-term securities	43,300			
Cash surrender value	9,400		52,700	
Property, plant, and equipment				
Equipment	124,000	(5)		
Less accumulated depreciation	40,000		84,000	
Intangible assets				
Patents	32,000			
Franchises	9,000		41,000	
Total assets			$400,000	
	Liabilities and Shareholders' Equity			
Current liabilities				
Accounts payable			$ 80,000	(6)
Bank overdraft			1,500	
Total current liabilities			81,500	
Long-term liabilities			110,000	
Total liabilities			191,500	
Shareholders' equity			208,500	
Total liabilities and shareholders' equity			$400,000	

(1) ($90,000 – $9,400 + $1,500)
(2) ($62,000 – $5,000)
(3) ($57,000 + $5,000)
(4) ($8,000 – $6,000)
(5) ($86,000 + $40,000 – $8,000 + $6,000)
(6) ($75,000 + $5,000)
*An alternative is to show it as an other asset.

Pr. 5-62 – Balance Sheet

Schaufel Company in the past has various classifications listed below on its balance sheet. You are asked for your professional opinion concerning the appropriate classification of each of the items 1-14 below.

a. Current Assets
b. Investments and Funds
c. Capital Assets
d. Intangible Capital Assets
e. Other Assets
f. Current Liabilities
g. Long-term Liabilities
h. Contributed Surplus and Common Shares
i. Retained Earnings
j. Other Liabilities

Instructions:

Indicate by letter how each of the following items should be classified. If an item need not be reported on the balance sheet, use the letter "X." A letter may be used more than once or not at all. If an item can be classified in more than one category, choose the category most favored by your textbook.

___ 1. Bank overdraft.
___ 2. Salaries which company budget shows will be paid to employees within the next year.
___ 3. Goods in process.
___ 4. Appropriation for bonded indebtedness.
___ 5. Organization costs.
___ 6. Payroll cash fund.
___ 7. Goods held on consignment.
___ 8. Accrued revenue on temporary investments.
___ 9. Advances to salespersons.
___ 10. Premium on bonds payable due two years from date.
___ 11. Employees' payroll deductions.
___ 12. Cash in bond sinking fund.
___ 13. Rent revenue collected in advance.
___ 14. Factory building retired from use and held for sale.

Solutions 5-62

1. f	4. i	7. x	10. g	13. f
2. x	5. d	8. a	11. f	14. e
3. a	6. a	9. a	12. b	

Pr. 5-63 Balance Sheet

The records of a corporation for year 3 reflected the following correct pretax amounts: gain from discontinued operations, $50,000; cash dividends declared and paid, $45,000; retained earnings, January 1, year 3, $275,000, correction of accounting error, $35,000 debit; income before income taxes and before discontinued operations, $165,000. The average income tax rate of 40 percent applies to all items except the dividends.

The December 31, year 3 (ending) balance of retained earnings was $________________.

Solution 5-63

Balance of retained earnings, December 31, year 3....	$338,000
	=======
Beginning balance.................................	$275,000
Correction of error ($35,000 x 60%)................	(21,000)
Income ($165,000) x 60%)............................	99,000
Gain from discontinued operations ($50,000 x60%)..................	30,000
Dividends...	(45,000)
Ending balance...................................	$338,000
	=======

Pr. 5-64 Balance Sheet

A company reported current assets of $120,000 and current liabilities of $150,000, therefore, the:
(a) Amount of working capital was $______________________.
(b) Working capital ratio was $__________________________.

Solutions 5-64
(a) Working capital: $120,000 - $150,000 = $30,000 negative
(b) Working capital ratio: $120,000 / 1$150,000 = 0.80

Pr. 5-65 Balance Sheet
A company reported current assets of $450,000, current liabilities of $250,000 and total assets of $1 Million; therefore, the:
(a) Amount of working capital was $______________________.
(b) Working capital ratio was $__________________________.

Solutions 5-65

(a) Working capital: $450,000 - $250,000 = $200,000
(b) Working capital ratio: $450,000 / $250,000 = 1.80

Pr 5-66

Morley Corporation completed the following transactions:

(a) At the beginning of the year issued $50,000, 10 percent bonds payable (interest payable annually), due in 10 years, for $48,000 cash. Any bond premium or discount will be amortized on the straight-line basis. Give the entry to record the first interest payment.

(b) Issued 3,500 shares of its common shares and received cash, $35,000, which was credited in full to the common shares subscribed account. Give the required correcting entry.

(c) The working capital ratio for the company at the end of year one was 1.5 and the current assets, $156,750. Therefore, the current liabilities amounted to $______________________.

Solutions 5-66

(a) Bond interest expense	5,200	
Discount on bonds payable ($2,000 / 10)		200
Cash ($50,000 x 10%)		5,000
	35,000	
(b) Common shares -- subscribed		
Common shares		35,000

(c) $156,750 / 1.5 = $104,500

Use the following information for questions 67 and 68.

Pr. 5-67 Cash Flow statement - direct method

The Controller of Schmidt Tooling Corporation has provided you with the following information:

Schmidt Tooling Corporation
Income Statement
For the Year Ended December 31, 2010

Net Sales		620,000
Operating expenses		410,000
		210,000
Income from operations		
Other revenues and expenses		
Gain on sale of equipment	30,000	
Interest expense	8,000	22,000
Income before income taxes		232,000
Income taxes		92,800
Net income		139,200

Schmidt Tooling Corporation
Comparative Account Information
Relating to Operations
For the Year Ended December 31, 2010

	2010	2009
Accounts receivable	56,000	40,000
Prepaid insurance	5,000	6,000
Accounts payable	59,000	47,000
Interest payable	600	1,500
Income taxes payable	4,200	6,000
Unearned revenue	20,000	14,000

Instructions:

Prepare a statement of cash flows (for the company's operating activities only) for the year ended December 31, 2010 using the *direct* format.

Solution 5-67

Schmidt Tooling Corporation
Partial Statement of Cash Flows
For the Year Ended December 31, 2010

Cash received from customers		$610,000
Cash paid		
For operating expenses	$397,000	
For interest	$8,900	
For income taxes	$94,600	$500,500
Net cash provided by operating activities		$109,500

Computations:

Cash received from customers:

Net sales	$ 620,000
- Increase in accounts receivable	(16,000)
+ Increase in unearned revenue	6,000
	$ 610,000

Cash paid for operating expenses:

Operating expenses	$ 410,000
- Decrease in prepaid insurance	(1,000)
- Increase in accounts payable	(12,000)
	$ 397,000

Cash paid for interest:

Interest expense	$ 8,000
+ Decrease in interest payable	900
	$ 8,900

Cash paid for income tax:

Income tax expense	$ 92,800
+ Decrease in income tax payable	1,800
	$ 94,600

Pr. 5-68 Cash Flow statement - indirect method

Instructions

Use the information provided in Pr. 5-67 previously. Prepare a statement of cash flows (for the company's operating activities only) for the year ended December 31, 2010 using the *indirect* format.

Solution 5-68

Schmidt Tooling Corporation
Partial Statement of Cash Flows
For the Year Ended December 31, 2010

Cash flows from operating activities

Net income	$139,200
Adjustments:	
Gain on sale of equipment	(30,000)
Increase in accounts receivable	(16,000)
Decrease in prepaid insurance	1,000
Increase in accounts payable	12,000
Decrease in interest payable	(900)
Decrease in income taxes payable	(1,800)
Increase in unearned revenue	6,000
Net cash provided by operating activities	$109,500

LEGAL NOTICE

CHAPTER 6

REVENUE RECOGNITION

MULTIPLE CHOICE—Conceptual

Answer	No.	Description
d	1.	Revenue recognition principle.
b	2.	Definition of "realized."
a	3.	Definition of "earned."
d	4.	Recognizing revenue at point of sale.
d	5.	Recording sales when right of return exists.
c	6.	Revenue recognition when right of return exists.
d	7.	Revenue recognition when right of return exists.
b	8.	Consignment sales—consignor vs. consignee
d	9.	Revenue recognition and consignment sales
b	10.	Appropriate accounting method for long-term contracts.
c	11.	Percentage-of-completion method.
b	12.	Percentage-of-completion method.
c	13.	Classification of progress billings and construction in process.
b	14.	Calculation of gross profit using percentage-of-completion.
a	15.	Disclosure of earned but unbilled revenues.
c	16.	Revenue, cost, and gross profit under completed contract.
b	17.	Disadvantage of using percentage-of-completion.
a	18.	Loss recognition on a long-term contract.
c	19.	Accounting for long-term contract losses.
d	20.	Criteria for revenue recognition of completion of production.
a	21.	Completion-of-production basis.
c	22.	Measurement and collectability.
d	23.	Application of the contract based approach.
a	24.	Use of the completed contract method.
d	25.	Recognition of losses in long-term contracts.
c	26.	The economics of business transactions.
c	27.	The earnings approach.
b	28.	Similarities between PE GAAP and IFRS.
a	29.	Revenue recognition in consignment sales.
b	30	Revenue analysis.
c	31.	Value-adding actions.
d	32.	Problems with the earnings approach.
d	33.	Revenue recognition by the consignor.
d	34.	The concept of commercial substance
d	35.	The concept of constructive obligations.
b	36.	The definition of revenue.
a	37.	The proposed new model of revenue recognition.
b	38.	The allocation of selling price in bundled sales.

MULTIPLE CHOICE—Computational

Answer	No.	Description
c	39.	Percentage-of-completion method.
c	40.	Percentage-of-completion method.
a	41.	Determine cash collected on long-term construction contract.
c	42.	Determine gross profit using percentage-of-completion.
c	43.	Gross profit to be recognized using percentage-of-completion.
b	44.	Gross profit to be recognized using percentage-of-completion.
c	45.	Profit to be recognized using completed-contract method.
b	46.	Gross profit to be recognized using percentage-of-completion.
b	47.	Profit to be recognized using completed-contract method.
c	48.	Loss recognized using completed-contract method.
c	49.	Revenue recognition using completed-contract method.
c	50.	Reporting a current liability with completed-contract-method.
a	51.	Reporting inventory under completed-contract method.
a	52.	Bundled sales – application of the fair value method.
a	53.	Bundled sales – application of the residual value method.
d	54.	Dealing with collection uncertainty.
b	55.	Interest recognized on instalment sales.
a	56.	Revenue recognized under the cost recovery method.
a	57.	Calculation of the net contract position – contract based approach.
a	58.	The construction in progress account – calculation of missing values.
a	59.	Application of the percentage of completion method.
b	60.	Sales on consignment.
b	61.	Reporting inventory on consignment.

MULTIPLE CHOICE—CPA Adapted

Answer	No.	Description
a	62.	Definition of "recognition."
b	63.	Determine contract costs incurred during year.
d	64.	Gross profit to be recognized using percentage-of-completion.
d	65.	Profit to be recognized using completed-contract method.
c	66.	Revenue recognized under completed-production method.
a	67.	Effect of collections received on service contracts.

EXERCISES

Item	Description
E6-68	Definitions.
E6-69	Terminology.
E6-70	Long-term contracts.
E6-71	Journal entries—percentage-of-completion.
E6-72	Percentage-of-completion method.
E6-73	Percentage-of-completion method.
E6-74	Percentage-of-completion and completed-contract methods.
E6-75	Contract-based approach.
E6-76	Bundled sales.
E6-77	Instalment sales.
E6-78	Consignment sales.
E6-79	Reporting of gross or net revenues

PROBLEMS

Item	Description
P6-80	Long-term contract accounting—completed contract.
P6-81	Long-term construction project accounting.
P6-82	Accounting for long-term construction contracts.
P6-83	Long term contract (Contract-based approach).
P6-84	Consignment sales.
P6-85	Completed contract and percentage-of-completion methods.
P6-86	Revenue recognition.
P6-87	Revenue recognition.
P6-88	Revenue recognition.

MULTIPLE CHOICE—Conceptual

1. The earnings approach to accounting for revenues provides that
   a. performance is achieved.
   b. the amount earned is reasonably measurable.
   c. collectibility is reasonably assured.
   d. all of these.

2. Under the earnings approach, when goods or services are exchanged for cash or claims to cash (receivables), revenues are
   a. earned.
   b. realized.
   c. recognized.
   d. all of these.

3. When the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues, revenues are
   a. earned.
   b. realized.
   c. recognized.
   d. all of these.

4. Which of the following is *not* a reason why revenue is recognized at time of sale under the earnings approach?
   a. The earning process is substantially complete.
   b. The amount is reasonably measured.
   c. Title legally passes from seller to buyer.
   d. All of these are reasons to recognize revenue at time of sale.

5. An alternative available when the seller is exposed to continued risks of ownership through return of the product is
   a. recording the sale, and accounting for returns as they occur in future periods.
   b. not recording a sale until all return privileges have expired.
   c. recording the sale, but reducing sales by an estimate of future returns.
   d. all of these.

6. Under the earnings approach, a sale should *not* be recognized as revenue by the seller at the time of sale if
   a. payment was made by cheque.
   b. the selling price is less than the normal selling price.
   c. the buyer has a right to return the product and the amount of future returns cannot be reasonably estimated.
   d. none of these.

7. If a company sells its product but gives the buyer the right to return the product, revenue from the sales transaction should be recognized at the time of sale under the earnings approach if
   a. the market for returnable goods is untested.
   b. the amount of goods returned is high.
   c. there is a transfer of the risks and rewards of ownership.
   d. the amount of future returns can be reasonably estimated.

8. Under a consignment sales arrangement,
   a. the consignor receives the merchandise to sell.
   b. the consignor retains legal title.
   c. the consignee ships the merchandise to the consignor.
   d. the consignee retains legal title.

9. Under a consignment sales arrangement, revenue is recognized under the earnings approach
   a. upon shipment of the merchandise to the consignee.
   b. upon receipt of the merchandise by the consignee.
   c. upon sale by the consignee.
   d. upon receipt by the consignor of notification of the sale.

10. In selecting an accounting method for a newly contracted long-term construction project under private entity GAAP, the principal factor to be considered should be
    a. the terms of payment in the contract.
    b. the degree to which a reliable estimate of the costs to complete and extent of progress toward completion is practicable.
    c. the method commonly used by the contractor to account for other long-term construction contracts.
    d. the inherent nature of the contractor's technical facilities used in construction.

11. Under private entity GAAP, the profession requires that the percentage-of-completion method be used when certain conditions exist. Which of the following is *not* one of those necessary conditions?
    a. Estimates of progress toward completion, revenues, and costs are reasonably dependable.
    b. The contractor can be expected to perform the contractual obligation.
    c. The buyer can be expected to satisfy some of the obligations under the contract.
    d. The contract clearly specifies the enforceable rights of the parties, the consideration to be exchanged, and the manner and terms of settlement.

12. When work to be done and costs to be incurred on a long-term contract can be estimated dependably, which of the following methods of revenue recognition is preferable under private entity GAAP?
    a. Instalment method
    b. Percentage-of-completion method
    c. Completed-contract method
    d. None of these

13. Under the earnings approach, how should the balances of progress billings and construction in process be shown at reporting dates prior to the completion of a long-term contract?
    a. Progress billings as deferred income, construction in progress as a deferred expense.
    b. Progress billings as income, construction in process as inventory.
    c. Net, as a current asset if debit balance and current liability if credit balance.
    d. Net, as income from construction if credit balance, and loss from construction if debit balance.

14. Under the earnings approach in accounting for a long-term construction-type contract using the percentage-of-completion method, the gross profit recognized during the first year would be the estimated total gross profit from the contract, multiplied by the percentage of the costs incurred during the year to the
    a. total costs incurred to date.
    b. total estimated cost.
    c. unbilled portion of the contract price.
    d. total contract price.

15. Under the earnings approach, how should earned but unbilled revenues at the balance sheet date on a long-term construction contract be disclosed if the percentage-of-completion method of revenue recognition is used?
    a. As construction in process in the current asset section of the balance sheet.
    b. As construction in process in the noncurrent asset section of the balance sheet.
    c. As a receivable in the noncurrent asset section of the balance sheet.
    d. In a note to the financial statements until the customer is formally billed for the portion of work completed.

16. Under the completed-contract method,
    a. revenue, cost, and gross profit are recognized during the production cycle.
    b. revenue and cost are recognized during the production cycle, but gross profit recognition is deferred until the contract is completed.
    c. the contract-based approach to recognizing revenues would not be allowed.
    d. none of these.

17. The principal disadvantage of using the percentage-of-completion method of recognizing revenue from long-term contracts is that it
    a. is unacceptable for income tax purposes.
    b. gives results based upon estimates which may be subject to considerable uncertainty.
    c. is likely to assign a small amount of revenue to a period during which much revenue was actually earned.
    d. none of these.

18. Cost estimates on a long-term contract may indicate that a loss will result on completion of the entire contract. In this case, the entire expected loss should be
    a. recognized in the current period, regardless of whether the percentage-of-completion or completed-contract method is employed.
    b. recognized in the current period under the percentage-of-completion method, but the completed-contract method should defer recognition of the loss to the time when the contract is completed.
    c. recognized in the current period under the completed-contract method, but the percentage-of-completion method should defer the loss until the contract is completed.
    d. deferred and recognized when the contract is completed, regardless of whether the percentage-of-completion or completed-contract method is employed.

19. Cost estimates at the end of the second year indicate a loss will result on completion of the entire contract. Which of the following statements is correct?
    a. Under the completed-contract method, the loss is not recognized until the year the construction is completed.
    b. Under the percentage-of-completion method, the gross profit recognized in the first year must not be changed.
    c. Under the completed-contract method, when the billings exceed the accumulated costs, the amount of the estimated loss is reported as a current liability.
    d. Under the completed-contract method, when the Construction in Process balance exceeds the billings, the estimated loss is added to the accumulated costs.

20. The criteria for recognition of revenue at completion of production of precious metals and farm products include
    a. an established market with quoted prices.
    b. low additional costs of completion and selling.
    c. units are interchangeable.
    d. all of these.

21. In certain cases revenue is recognized at the completion of production even though no sale has been made. Which of the following statements is *not* true?
    a. Examples involve precious metals or farm equipment.
    b. The products possess immediate marketability at quoted prices.
    c. No significant costs are involved in selling the product.
    d. All of these statements are true.

22. A sale that requires the customer to pay the purchase price in instalments
    a. should always be recognized under the contract-based view as the contract has already established the customer's obligation to pay.
    b. should only be recognized upon receipt of the last instalment payment.
    c. may be recognized under the earnings approach if measurement and collectability issues do not exist.
    d. None of these.

23. The completed contract method for accounting for long-term construction projects
    a. requires that no revenue is recognized until the project is completed.
    b. requires that costs are accumulated and revenue is recognized in proportion to cash collected.
    c. is not compatible with the contract-based approach to revenue recognition
    d. (a) and (c)

24. Which of the following statements does *not* describe a long term construction project that is accounted for under the completed contract method?
    a. Revenues are recognized evenly throughout the contract.
    b. Revenues are recognized at the end of the project.
    c. Losses are recognized immediately
    d. None of these

25. Losses in long-term construction projects
    a. are recognized immediately under the completed-contract method
    b. are recognized immediately under the percentage-of-completion method
    c. are generally deferred
    d. (a) and (b)

26. Which of the following concepts is *not* relevant for understanding the economics of business transactions?
    a. Their reciprocal nature.
    b. Their physical nature.
    c. All of these are relevant
    d. The presence of concessionary terms

27. Under an earnings approach to accounting for revenues, the main focus is placed on
    a. the creation of contractual rights of the underlying sales agreement.
    b. the adherence to relevant contractual obligations.
    c. the earnings process itself and how value is added.
    d. the presentation on the financial statements.

28. Under both private entity GAAP and IFRS,
    a. the earnings approach to revenue recognition is followed.
    b. all of these
    c. the percentage of completion methods are allowed.
    d. warranty costs are accrued.

29. The journal entries to recognize the revenue from a consignment sale would likely be identical under the earnings and the contract-based approaches assuming
    a. the contract is entered into at the same time as when control over the goods is passed to the customer.
    b. the underlying goods or services are valued under the residual value method
    c. the completed contract method is used
    d. the percentage-of-completion method is used.

30. Which of the following types of analyses would show a company's year-to year changes in revenue?
    a. Ratio analysis
    b. Trend analysis
    c. Regression analysis
    d. None of these

31. The actions a company takes to add value are referred to as
    a. The point of delivery
    b. The critical event
    c. The earnings process
    d. None of these

32. Which of the following would normally be considered as a problem associated with the earnings approach to revenue recognition?
    a. This approach may be subject to a considerable degree of subjective judgement.
    b. The existence of multiple and sometimes conflicting guidelines
    c. The difficulties arising from the split of risks and rewards between buyer and seller.
    d. All of these

33. Under the earnings approach, revenue is recognized by the consignor when the
    a. goods are shipped to the consignee.
    b. consignee receives the goods.
    c. consignor receives an advance from the consignee.
    d. consignor receives an account sales from the consignee.

34. The concept of commercial substance in purchase and sales transactions means that
    a. The transaction is a bona fide purchase and sale
    b. The entity's cash flows are expected to change
    c. The transaction must involve tangible assets
    d. (a) and (b)

35. The concept of a constructive obligation in business law refers to an obligation
    a. that may not be explicitly stated in the contract
    b. that may have been created through past practice
    c. that may be enforceable under common law
    d. All of these

36. A credit that is realized through an entity's ordinary activities would be treated as
    a. gain
    b. revenue
    c. income
    d. none of these

37. The new revenue recognition model currently studied by the IASB and FASB
    a. is the contract-based approach
    b. is the earnings approach
    c. the percentage of completion method
    d. the completed contract method

38. When a sale involves goods *and* services, the selling price should *not* be
   a. allocated to each of these parts
   b. allocated only to the part with the higher value
   c. allocated using the relative fair value method
   d. allocated using the residual method

Multiple Choice Answers—Conceptual

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.
1	d	7	d	13	c	19	c	25	d	31	c	37	a
2	b	8	b	14	b	20	d	26	c	32	d	38	b
3	a	9	d	15	a	21	a	27	c	33	d		
4	d	10	b	16	c	22	c	28	b	34	d		
5	d	11	c	17	b	23	d	29	a	35	d		
6	c	12	b	18	a	24	a	30	b	36	b		

MULTIPLE CHOICE—Computational

39. Kehl Construction Corporation contracted to construct a building for $1,500,000. Construction began in 2010 and was completed in 2011. Data relating to the contract are summarized below:

	Year ended December 31,	
	2010	2011
Costs incurred	$600,000	$460,000
Estimated costs to complete	400,000	—

Kehl uses the percentage-of-completion method and the earnings approach as the basis for income recognition. For the years ended December 31, 2010, and 2011, respectively, Kehl should report gross profit of

a. $270,000 and $170,000.
b. $900,000 and $600,000.
c. $300,000 and $140,000.
d. $0 and $440,000.

40. Molder Construction Company uses the percentage-of-completion method of accounting. In 2010, Molder began work on a contract it had received which provided for a contract price of $7,400,000. Other details follow:

	2010
Costs incurred during the year	$3,600,000
Estimated costs to complete as of December 31	2,400,000
Billings during the year	3,300,000
Collections during the year	1,950,000

Under the earnings approach, what should be the gross profit recognized in 2010?

a. $300,000.
b. $4,440,000.
c. $840,000.
d. $1,400,000.

Use the following information for questions 41 and 42:

In 2010, Rupp Corporation began construction work under a three-year contract. The contract price is $3,500,000. Rupp uses the percentage-of-completion method for financial accounting purposes. The income to be recognized each year is based on the proportion of costs incurred to total estimated costs for completing the contract. The financial statement presentations relating to this contract at December 31, 2010, follow:

Balance Sheet		
Accounts receivable—construction contract billings		$150,000
Construction in progress	$425,000	
Less contract billings	320,000	
Costs and recognized profit in excess of billings		105,000
Income Statement		
Income (before tax) on the contract recognized in 2010		$105,000

41. How much cash was collected in 2010 on this contract?

a. $170,000.
b. $200,000.
c. $25,000.
d. $300,000.

42. What was the initial estimated total income before tax on this contract?
a. $381,430.
b. $405,231.
c. $864,706.
d. $650,204.

43. List Construction Co. uses the percentage-of-completion method. In 2010, List began work on a contract for $1,650,000 and it was completed in 2011. Data on the costs are:

	Year Ended December 31	
	2010	2011
Costs incurred	$585,000	$420,000
Estimated costs to complete	390,000	—

Under the earnings approach, for the years 2010 and 2011, List should recognize gross profit of

	2010	2011
a.	$0	$645,000
b.	$387,000	$258,000
c.	$405,000	$240,000
d.	$405,000	$645,000

Use the following information for questions 44 and 45:

Spark Ltd. began work in 2010 on contract #731 which provided for a contract price of $2,400,000. Other details follow:

	2010	2011
Costs incurred during the year	$ 400,000	$1,225,000
Estimated costs to complete, as of December 31	1,200,000	0
Billings during the year	450,000	1,800,000
Collections during the year	300,000	1,950,000

44. Assume that Spark uses the percentage-of-completion method of accounting. Under the earnings approach, the portion of the total gross profit to be recognized as income in 2010 is
a. $150,000.
b. $200,000.
c. $600,000.
d. $800,000.

45. Assume that Spark uses the completed-contract method of accounting. The portion of the total gross profit to be recognized as income in 2011 is
a. $300,000.
b. $450,000.
c. $775,000.
d. $2,400,000.

Use the following information for questions 46 and 47:

Frey Ltd. began work in 2010 on a contract for $2,500,000. Other data are:

	2010	2011
Costs incurred to date	$1,080,000	$670,000,
Estimated costs to complete	720,000	—
Billings to date	840,000	2,500,000
Collections to date	600,000	2,000,000

46. If Frey uses the percentage-of-completion method, the gross profit to be recognized in 2010 under the earnings approach is
a. $400,000.
b. $420,000.
c. $900,000.
d. $200,000.

47. If Frey uses the completed-contract method, the gross profit to be recognized in 2011 under the earnings approach is
a. $800,000.
b. $750,000.
c. $2,000,000.
d. $1,700,000.

48. Beaver Builders, Ltd. is using the completed-contract method for a $4,100,000 contract that will take two years to complete. Data at December 31, 2010, the end of the first year, are:

Costs incurred to date	$1,850,000
Estimated costs to complete	2,200,000
Billings to date	1,700,000
Collections to date	1,400,000

The gross profit or loss that should be recognized for 2010 under the earnings approach is
a. $0.
b. a $50,000 loss
c. a $50,000 gross profit
d. a $100,000 gross profit

Use the following information for questions 49 through 51:

Peske Construction Co. began operations in 2010. Construction activity for 2010 is shown below. Peske uses the completed-contract method.

Contract	Contract Price	Billings Through 12/31/10	Collections Through 12/31/10	Costs to 12/31/10	Estimated Costs to Complete
1	$1,280,000	$1,260,000	$1,040,000	$860,000	—
2	1,440,000	600,000	400,000	328,000	$752,000
3	1,320,000	760,000	700,000	900,000	480,000

49. Which of the following should be shown on the income statement for 2010 related to Contract 1?
    a. Gross profit, $180,000.
    b. Gross profit, $400,000.
    c. Gross profit, $420,000.
    d. Gross profit, $240,000.

50. Which of the following should be shown on the balance sheet at December 31, 2010 related to Contract 2?
    a. Inventory, $272,000.
    b. Inventory, $328,000.
    c. Current liability, $272,000.
    d. Current liability, $600,000.

51. Which of the following should be shown on the balance sheet at December 31, 2010 related to Contract 3?
    a. Inventory, $80,000.
    b. Inventory, $140,000.
    c. Inventory, $840,000.
    d. Inventory, $900,000.

Use the following information for questions 52 and 53

52. A product and service are bundled together and sold to customers for $175. The fair values of the product and service are $150 and $50 respectively. Under the fair value method, how much would be allocated to the product?
    a. $131.25
    b. $87.50
    c. $150.00
    d. $100.00

53. How much would be allocated to the product under the residual value method?
    a. $125.00
    b. $131.25
    c. $150.00
    d. $100.00

54. Kohlman Co. has made a sale to a customer valued at $1.5 Mill. The associated expenses are $0.3 Mill. Some aspects of this sale have created an element of measurement uncertainty. Assuming that this element of uncertainty can be reasonably estimated at $0.45 Mill. Kohlman should
    a. Reduce revenues by $0.45 Mill
    b. Increase expenses by $0.45 Mill
    c. None of these
    d. (a) or (b)

55. Moor Company sold some machinery to Gale Company on January 1, 2010. The cash selling price would have been $284,310. Gale entered into an instalment sales contract which required annual payments of $75,000, including interest at 10 percent, over five years. The first payment was due on December 31, 2010. The collection of the payments is reasonably assured and measurement is not an issue. What amount of interest income should be included in Moor's 2011 income statement (the second year of the contract)?
    a. $7,500.
    b. $23,774.
    c. $15,000.
    d. $28,431.

56. On January 1, 2010, Bissel Co. sold land that cost $90,000 for $120,000, receiving a note bearing interest at 10 percent. The note will be paid in three annual instalments of $48,255 starting on December 31, 2010. Assuming that collection of the note is very uncertain, how much revenue from this sale should Bissel recognize in 2010?
    a. $0.
    b. $9,000.
    c. $12,000.
    d. $30,000.

57. Berlak Company entered into a contract with Charles Corporation. Berlak agreed to provide Charles with building supplies. Charles agreed to pay a total of $18,000 at delivery. Under the contract-based view, Berlak's *net contract position* can be assumed to be
    a. nil
    b. $18,000
    c. $9,000
    d. $4,500

58. Consider a project that was correctly accounted for under the percentage-of-completion method. At the end of the project, the construction in process account includes total debits and credits of $3.5 Mill. Assuming that gross profit of $1.2 Mill. was recognized throughout the contract, total constructions costs were:
    a. $2.3 Mill.
    b. $3.5 Mill.
    c. $2.1 Mill.
    d. $4.6 Mill.

59. At the end of year 2, the accounting records for a multi-year construction project indicate actual costs incurred to-date, and most recent estimate of total cost of $3.2 Mill and $9.5 Mill respectively. Assuming the percentage-of completion method is used, at the end of year 2 the project is
    a. 33.7% complete
    b. 31.2% complete
    c. 26.1% complete
    d. none of these

Use the following information for questions 60 and 61:

60. On April 1, 2010, Green Co. consigned 50 handcrafted garden benches to Garden Co. The per unit cost of the benches was $350 and total freight was $700 (the freight was paid by Garden). On August 1, Green received a cheque in the amount of $14,100 from Garden which included the following information:

Number of units sold:	20
Expenses deducted:	
Freight:	$700
Commission (20% of sales price)	?
Advertising	$450
Delivery	$290

Under the earnings approach, total sales were
    a. $15,540
    b. $19,425
    c. $18,550
    d. $19,060

61. The inventory of benches will be reported on whose balance sheet and at what amount?
    a. Green's Balance Sheet, $10,500
    b. Green's Balance Sheet, $10,920
    c. Garden's Balance Sheet $10,500
    d. Garden's Balance Sheet, $10,920

Multiple Choice Answers—Computational

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.
39.	c	43.	c	47.	b	51.	a	55.	b	59.	a
40.	c	44.	b	48.	c	52.	a	56.	a	60.	b
41.	a	45.	c	49.	c	53.	a	57.	a	61.	b
42.	c	46.	b	50.	c	54.	d	58.	a		

MULTIPLE CHOICE—CPA Adapted

62. According to the AcSB guidelines, the process of reporting an item in the financial statements of an entity is
    a. recognition.
    b. realization.
    c. allocation.
    d. matching.

63. Shore Construction Co. has consistently used the percentage-of-completion method of recognizing revenue. During 2010, Shore entered into a fixed-price contract to construct an office building for $6,000,000. Information relating to the contract is as follows:

	At December 31	
	2010	2011
Percentage of completion	15%	45%
Estimated total cost at completion	$4,500,000	$4,800,000
Gross profit recognized (cumulative)	300,000	720,000

    Under the earnings approach, contract costs incurred during 2011 were
    a. $1,440,000.
    b. $1,485,000.
    c. $1,575,000.
    d. $2,160,000.

64. Lear Constructors, Ltd. has consistently used the percentage-of-completion method of recognizing income. In 2010, Lear started work on a $7,000,000 construction contract that was completed in 2011. The following information was taken from Lear's 2010 accounting records:

Progress billings	$2,200,000
Costs incurred	2,100,000
Collections	1,400,000
Estimated costs to complete	4,200,000

    Under the earnings approach, what amount of gross profit should Lear have recognized in 2010 on this contract?
    a. $700,000.
    b. $466,667.
    c. $350,000.
    d. $233,333.

65. During 2010, Moss Corp. started a construction job with a total contract price of $1.4 million. The job was completed on December 15, 2011. Additional data are as follows:

	2010	2011
Actual costs incurred	$540,000	$610,000
Estimated remaining costs	540,000	—
Billed to customer	480,000	920,000
Received from customer	400,000	960,000

Under the completed-contract method, what amount should Moss recognize as gross profit for 2011?
a. $90,000.
b. $125,000.
c. $190,000.
d. $250,000.

66. Toledo Farms produced 180 tonnes of wheat during the 2010 season. Toledo sells all of its wheat to Pool Elevators, which has agreed to purchase Toledo's entire production at the prevailing market price. Recent legislation assures that the market price will not fall below $132 per tonne during the next two years. Toledo's costs of selling and distributing the wheat are immaterial and can be reasonably estimated. Toledo reports its inventory at expected exit value. During 2010, Toledo sold and delivered to Pool Elevators 150 tonnes at the market price of $135 per tonne. Toledo sold the remaining 30 tonnes during 2011 at the market price of $138 per tonne. Under the earnings approach, what amount of revenue should Toledo recognize in 2010?
a. $20,250.
b. $23,760.
c. $24,210.
d. $24,300.

67. Malek Inc. is a retailer of home appliances and offers a service contract on each appliance sold. Elton sells appliances on instalment contracts, but all service contracts must be paid in full at the time of sale. Collections received for service contracts should be recorded as an increase in a
a. deferred revenue account.
b. sales contracts receivable valuation account.
c. shareholders' valuation account.
d. service revenue account.

Multiple Choice Answers—CPA Adapted

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.
62.	a	64.	d	66.	c						
63.	b	65.	d	67.	a						

DERIVATIONS — Computational

No. **Answer** **Derivation**

39. c

$$\frac{\$600,000}{\$600,000 + \$400,000} \times (\$1,500,000 - \$1,000,000) = \$300,000$$

($1,500,000 – $1,060,000) – $300,000 = $140,000.

40. c

$$\frac{\$3,600,000}{\$3,600,000 + \$2,400,000} \times (\$7,400,000 - \$6,000,000) = \$840,000.$$

41. a $320,000 - $150,000 = $170,000.

42. c $425,000 – $105,000 = $320,000

$$\frac{\$320,000}{\text{Total estimated cost}} \times (\$3,500,000 - \text{Total estimated cost}) = \$105,000$$

Total estimated cost = $2,635,294
$3,500,000 – $2,635,294 = $864,706

43. c

$$\frac{\$585,000}{\$975,000} \times (\$1,650,000 - \$975,000) = \$405,000$$

($1,650,000 – $1,005,000) – $405,000 = $240,000.

44. b

$$\frac{\$400,000}{\$1,600,000} \times (\$2,400,000 - \$1,600,000) = \$200,000.$$

45. c $2,400,000 – $1,625,000 = $775,000.

46. b

$$\frac{\$1,080,000}{\$1,800,000} \times (\$2,500,000 - \$1,800,000) = \$420,000.$$

47. b $2,500,000 – $1,750,000 = $750,000.

48. c $4,100,000 – ($1,850,000 + $2,200,000) = $50,000.

49. c $1,280,000 – $860,000 = $420,000.

50. c $600,000 – $328,000 = $272,000.

51. a ($900,000 – $60,000) – $760,000 = $80,000.

Derivations (cont.)

No.	Answer	Derivation
52.	a	\$150 x [\$175 / (\$150 + \$50)] = \$131.25
53.	a	\$175 - \$50 = \$125
54.	d	n/a
55.	b	2010: \$75,000 – (\$284,310 × 10%) = \$46,569. 2011: (\$284,310 – \$46,569) × 10% = \$23,774.
56.	a	\$0.
57.	a	n/a
58.	a	\$3.5 Mill - \$1.2 Mill = \$2.3 Mill
59.	a	\$3.2 Mill / \$9.5 Mill = 33.7%
60.	b	Sales - (Sales x 20%) - \$700 - \$450 - \$290 = \$14,100 0.8 Sales = \$15,540 1.0 Sales = \$19,425
61.	b	(\$350 x 30) + [(\$700 / 50) x 30] = \$10,920

DERIVATIONS — CPA Adapted

No.	Answer	Derivation
62.	a	Conceptual.
63.	b	(\$4,800,000 × □45%) – (\$4,500,000 × □15%) = \$1,485,000.
64.	d	$\frac{\$2,100,000}{\$6,300,000} \times$ □ (\$7,000,000 – \$6,300,000) = \$233,333.
65.	d	\$1,400,000 – \$540,000 – \$610,000 = \$250,000.
66.	c	(150 tonnes × \$135) + (30 tonnes × \$132) = \$24,210.
67.	a	Conceptual.

EXERCISES

Ex. 6-68—Definitions.

Provide clear, concise answers for the following.

1. Explain the conceptual difference between the earnings and contract-based approaches to accounting for revenues.
2. How is revenue recognized under the earnings approach?
3. How is revenue recognized under the contract-based approach?
4. How are sales accounted for in the presence of collection and measurement uncertainty?
5. What are the two main methods to account for long-term construction projects under private entity GAAP?
6. Why is it important to understand the business perspective of selling transactions?
7. Explain the term *onerous contracts* and its implications.

Solution 6-68

1. The earnings approach focuses on the earnings process itself and how value is added. The contract-based approach focuses on the creation of contractual rights and obligations that are created by sales contracts.
2. Under the earnings approach, revenue is recognized when performance is substantially complete and collection is reasonably assured.
3. Under the contract-based approach, the net contract position is initially recognized (through assets and corresponding liabilities) when the contract has been entered into. Revenue is subsequently recognized as the contract obligations are fulfilled.
4. In the absence of reasonable expectation of collection and/or ability to measure the related revenue, sales should not be booked.
5. The two main methods allowed under private entity GAAP are the percentage-of-completion and the completed contract methods.
6. The business perspective includes the physical and reciprocal nature as well as any concessionary terms of the transaction. This may impact the timing, measurement and recognition of those sales.
7. Onerous contracts are contracts that are no longer profitable to the company. These contracts should be re-measured and a loss should be recognized.

Ex. 6-69—Terminology.

In the space provided at right, write the word or phrase that is defined or indicated.

1. The way transactions are booked when the seller is acting as principal in the sale. 1. ______________________

2. The analysis of a company's year-to-year changes in revenues. 2. ______________________

3. Sales that are comprised of several individual components 3. ______________________

4. The party acting as an agent for the seller. 4. ______________________

5. The method to allocate sales prices to individual components of a sales bundle that ensures that upfront revenues are not overstated. 5. ______________________

6. The method used to account for long-term contracts that do not recognize profits before the completion of the project. 6. ______________________

7. The account used in the percentage-of completion and completed contract methods to accumulate costs and recognize profits. 7. ______________________

8. The notion of giving something up and receiving something in return (i.e. in a business transaction). 8. ______________________

9. The unbilled revenue from a long-term construction project shown as a debit on the contractors' balance sheet. 9. ______________________

Solution 6-69

1. Gross basis.
2. Trend analysis.
3. Bundled sales.
4. The consignee.
5. The residual value method.
6. The completed contract method.
7. The construction in process account.
8. Reciprocity.
9. Cost and recognized profit in excess of billings.

Ex. 6-70—Comparison of accounting methods for long-term contracts

Compare the percentage-of-completion and completed-contract methods.

Solution 6-70

The percentage-of-completion method recognizes revenue prior to the completion of the project. A major advantage of this method is that the contractors' revenue stream is not distorted. However, the reliance on estimates, rather than on actual numbers, is a disadvantage. This method conforms to the earnings-based view of revenue recognition.

Under the completed contract method, revenue recognition is deferred until the completion of the project. A major advantage of this method is the use of actual numbers, rather than estimates. A major disadvantage is the distortion of income, as no revenue is recognized during the contract. This method does *not* conform to the earnings-based view of revenue recognition.

Ex. 6-71—Journal entries—percentage-of-completion.

Mallard Construction Company was awarded a contract to construct an interchange at the junction of two major freeways in a Canadian city at a total contract price of $8,000,000. The estimated total costs to complete the project were $6,000,000.

Instructions

Under the earnings approach

(a) Make the entry to record construction costs of $3,600,000, on construction in process to date.

(b) Make the entry to record progress billings of $2,000,000.

(c) Make the entry to recognize the profit that can be recognized to date, on a percentage-of-completion basis.

Solution 6-71

(a)	Construction in Process	3,600,000	
	Materials, Cash, Payable, Etc.		3,600,000
(b)	Accounts Receivable—Construction in Process	2,000,000	
	Billings on Construction in Process		2,000,000
(c)	Construction Expenses	3,600,000	
	Construction in Process (60% complete)	1,200,000	
	Revenue from Long-term Contract		4,800,000

Ex. 6-72—Percentage-of-completion method.

Feifel Construction Co. contracted to build a bridge for $5,000,000. Construction began in 2010 and was completed in 2011. Data relating to the construction are:

	2010	2011
Costs incurred	$1,620,000	$1,400,000
Estimated costs to complete	1,380,000	—

Vivien uses the percentage-of-completion method.

Instructions

Under the earnings approach

(a) How much revenue should be reported for 2010? Show your calculation.
(b) Make the entry to record progress billings of $1,700,000 during 2010.
(c) Make the entry to record the revenue and gross profit for 2010.
(d) How much gross profit should be reported for 2011? Show your calculation.

Solution 6-72

(a) $\dfrac{\$1,620,000}{\$3,000,000} \times \$5,000,000 = \underline{\$2,700,000}$

(b)	Accounts Receivable	1,700,000	
	Billings on Construction in Process		1,700,000
(c)	Construction Expenses	1,620,000	
	Construction in Process	1,080,000	
	Revenue from Long-term Contracts		2,700,000

Solution 6-72 (Continued)

(d)	Revenue	$5,000,000
	Costs	3,020,000
	Total gross profit	1,980,000
	Recognized in 2010	(1,080,000)
	Recognized in 2011	$ 900,000
	Or	
	Total revenue	$5,000,000
	Recognized in 2010	(2,700,000)
	Recognized in 2011	2,300,000
	Costs in 2011	(1,400,000)
	Gross profit in 2011	$ 900,000

Ex. 6-73—Percentage-of-completion method.

Pod Builders contracted to build a high-rise for $12,000,000. Construction began in 2010 and is expected to be completed in 2013. Data for 2010 and 2011 are:

	2010	2011
Costs incurred	$1,800,000	$3,400,000
Estimated costs to complete	7,200,000	4,800,000

Pod uses the percentage-of-completion method.

Instructions

Under the earnings approach

(a) How much gross profit should be reported for 2010? Show your calculation.

(b) How much gross profit should be reported for 2011?

(c) Make the journal entry to record the revenue and gross profit for 2011.

Solution 6-73

(a) $\frac{\$1,800,000}{\$9,000,000} \times \$3,000,000 = \underline{\underline{\$600,000}}$

(b) $\frac{\$5,200,000}{\$10,000,000} \times \$2,000,000 = \$1,040,000$

Less 2010 gross profit	600,000
Gross profit in 2011	$ 440,000

(c)

Construction in Process	440,000	
Construction Expenses	3,400,000	
Revenue from Long-term Contracts		3,840,000

Ex. 6-74—Percentage-of-completion and completed-contract methods.

On February 1, 2010, Marcos Contractors agreed to construct a building at a contract price of $3,000,000. Marcos estimated total construction costs would be $2,000,000 and the project would be finished in 2012. Information relating to the costs and billings for this contract is as follows:

	2010	2011	2012
Total costs incurred to date	$ 750,000	$1,320,000	$2,300,000
Estimated costs to complete	1,250,000	880,000	-0-
Customer billings to date	1,100,000	2,000,000	3,000,000
Collections to date	1,000,000	1,750,000	2,950,000

Instructions

Under the earnings approach

Fill in the correct amounts on the following schedule. For percentage-of-completion accounting and for completed-contract accounting, show the gross profit that should be recorded for 2010, 2011, and 2012.

	Percentage-of-Completion Gross Profit		Completed-Contract Gross Profit
2010	__________	2010	__________
2011	__________	2011	__________
2012	__________	2012	__________

Solution 6-74

	Percentage-of-Completion Gross Profit		Completed-Contract Gross Profit
2010	$375,000[a]	2010	—
2011	$105,000[b]	2011	—
2012	$220,000[c]	2012	$700,000[d]

[a] $\frac{\$750,000}{\$2,000,000} \times \$1,000,000 = \$375,000$

[b] $\frac{\$1,320,000}{\$2,200,000} \times \$800,000 = \$480,000$

Less 2010 gross profit	(375,000)
2011 gross profit	$105,000

[c]Total revenue	$3,000,000
Total costs	2,300,000
Total gross profit	700,000
Recognized to date	(480,000)
2012 gross profit	$ 220,000

[d]Total revenue	$3,000,000
Total costs	2,300,000
Total gross profit	$ 700,000

Ex. 6-75 - Contract-based approach

In January 2010 McKay Construction Co. contracted to construct a building for $6,000,000. Construction started in early 2010 and was completed in 2011.
The following additional information is available:

	2010	2011
Costs incurred	$2,430,000	$2,700,000
Estimated costs to complete	2,600,000	—
Collections during the year	2,400,000	3,600,000

McKay uses the percentage-of-completion method.

Instructions
Under the *contract-based* approach,
(a) How much revenue should McKay report for 2010?
(b) Prepare all entries for 2010 and 2011 for McKay.

Solution 6-75

(a)
[$2,430,000 / ($2,430,000 + $2,600,000)] x $6,000,000 = <u>$2,898,608</u>
[($2,430,000 + $2,700,000) / ($2,430,000 + 2,700,000 + $0) x $6,000,000] - $2,898,608 = <u>$3,101,392</u>

(b)
2010:

<u>To record contract rights and obligations - January 2010:</u>

Contract asset	6,000,000	
Contract liability		6,000,000

<u>To record construction cost - 2010:</u>

Contract liability	2,430,000	
Materials, Cash, Payables etc.		2,430,000

<u>To record collections - 2010:</u>

Cash	2,400,000	
Contract asset		2,400,000

<u>To recognize revenue and gross profit - 2010:</u>

Construction expenses	2,430,000	
Contract liability		2,430,000
Contract asset	2,898,608	
Revenue from long-term contract		2,898,608

2011:

<u>To record construction cost - 2011:</u>

Contract liability	2,700,000	
Materials, Cash, Payables etc.		2,700,000

<u>To record collections - 2011:</u>

Cash	3,600,000	
Contract asset		3,600,000

<u>To recognize revenue and gross profit - 2011:</u>

Construction expenses	2,700,000	
Contract liability		2,700,000
Contract asset	3,101,392	
Revenue from long-term contract		3,101,392

Ex. 6-76 - Bundled Sales

Numerica Inc., a software company sells a new accounting software and user support bundled together. The fair value of the software is $750 and the fair value of the user support is $250. The user support is valid for a period of 12 months calculated from the date of software purchase. To be able to compete with a competitor's offering, Numerica decided to sell the bundle at a discount for $900.
During its first month of sales, 100 units of this software bundle were sold at the discounted price and expenses were $25,000.

Instructions
(a) Calculate the sale price that should be allocated to each component of the bundle using the fair value method.

(b) Calculate the sale price that should be allocated to each component of the bundle using the *residual* value method.

(c) Assuming that the fair value method is used and income taxes of 30%, calculate the income applicable to Numerica's first month of sales.

Solution 6-76

(a) Fair value method:	
Software: $750 x [$900 / ($750 + $250)] =	$675.00
User Support: $250 x [$900 / ($750 + $250)] =	$225.00
	$900.00
(b) Residual value method:	
Software: $900 - $250	$650.00
User Support: $900 - $650	$250.00
	$900.00
(c) Income calculation:	
Sales ($900 x 100)	$90,000
Less:	
Expenses	($25,000)
User Support Unearned Portion	(20,625)
[($225 x 100) x 11/12]	
Income before tax	44,375
Less Income tax (30%)	(13,313)
Net Income	$31,063

Ex. 6-77—Instalment sales.

Rosen Company sells office equipment. On January 1, 2010, Rosen entered into an instalment sale contract with Diehl Company for a six-year period expiring January 1, 2016. Equal annual payments under the instalment sale are $312,000 and are due on January 1. The first payment was made on January 1, 2010.

Additional information is as follows:

The cash selling price of the equipment, i.e., the amount that would be realized on an outright sale, is $1,528,000.

The cost of sales relating to the equipment is $1,200,000.

The finance charges relating to the instalment period are $344,000 based on a stated interest rate of 9% which is appropriate. For tax purposes, Rosen appropriately uses the accrual basis for recording finance charges.

Circumstances are such that the collection of the instalment sale is reasonably assured and measurement uncertainties do not exist.

Assume that the income tax rate is 30 percent

Instructions
Under the earnings approach
What income (loss) before income taxes should Rosen appropriately record as a result of this transaction for the year ended December 31, 2010? Show supporting calculations in good form.

Solution 6-77

Rosen Company
Calculation of Income Before Income Taxes
On Instalment Sales Contract
For the Year Ended December 31, 2010

Sales	$1,528,000
Cost of Sales	1,200,000
Gross Profit	328,000
Interest Revenue (Schedule I)	109,440
Income before Income Taxes	$ 437,440

Schedule I

Calculation of Interest Revenue on
Instalment Sales Contract

Cash selling price (sales)	$1,528,000
Payment made on January 1, 2010	312,000
Balance outstanding at 12/31/10	1,216,000
Interest rate	9%
Interest Revenue	$ 109,440

Ex. 6-78 - Consignment Sale

In 2010, the following transaction occurred between McKenzie Wholesale Corp. (Consignor) and Bravo Superstores (Consignee):
On March 2, 2010 McKenzie shipped merchandise costing $52,000 to Bravo. McKenzie paid $4,000 for freight and Bravo paid $3,000 for advertising (to be reimbursed by McKenzie). By the end of the third quarter of 2010 (September 30, 2010), Bravo advised McKenzie that the entire stock was sold for $70,000 and forwarded the proceeds (net of a 15% commission and the outlay for advertising) to McKenzie.

Instructions
Prepare all entries for Bravo to account for this transaction.

Solution 6-78

To set up receivable for advertising:		
Receivable from Consignor	3,000	
Cash		3,000
To record sale:		
Cash	70,000	
Payable to Consignor		70,000
Remittance to Consignor:		
Payable to Consignor*	70,000	
Receivable from Consignor		3,000
Commission revenue		10,500
Cash		56,500

*$70,000 x 15% = $10,500

***Ex. 6-79**—Reporting of gross or net revenues.

Discuss factors to consider in determining whether gross or net revenues should be reported on the income statement.

Solution 6-79

Factors to consider:
1. whether the company is acting as principal or are they acting as agent or broker-principal would support reporting gross revenue, agent/broker would support reporting net
2. whether the company takes title to the goods being sold—taking title supports reporting the gross revenue
3. whether the company has the risks and rewards of ownership of the goods being sold—having the risks and rewards supports reporting the gross revenue

PROBLEMS

Pr. 6-80—Long-term contract accounting (completed-contract).

Kuhn Construction, Ltd. experienced the following construction activity in 2010, the first year of operations.

Contract	Total Contract Price	Billings through 12/31/10	Cash Collections through 12/31/10	Cost Incurred through 12/31/10	Estimated Additional Costs to Complete
X	$260,000	$170,000	$155,000	$182,000	$ 63,000
Y	325,000	130,000	130,000	100,000	247,000
Z	388,000	388,000	316,000	252,000	-0-
	$973,000	$688,000	$601,000	$534,000	$310,000

Each of the above contracts is with a different customer, and any work remaining at December 31, 2010 is expected to be completed in 2011.

Instructions
Prepare a partial income statement and a partial balance sheet to indicate how the above contract information would be reported. Kuhn uses the completed-contract method.

Solution 6-80

Kuhn Construction, Ltd.
Income Statement
For the Year 2010

Revenue from long-term contracts (contract Z)		$388,000
Cost of construction (contract Z)		252,000
Gross profit		$136,000
Provision for loss (contract Y)*		22,000
*Contract costs through 12/31/10	$100,000	
Estimated costs to complete	247,000	
Total estimated costs	347,000	
Total contract price	325,000	
Loss recognized in 2010	$ 22,000	

Carey Construction, Ltd.
Balance Sheet
As of 12/31/10

Current assets:		
Accounts receivable ($688,000 – $601,000)		$ 87,000
Inventories		
Construction in process (contract X)	$182,000	
Less: Billings	170,000	
Unbilled contract costs		12,000
Current liabilities:		
Billings ($130,000) in excess of contract costs ($100,000)		30,000
Estimated loss from long-term contracts		22,000

Pr. 6-81—Long-term construction project accounting.

Pullman Construction specializes in the construction of commercial and industrial buildings. The contractor is experienced in bidding long-term construction projects of this type, with the typical project lasting fifteen to twenty-four months. The contractor uses the percentage-of-completion method of revenue recognition since, given the characteristics of the contractor's business and contracts, it is the most appropriate method. Progress toward completion is measured on a cost to cost basis. Pullman began work on a lump-sum contract at the beginning of 2010. As bid, the statistics were as follows:

Lump-sum price (contract price)		$2,000,000
Estimated costs		
Labour	$425,000	
Materials and subcontractor	875,000	
Indirect costs	200,000	1,500,000
		$ 500,000

At the end of the first year, the following was the status of the contract:

Billings to date		$1,115,000
Costs incurred to date		
Labour	$207,000	
Materials and subcontractor	519,000	
Indirect costs	75,000	801,000
Latest forecast total cost		1,500,000

It should be noted that included in the above costs incurred to date were standard electrical and mechanical materials stored on the job site, but not yet installed, costing $51,000. These costs should not be considered in the costs incurred to date.

Instructions

Under the earnings approach

(a) Calculate the percentage of completion on the contract at the end of 2010.

(b) Indicate the amount of gross profit that would be reported on this contract at the end of 2010.

(c) Make the journal entry to record the income (loss) for 2010 on Pullman's books.

(d) Indicate the account(s) and the amount(s) that would be shown on the balance sheet of Pullman Construction at the end of 2010 related to its construction accounts. Also indicate where these items would be classified on the balance sheet. Billings collected during the year amounted to $980,000.

(e) Assume the latest forecast on total costs at the end of 2010 was $2,050,000. How much income (loss) would Pullman report for the year 2010?

Solution 6-81

(a)

Costs to date	$801,000
Less materials on job site	(51,000)
	$750,000

$$\frac{\text{Costs Incurred to Date}}{\text{Total Estimated Costs}} = \text{Percentage of Completion}$$

$$\frac{\$750{,}000}{\$1{,}500{,}000} = 50\%$$

(b)

50% × $2,000,000 =	$1,000,000
Costs incurred	750,000
Income	$ 250,000

(c)

Construction Expense	750,000	
Construction in Process	250,000	
Revenue from Long-term Project		1,000,000

(d) Current Asset

Accounts receivable	$135,000	($1,115,000 – $980,000)

Current Liability

Billings in excess of contract costs and recognized profit	$115,000	($1,115,000 – $1,000,000)

(e) Total loss reported in 2010

Contract price	$2,000,000
Estimated cost to complete	2,050,000
Amount of loss to be reported	$ (50,000)

Pr. 6-82—Accounting for long-term construction contracts.

The board of directors of Basten Construction Company is meeting to choose between the completed-contract method and the percentage-of-completion method of accounting for long-term contracts in the company's financial statements. You have been engaged to assist Basten's controller in the preparation of a presentation to be given at the board meeting. The controller provides you with the following information:

1. Basten commenced doing business on January 1, 2010.
2. Construction activities for the year ended December 31, 2010, were as follows:

Project	Total Contract Price	Billings Through 12/31/10	Cash Collections Through 12/31/10
A	$ 615,000	$ 340,000	$ 310,000
B	450,000	135,000	135,000
C	475,000	475,000	390,000
D	600,000	240,000	160,000
E	480,000	400,000	400,000
	$2,620,000	$1,590,000	$1,395,000

Project	Contract Costs Incurred Through 12/31/10	Estimated Additional Costs to Complete Contracts
A	$ 510,000	$120,000
B	130,000	260,000
C	350,000	-0-
D	370,000	290,000
E	320,000	80,000
	$1,680,000	$750,000

3. Each contract is with a different customer.
4. Any work remaining to be done on the contracts is expected to be completed in 2011.

Instructions

Under the earnings approach

(a) Prepare a schedule by project, computing the amount of income (or loss) before selling, general, and administrative expenses for the year ended December 31, 2010, which would be reported under:
   (1) The completed-contract method.
   (2) The percentage-of-completion method (based on estimated costs).

(b) Prepare the general journal entry(ies) to record revenue and gross profit on project B (second project) for 2010, assuming that the percentage-of-completion method is used.

(c) Indicate the balances that would appear in the balance sheet at December 31, 2010 for the following accounts for Project D (fourth project), assuming that the percentage-of-completion method is used.
   Accounts Receivable
   Billings on Construction in Process
   Construction in Process

(d) How would the balances in the accounts discussed in part (c) change (if at all) for Project D (fourth project), if the completed-contract method is used?

Solution 6-82

(a) (1) and (2)

Projects	A	B	C	D	E
Contract price	$615,000	$450,000	$475,000	$600,000	$480,000
Contract costs incurred	510,000	130,000	350,000	370,000	320,000
Additional costs to complete	120,000	260,000	-0-	290,000	80,000
Total cost	630,000	390,000	350,000	660,000	400,000
Total gross profit or (loss)	$ (15,000)	$ 60,000	$125,000	$ (60,000)	$ 80,000

The amount reported as income (loss) under the completed-contract method for 2010 is:

Project	A	$(15,000)
	B	-0-
	C	125,000
	D	(60,000)
	E	-0-
		$ 50,000

The amount reported as income (loss) under the percentage-of-completion method for 2010 is:

Project	A	$(15,000)	
	B	20,000	$60,000 × ($130,000 ÷ $390,000)
	C	125,000	
	D	(60,000)	
	E	64,000	$80,000 × ($320,000 ÷ $400,000)
		$134,000	

(b)

Construction in Process	20,000	
Construction Expenses	130,000	
Revenue from Long-term Contracts		150,000

(c)

Billings	$240,000
Cash collections	160,000
Accounts receivable	$ 80,000
Billings on Construction in Process	$240,000
Costs incurred	$370,000
Loss reported	(60,000)
Construction in process	$310,000

(d) The account balances would be the same.

Pr. 6-83 - Long-term contract (contract-based approach)

On January 1, year 1, Danube Company, a management consulting firm, entered into a contract with James Company to provide advisory services over a four-year period. The contract price was $4 Mill. and was paid in four equal annual payments at the end of each year. James' expenses relating to this contract were $650,000, $730,000, $780,000 and $710,000 for years 1 to 4 respectively. Collectibility was reasonably assured throughout the duration of the contract and measurement uncertainties were not an issue.

Instructions

Under the contract approach:
Prepare all journal entries for years 1 to 4.

Solution 6-83

	Year-1		**Year-2**		**Year-3**		**Year-4**	
	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
To record contract rights and obligations:								
Contract asset	4,000,000							
Contract liability		4,000,000						
To record contract expenses:								
Contract liability	650,000		730,000		780,000		710,000	
Materials, Cash, Payables etc.		650,000		730,000		780,000		710,000
To record collections:								
Cash	1,000,000		1,000,000		1,000,000		1,000,000	
Contract asset		1,000,000		1,000,000		1,000,000		1,000,000
To recognize revenue and gross profit:								
Expenses	650,000		730,000		780,000		710,000	
Contract liability		650,000		730,000		780,000		710,000
Contract asset	1,000,000		1,000,000		1,000,000		1,000,000	
Revenue from long-term contract		1,000,000		1,000,000		1,000,000		1,000,000

Pr. 6-84—Consignment sales.

Ingram Corp ships merchandise costing $230,000 on consignment to Faba Stores. Ingram pays the freight of $5,000. Faba Stores is to receive upon sale a 12% commission and a 6% allowance to offset its advertising expenses. At the end of the period, Faba notifies Ingram that 50% of the merchandise has been sold for $280,000.

Instructions
Under the earnings approach
Record the entries required by the two companies.

Solution 6-84

a) On shipment

Ingram			Faba		
Inventory on Consignment	230,000				
Goods Inventory		230,000			

b) Payment of freight

Ingram			Faba		
Inventory on Consignment	5,000				
Cash		5,000			

c) Sales of consigned merchandise

Ingram			Faba		
			Cash	280,000	
			Payable to Consignor		280,000

d) Notification of sales and expenses and remittance of cash

Ingram			Faba		
Cash	229,600		Payable To Consignor	280,000	
Advertising Expense	16,800		Advertising Expense		16,800
Commission Expense	33,600		Commission Revenue		33,600
Revenue From Consignment Sales		280,000	Cash		229,600
Cost of Goods Sold	117,500				
Inventory on Consignment		117,500			

0.50 * (230,000 + 5,000) = 117,500

$280,000 x 12% = $33,600
$280,000 x 6% = $16,800
$280,000 - $33,600 - $16,800 = $229.600

Pr. 6-85 – Long term construction project under two methods

On January 1, 2010, Alpha Company started a construction project for Ergola Corporation for $4,500,000. Relevant data for 2010 and 2011 are as follows:

	2010	**2011**
Current year construction costs	$ 3,300,000	$ 620,000
Estimated remaining costs to complete the contract	600,000	-0-
Current year billings to customer	3,100,000	1,400,000
Current year collections from customer	3,000,000	1,500,000

Instructions
Under the earnings approach
Calculate the following amounts for each method:

	Completed Contract		**Percentage-of-Completion**	
	2010	**2011**	**2010**	**2011**
(a) Gross Profit	$	$	$	$
(b) Construction in progress Year-end balance	$	$	$	$
(c) Costs in excess of billings (Billings in excess of costs)	$	$	$	$

Solution 6-85

	Completed Contract		**%-of-Completion**	
	2010	**2011**	**2010**	**2011**
(a) Gross Profit	$ -0-	$ 580,000	$ 507,692	$ 72,308
(b) Construction in process	3,300,000	-0-	3,807,692	-0-
(c) Cost in excess of billings	200,000	-0-	707,692	-0-

Calculations:
4,500,000 – 3,300,000 – 620,000 = <u>580,000</u>
3,300,000 – 3,100,000 = <u>200,000</u>
(4,500,000 – 3,300,000 – 600,000) x (3,300,000 / (3,300,000 + 600,000)) = <u>507,692</u>
3,300,000 + 507,692 = <u>3,807,692</u>
3,807,692 – 3,100,000 = <u>707,692</u>
[(4,500,000–3,300,000–620,000)x[(3,300,000+620,000)/(3,300,000+620,000)]– 507,692 = <u>72,308</u>

Pr.6-86 Revenue Recognition

On June 15, 2010, Karr Construction Company signed a $360,000 contract to build a small structure for Globe Company. AB estimated that total cost to construct would be $320,000. Construction started immediately because the required completion date was August 31, 2011. Karr's relevant data relating to this construction project were as follows:

	2010	2011	Total
Contract price....................			$360,000
Actual costs incurred by year......	$ 120,000	$204,000	
Estimated costs to complete........	$ 200,000	-0-	
Progress billings (to XY) by year..	112,000	248,000	
Collections (XY) cash by year......	110,000	250,000	

Required:
How much gross profit should Karr recognize each year, assuming:

Method Used	For 2010	For 2011
(a) Completed contract	$	$
(b) Percentage-of-completion		

Solution 6-86

Method Used	For 2010	For 2011
(a) Completed contract	-0-	$ 36,000
(b) Percentage-of-completion	$ 15,000 *	$ 21,000 **

*(360,000 - $320,000) x 120,000/320,000 = $15,000
**$36,000 - $15,000 = $21,000

Pr. 6-87- Revenue Recognition

Below are several independent situations that occurred during 2010 for the Mayer Corporation:

Situation 1:
Mayer entered into a consignment arrangement with Smith Corporation. Smith will sell the goods and retain a commission.
Situation 2:
Mayer agreed to provide consulting services to Arbour Company, a small company with a questionable credit rating. The term of the contract is 3 years.
Situation 3:
Mayer sold equipment that includes a one-year warranty. The individual fair values of the equipment and warranty components are readily ascertainable.

Instructions
For each situation, explain how revenue should be recognized under the earnings approach. Be sure to include your reasoning.

Solution 6-87

Situation 1:
As the risks and rewards presumably remain with the seller (Mayer), an actual sale does not occur until the goods are sold to a third party. As a result, revenue should not be recognized before that time. Commission, as well as any other related expenses would be deducted.

Situation 2:
Assuming Mayer can ascertain any direct costs relating to the contract, measurement does not appear to be at issue. The customer's creditworthiness however is a concern and requires that revenue recognition be delayed until payment is received.

Situation 3:
Assuming collectibility and measurement are not at issue, Mayer should recognize all revenues that are attributable to the equipment components. The recognition of revenues related to the warranty components would be delayed until earned (as the service is provided).

Pr. 6-88 Revenue Recognition

The Law office of L&M provides legal services for Coresh Inc. from the inception until present (2011). The Law office signed a contract for a lump-sum payment of $30,000 in October of 2010. Assume that L&M can reliably estimate future direct costs associated with the contract. The following services were performed based on the estimate by L&M.

	Direct Costs	Date Completed
Research Potential lawsuit	$ 2,500	December, 2010
Prepare and file documents	7,500	March, 2011
Serve as Coresh counsel during legal proceedings	7,500	October 2011

Instructions:
Under the earnings approach

a. When should L&M recognize revenue in this situation? Explain
b. Give entries to recognize revenues related to this contract for L&M.

Solution 6-88

Requirement a

L&M could use a method of proportional revenue recognition, where some revenue is recognized when each service is rendered. This is appropriate because more than one dissimilar performance act is required. Service revenue should be recognized in proportion to the costs for each act.

Requirement b

October 2010, to record the lump sum advance for services:

Cash	30,000	
Unearned service revenue		30,000

December 2010, to recognize earned revenue for research completed:

Unearned service revenue	4,286	
Service revenue		4,286*

*Total estimated direct costs:
$2,500 + $7,500 + $7,500 = $17,500
Service revenue recognized:
($2,500 ÷ $17,500) × $30,000 = $4286 (rounded).

March 2011, to recognize earned revenue for preparation and filing of documents:

Unearned service revenue	12,857	
Service revenue		12,857*

*Service revenue recognized:
($7,500 ÷ $17,500) × $30,000 = $12,857.

Solution 6-88 (Continued)

October 2011, to recognize earned revenue for serving as counsel:

Unearned service revenue	12,857	
Service revenue		12,857*

*Service revenue recognized:
($7,500 ÷ $17,500) × $30,000 = $12,857.

In each case above when revenues are recognized, direct costs associated with revenue recognized are expensed as incurred.

LEGAL NOTICE

CHAPTER 7

CASH AND RECEIVABLES

MULTIPLE CHOICE—Conceptual

Answer	No.	Description
d	1.	Identification of cash items.
b	2.	Identification of cash items.
d	3.	Classification of travel advance.
d	4.	Classification of bank overdraft.
d	5.	Classification of compensating balances.
c	6.	Amortization methods allowed under PE GAAP.
a	7.	Amortization methods allowed under IFRS.
a	8.	Non-recognition of interest element.
b	9.	The direct-write off method.
b	10.	Valuation of notes receivable.
a	11.	Recovery of value of temporary investment.
c	12.	Valuation of notes receivable
a	13.	Receivables liquidity.
a	14.	Accounting for temporary investments in debt securities.
d	15.	Definition of trade receivables.
a	16.	Notes issued at above face value.
a	17.	Classification of sales discounts.
c	18.	Valuation of short-term receivables.
d	19.	Bad debt provision and the matching concept.
a	20.	Bad debts as a percentage of sales.
d	21.	Surrender of control.
a	22.	Bad debts as a percentage of receivables.
a	23.	Collection of a previously written off accounts receivable.
d	24.	Securitization.
d	25.	Gross and net recording.
d	26.	Accounts receivable turnover ratio.
d	27.	Analysis of receivables.
c	*28.	Purpose of Cash Over & Short account.
b	*29.	Classification of bank service charges.
c	*30.	Treatment of bank credits on bank reconciliation.

*This topic is dealt with in an Appendix to the chapter.

MULTIPLE CHOICE—Computational

Answer	No.	Description
b	31.	Recording of receivables using the net-method.
c	32.	Recording of receivables using the gross method.

MULTIPLE CHOICE—Computational (cont.)

Answer	No.	Description
b	33	Use of the net method when discount is taken.
d	34.	Calculate net realizable value of accounts receivable.
b	35.	Calculate bad debt expense using aging of receivables.
c	36.	Calculation of implicit interest rate for zero-interest bearing note.
b	37.	Recognition of interest income in the first year.
d	38.	Recognition of interest income in subsequent years.
c	39.	Calculate cash proceeds from transfer of receivables.
c	40.	Entry to record collection of assigned receivables.
b	41.	Factoring receivables without recourse.
b	42.	Factoring receivables with recourse.
d	*43.	Entry to replenish petty cash.
c	*44.	Calculate correct balance in bank account.
d	*45.	Calculate correct cash balance.
b	*46.	Calculate correct cash balance.
a	*47.	Calculate correct cash balance.
b	*48.	Calculate correct cash balance.

MULTIPLE CHOICE—CPA Adapted

Answer	No.	Description
b	49.	Determine current net receivables.
d	50.	Calculate adjustment for bad debts.
a	51.	Calculate bad debt expense.
c	52.	Calculate adjustment to write off bad debts.
c	53.	Effect of a write-off under the allowance method.
a	54.	Determine balance in the Allowance for Doubtful Accounts.
b	55.	Assignment and factoring of accounts receivable.
d	*56.	Calculate correct cash balance.
a	*57.	Calculate the cash balance per books.

EXERCISES

Item	Description
E7-58	Definitions.
E7-59	Terminology.
E7-60	Entries for bad debt expense.
E7-61	Accounts receivable assigned.
E7-62	Accounts receivable analysis and securitization

PROBLEMS

Item	Description
P7-63	Amortization of discount under the straight-line and effective interest methods
P7-64	Entries for bad debt expense.
P7-65	Accounts receivable assigned.
*P7-66	Factoring accounts receivable.
*P7-67	Bank reconciliation.

MULTIPLE CHOICE—Conceptual

1. Which of the following is *not* considered cash for financial reporting purposes?
   a. Petty cash funds and change funds
   b. Money orders, certified cheques, and personal cheques
   c. Coin, currency, and available funds
   d. Postdated cheques and I.O.U.'s

2. Which of the following is considered cash?
   a. Certificates of deposit (CDs)
   b. Money market chequing accounts
   c. Money market savings certificates
   d. Postdated cheques

3. Travel advances should be reported as
   a. supplies.
   b. cash because they represent the equivalent of money.
   c. investments.
   d. none of these.

4. Bank overdrafts, if material, should
   a. be reported as a deduction from the current assets section.
   b. be reported as a deduction from cash.
   c. be netted against cash and a net cash amount reported.
   d. be reported as a current liability.

5. Deposits held as compensating balances
   a. usually do not earn interest.
   b. if legally restricted and held against short-term credit may be included as cash.
   c. if legally restricted and held against long-term credit may be included among current assets.
   d. none of these.

6. Under private entity GAAP, interest income and the amortization of discounts and premiums for financial assets must be accounted for using the
   a. effective interest method only
   b. straight-line method
   c. the straight-line or the effective interest method
   d. the units-of-production method

7. Under IFRS, interest income and the amortization of discounts and premiums for financial assets must be accounted for using the
   a. effective interest method only (unless the assets is held for trading purposes)
   b. straight-line method
   c. the straight-line or the effective interest method
   d. the units-of-production method

8. The interest element for trade receivables
   a. is usually not recognized because of materiality considerations
   b. must always be recognized and be accounted for using the net method.
   c. is recognized at their net realizable value.
   d. becomes more significant as the time between the sale and payment *shortens*.

9. The direct write off method to accounting for the impairment of receivables
   a. Is never an acceptable method.
   b. Is an acceptable method when the effect of not applying the allowance method would be immaterial.
   c. Is specifically disallowed under private entity GAAP.
   d. Would usually result in the same net income as the allowance method.

10. When a note receivable was issued at an amount that is *less* than its face value
    a. The note was issued at a premium
    b. The note was issued at a discount
    c. The note's stated rate was the same as the prevailing market rate of interest
    d. None of these

11. Imputation is the process of determining an appropriate interest rate, and the resulting rate is called:
    a. Imputed interest rate
    b. Discounted interest rate
    c. Secured borrowing rate
    d. Asset bearing rate

12. When the stated rate and market rate of a note receivable are the same
    a. the note's face value would be *different*
    b. the note's face value would be indeterminable
    c. the note's face value and fair value would be the same
    d. None of these

13. The ratio that is used to assess the receivables liquidity is:
    a. Receivable turnover ratio
    b. Current Ratio
    c. Asset turnover
    d. Inventory turnover

14. Receivables are claims held against customers for services, goods or money. The three classifications for receivables are:
    a. Trade or non-trade, current or non current, and accounts receivable or notes receivable
    b. Trade or non-trade, current or non current and trade discount
    c. Current or non current, accounts receivable or notes receivable and inventory
    d. Current or non current, trade or non-trade and allowance method

15. The category "trade receivables" includes
    a. advances to officers and employees.
    b. income tax refunds receivable.
    c. claims against insurance companies for casualties sustained.
    d. none of these.

16. When a note receivable was issued at an amount that is *more* than its face value
    a. The note was issued at a premium and the note's stated rate was different from the market rate of interest
    b. The note was issued at a discount and the note's stated rate was the same as the prevailing market rate of interest
    c. The note was issued at a premium and the note's stated rate was the same as the prevailing market rate of interest
    d. None of these

17. If a company employs the gross method of recording accounts receivable from customers, then sales discounts taken should be
    a. reported as a deduction from sales in the income statement.
    b. reported as an item of "other expense" in the income statement.
    c. reported as a deduction from accounts receivable in determining the net realizable value of accounts receivable.
    d. reported as sales discounts forfeited in the cost of goods sold section of the income statement.

18. Assuming that the ideal measure of short-term receivables in the balance sheet is the discounted value of the cash to be received in the future, failure to follow this practice usually does not make the balance sheet misleading because
    a. most short-term receivables are not interest-bearing.
    b. the allowance for uncollectible accounts includes a discount element.
    c. the amount of the discount is not material.
    d. most receivables can be sold to a bank or factor.

19. Which of the following methods of estimating the impairment of receivables does *not* properly match expense and revenue?
    a. Charging bad debts with a percentage of sales under the allowance method.
    b. Charging bad debts with an amount derived from a percentage of accounts receivable under the allowance method.
    c. Charging bad debts with an amount derived from aging accounts receivable under the allowance method.
    d. Charging bad debts as accounts are written off as uncollectible.

20. Which of the following methods of determining annual bad debts expense best achieves the matching concept?
    a. Percentage of sales
    b. Percentage of ending accounts receivable
    c. Percentage of average accounts receivable
    d. Direct write-off

21. When the transferee retains the right to pledge transferred receivables
    a. the transaction would *not* qualify as a sale.
    b. the transferee has surrendered control
    c. the transferee has *not* surrendered control.
    d. (a) and (c)

22. The advantage of relating a company's bad debt expense to its outstanding accounts receivable is that this approach
    a. gives a reasonably correct statement of receivables in the balance sheet.
    b. best relates bad debts expense to the period of sale.
    c. is the only generally accepted method for valuing accounts receivable.
    d. makes estimates of uncollectible accounts unnecessary.

23. Under the allowance method of recognizing uncollectible accounts, the entry to recognize the collection of a previously written off uncollectible account
    a. increases the allowance for doubtful accounts.
    b. has no effect on the allowance for doubtful accounts.
    c. decreases the allowance for doubtful accounts.
    d. increases net income.

24. Securitization of assets usually involves
    a. sale to only one company.
    b. the seller does not continue to service the receivables.
    c. the receivables quality is low.
    d. many investors.

25. Under the *net* method of recording accounts receivable
    a. The sales discount forfeited by the customer would be recognized as "other revenue"
    b. The sales discount forfeited by the customer would be recognized as an expense.
    c. The theoretically preferred method would be used
    d. (a) and (c)

26. The accounts receivable turnover ratio is calculated by dividing
    a. gross sales by ending net receivables.
    b. gross sales by average net receivables.
    c. net sales by ending net receivables.
    d. net sales by average net receivables.

27. Receivables are usually analyzed in terms of
    a. their turnover
    b. their age
    c. their change relative to related accounts
    d. all of these

*28. A Cash Over and Short account is
    a. not generally accepted.
    b. debited when the petty cash fund proves out over.
    c. debited when the petty cash fund proves out short.
    d. a contra account to Cash.

*29. The journal entries for a bank reconciliation
   a. are taken from the "balance per bank" section only.
   b. may include a debit to Office Expense for bank service charges.
   c. may include a credit to Accounts Receivable for an NSF cheque.
   d. may include a debit to Accounts Payable for an NSF cheque.

*30. When preparing a bank reconciliation, bank credits are
   a. added to the bank statement balance.
   b. deducted from the bank statement balance.
   c. added to the balance per books.
   d. deducted from the balance per books.

Multiple Choice Answers—Conceptual

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.
1.	d	6.	c	11.	a	16.	a	21.	d	26.	d
2.	b	7.	a	12.	c	17.	a	22.	a	27.	d
3.	d	8.	a	13.	a	18.	c	23.	a	*28.	c
4.	d	9.	b	14.	a	19.	d	24.	d	*29.	b
5.	d	10.	b	15.	d	20.	a	25.	d	*30.	c

Solutions to those Multiple Choice questions for which the answer is “none of these.”

3. As receivables.
5. Many answers are possible.
15. Open accounts resulting from short-term extensions of credit to customers.

MULTIPLE CHOICE—Computational

Use the following information for questions 31 to 33.

31. Macoon Company has sold goods at terms 1/10, n/30. If the discount is not taken, the amount payable is $8,524. Assuming Macoon uses the *net* method, the entry to record the sale is
    a. A debit and credit of $7,671.60 to accounts receivable and sales respectively.
    b. A debit and credit of $8,438.76 to accounts receivable and sales respectively.
    c. A debit and credit of $8,524 to accounts receivable and sales respectively.
    d. Debits of $8,438.76 and $85.24 to accounts receivable and "forfeited sales discounts" and a credit to sales to balance

32. Assuming Macoon uses the *gross* method, the entry to record the sale is
    a. A debit and credit of $7,671.60 to accounts receivable and sales respectively.
    b. A debit and credit of $8,438.76 to accounts receivable and sales respectively.
    c. A debit and credit of $8,524 to accounts receivable and sales respectively.
    d. Debits of $8,438.76 and $85.24 to accounts receivable and "forfeited sales discounts" and a credit to sales to balance

33. Assuming Macoon has used the *net* method, and payment was received *within* the discount period, the entry to record the receipt of payment would include
    a. An additional debit of $85.24 to accounts receivable
    b. A credit of $8,438.76 to accounts receivable
    c. A credit of $85.24 to sales
    d. A debit of $85.24 to "forfeited sales discounts"

34. During the year, Bergh Company made an entry to write off a $4,000 uncollectible account. Before this entry was made, the balance in accounts receivable was $60,000 and the balance in the allowance account was $4,500. The net realizable value of accounts receivable after the write-off entry was
    a. $60,000.
    b. $59,500.
    c. $51,500.
    d. $55,500.

35. The following information is available for Sorensen Company:

Allowance for doubtful accounts at December 31, 2010	$ 8,000
Credit sales during 2011	400,000
Accounts receivable deemed worthless and written off during 2011	9,000

As a result of a review and aging of accounts receivable in early January 2012, however, it has been determined that an allowance for doubtful accounts of $7,500 is needed at December 31, 2011. What amount should Sorensen record as bad debt expense for the year ended December 31, 2011?
a. $6,500
b. $7,500
c. $8,500
d. $15,500

Use the following information for questions 36 to 38.

36. A company receives a four-year, $50,000 zero-interest bearing note. The present value is known to be $32,936.50. What is the implicit rate of interest?
a. 9%
b. 10%
c. 11%
d. 12%

37. Assuming the note was issued on January 1, and the effective interest method is used, the interest income to be recognized at December 31, Year 1 will be
a. $5,500.00
b. $3,623.02
c. $3,231.08
d. $4,511.23

38. Interest income to be recognized at December 31, Year 2 will be
a. $5,898.53
b. $4,356.31
c. $3,623.02
d. $4,021.55

Use the following information for questions 39 and 40.

Inn Co. assigned $500,000 of accounts receivable to Darwol Finance Co. as security for a loan of $420,000. Darwol charged a two percent commission on the amount of the loan; the interest rate on the note was ten percent. During the first month, Inn collected $110,000 on assigned accounts after deducting $380 of discounts. Inn accepted returns worth $1,350 and wrote off assigned accounts totalling $3,700.

39. The amount of cash Inn received from Darwol at the time of the transfer was
a. $378,000.
b. $410,000.
c. $411,600.
d. $420,000.

40. Entries during the first month would include a
    a. debit to Cash of $110,380.
    b. debit to Bad Debts Expense of $3,700.
    c. debit to Allowance for Doubtful Accounts of $3,700.
    d. debit to Accounts Receivable of $115,430.

Use the following information for questions 41 and 42.

On February 1, 2010, Otto Company factored receivables with a carrying amount of $200,000 to Kassim Company. Kassim Company assesses a finance charge of three percent of the receivables and retains five percent of the receivables. Relative to this transaction, you are to determine the amount of loss on sale to be reported in the income statement of Otto Company for February.

41. Assume that Otto factors the receivables on a without recourse basis. The loss to be reported is
    a. $0.
    b. $6,000.
    c. $10,000.
    d. $16,000.

42. Assume that Otto factors the receivables on a recourse basis. The recourse obligation has a fair value of $1,000. The loss to be reported is
    a. $6,000.
    b. $7,000.
    c. $10,000.
    d. $17,000.

*43. If a petty cash fund is established in the amount of $350, and contains $300 in cash and $45 in receipts for disbursements when it is replenished, the journal entry to record replenishment should include credits to the following accounts
    a. Petty Cash, $45.
    b. Petty Cash, $50.
    c. Cash, $45; Cash Over and Short, $5.
    d. Cash, $50.

*44. If the month-end bank statement shows a balance of $49,000, outstanding cheques are $16,000, a deposit of $7,000 was in transit at month end, and a cheque for $800 was erroneously charged by the bank against the account, the correct balance in the bank account at month end is
    a. $40,000
    b. $24,800
    c. $40,800
    d. $20,100

*45. In preparing its bank reconciliation for the month of April 2010, Rizzo, Inc. has available the following information.

Balance per bank statement, 4/30/10	$65,280
NSF cheque returned with 4/30/10 bank statement	380
Deposits in transit, 4/30/10	2,300
Outstanding cheques, 4/30/10	16,300
Bank service charges for April	25

What should be the correct balance of cash at April 30, 2010?

a. $46,680
b. $51,685
c. $51,300
d. $51,280

*46. Taylor, Ltd.'s chequebook balance on December 31, 2010 was $34,600. In addition, Taylor held the following items in its safe on December 31.

(1) A cheque for $820 from Peyton, Ltd. received December 30, 2010, which was not included in the chequebook balance.
(2) An NSF cheque from Gorki Company in the amount of $1,400 that had been deposited at the bank, but was returned for lack of sufficient funds on December 29. The cheque was to be re-deposited on January 3, 2011. The original deposit has been included in the December 31 chequebook balance.
(3) Coin and currency on hand amounted to $2,630

The proper amount to be reported on Taylor's balance sheet for cash at December 31, 2010 is

a. $34,020
b. $36,650
c. $38,050
d. $35,830

*47. The cash account shows a balance of $64,000 before reconciliation. The bank statement does not include a deposit of $3,100 made on the last day of the month. The bank statement shows a collection by the bank of $1,200 and a customer's cheque for $580 was returned because it was NSF. A customer's cheque for $360 was recorded on the books as $630, and a cheque written for $179 was recorded as $791. The correct balance in the cash account was

a. $64,962
b. $64,350
c. $63,738
d. $66,122

*48. In preparing its May 31, 2010 bank reconciliation, Kerrigan Co. has the following information available:

Balance per bank statement, 5/31/10	$41,000
Deposit in transit, 5/31/10	6,800
Outstanding cheques, 5/31/10	3,100
Note collected by bank in May	2,700

The correct balance of cash at May 31, 2010 is

a. $47,400
b. $44,700
c. $42,000
d. $47,800

Multiple Choice Answers—Computational

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.
31.	b	34.	d	37.	b	40.	c	*43.	d	*46.	b
32.	c	35.	b	38.	d	41.	b	*44.	c	*47.	a
33.	b	36.	c	39.	c	42.	b	*45.	d	*48.	b

MULTIPLE CHOICE—CPA Adapted

49. On the December 31, 2010 balance sheet of Yager Co., the current receivables consisted of the following:

Trade accounts receivable	$ 74,000
Allowance for doubtful accounts	(3,500)
Claim against shipper for goods lost in transit (November 2010)	4,000
Selling price of unsold goods sent by Yager on consignment at 130 percent of cost (not included in Yager's ending inventory)	29,000
Security deposit on lease of warehouse used for storing some inventories	24,000
Total	$127,500

At December 31, 2010, the correct total of Yager's current net receivables was
a. $78,000
b. $74,500
c. $70,500
d. $66,500

50. Mueller Co. prepared an aging of its accounts receivable at December 31, 2010 and determined that the net realizable value of the receivables was $290,000. Additional information is available as follows:

Allowance for doubtful accounts at 1/1/10—credit balance	$ 34,000
Accounts written off as uncollectible during 2010	23,000
Accounts receivable at 12/31/10	320,000
Uncollectible accounts recovered during 2010	5,000

For the year ended December 31, 2010, Mueller's bad debt expense would be
a. $20,000.
b. $23,000.
c. $16,000.
d. $14,000.

51. For the year ended December 31, 2010, Kurz Co. estimated its allowance for doubtful accounts using the year-end aging of accounts receivable. The following data are available:

Allowance for doubtful accounts, 1/1/10	$37,000
Estimated uncollectible accounts during 2010 (1% on credit sales of $4,000,000)	40,000
Uncollectible accounts written off, 11/30/10	52,000
Estimated uncollectible accounts per aging, 12/31/10	74,000

After year-end adjustment, the bad debt expense for 2010 should be
a. $89,000
b. $37,000
c. $126,000
d. $52,000

52. Moscowietz Co.'s allowance for doubtful accounts was $85,000 at the end of 2010 and $105,000 at the end of 2009. For the year ended December 31, 2010, Moscowietz reported bad debt expense of $18,000 in its income statement. What amount did Moscowietz debit to the appropriate account in 2010 to write off actual bad debts?
a. $20,000
b. $34,650
c. $38,000
d. $12,000

53. Under the allowance method of recognizing uncollectible accounts, the entry to write off an uncollectible account
a. increases the allowance for doubtful accounts.
b. has no effect on the allowance for doubtful accounts.
c. has no effect on net income.
d. decreases net income.

54. The following accounts were abstracted from Urich Co.'s unadjusted trial balance at December 31, 2010:

	Debit	Credit
Accounts receivable	$850,000	
Allowance for uncollectible accounts	11,000	
Net credit sales		$2,950,000

Urich Co. estimates that 1.5 percent of the gross accounts receivable will become uncollectible. After adjustment at December 31, 2010, the allowance for doubtful accounts should have a credit balance of
a. $12,750
b. $11,000
c. $44,250
d. $41,380

55. Which of the following is a method to generate cash from accounts receivable?

	Assignment	Factoring
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

*56. In preparing its August 31, 2010 bank reconciliation, Moira Corp. has available the following information:

Balance per bank statement, 8/31/10	$28,310
Deposit in transit, 8/31/10	7,280
Return of customer's cheque for insufficient funds, 8/30/10	700
Outstanding cheques, 8/31/10	3,450
Bank service charges for August	50

At August 31, 2010, Moira's correct cash balance is

a. $32,190
b. $32,090
c. $31,440
d. $32,140

*57. Solara, Ltd. had the following bank reconciliation at March 31, 2010:

Balance per bank statement, 3/31/10	$37,200
Add: Deposit in transit	10,300
	47,500
Less: Outstanding cheques	12,600
Balance per books, 3/31/10	$34,900

Data per bank for the month of April 2010 follow:

Deposits	$47,700
Disbursements	49,700

All reconciling items at March 31, 2010 cleared the bank in April. Outstanding cheques at April 30, 2010 totalled $5,000. There were no deposits in transit at April 30, 2010. What is the cash balance per books at April 30, 2010?

a. $30,200
b. $32,900
c. $35,200
d. $40,500

Multiple Choice Answers—CPA Adapted

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.
49.	b	51.	a	53.	c	55.	b	*57.	a
50.	d	52.	c	54.	a	*56.	d		

DERIVATIONS — Computational

No.	Answer	Derivation
31.	b	$8,524 x (1-0.01) = $8,438.76
32.	c	n/a
33.	b	n/a
34.	d	($60,000 – $4,000) – ($4,500 – $4,000) = $55,500.
35.	b	$8,000 – $9,000 + $8,500 = $7,500.
36.	c	$32,936.50 = $50,000 x PVF 4,?% PVF 4,?% = $32,936.50 / $50,000 PVF 4,?% = 0.65873 PVF 4,?% = 11% (Table A2)
37.	b	$32,936.50 x 11% = $3,623.02
38.	d	($32,936.50 + $3,623.02) x 11% = $4,021.55
39.	c	$420,000 – $8,400 = $411,600.
40.	c	

Derivations (cont.)

No.	Answer	Derivation
41.	b	$200,000 × .03 = $6,000.
42.	b	($200,000 × .03) + $1,000 = $7,000.
*43.	d	$350 - $300 = $50
*44.	c	$49,000 - $16,000 + $7,000 + $800 = $40,800
*45.	d	$65,280 + $2,300 - $16,300 = $51,280
*46.	b	$34,600 + $820 - $1,400 + $2,630 = $36,650
*47.	a	$64,000 + $1,200 - $580 - $270 + $612 = $64,962
*48.	b	$41,000 + $6,800 - $3,100 = $44,700

DERIVATIONS — CPA Adapted

No.	Answer	Derivation
49.	b	\$74,000 – \$3,500 + \$4,000 = \$74,500.
50.	d	Allowance for Doubtful Acct. balance \$34,000 + \$5,000 – \$23,000 = \$16,000 (before bad debt expense) \$320,000 – \$290,000 – \$16,000 = \$14,000 (bad debt expense).
51.	a	\$74,000 – \$37,000 + \$52,000 = \$89,000.
52.	c	\$105,000 + \$18,000 – \$85,000 = \$38,000
53.	c	Conceptual.
54.	a	\$850,000 × 1.5% = \$12,750
55.	b	Conceptual.
*56.	d	\$28,310 + \$7,280 – \$3,450 = \$32,140
*57.	a	\$37,200 + \$47,700 – \$49,700 = \$35,200 (4/30 balance per bank) \$35,200 – \$5,000 = \$30,200.

EXERCISES

Ex. 7-58 - Definitions.

Provide clear, concise answers for the following.

1. What are cash and cash equivalents and how are they reported?
2. What are receivables and how are they reported?
3. How are receivables measured?
4. How are impairments relating to uncollectible receivables accounted for?
5. How can receivables be “converted” to cash prior to their collection from customers?
6. How are receivables analyzed?
7. Identify the main differences between private entity GAAP and IFRS with respect to the accounting for receivables?

Solution 7-58

1. Cash and cash equivalents are financial assets. Cash consists of coins, currency and available funds on deposit at a bank, as well as negotiable instruments. Cash equivalents are highly liquid short-term investments that can be exchanged for known amounts of cash. Together they are usually reported as current asset, “cash and cash equivalents”, in the balance sheet, unless the funds are restricted or otherwise encumbered.

2. Receivables are claims against customers and others for cash or other financial assets. They are classified according to their nature as trade, non-trade and accounts receivable (or notes receivable). Current receivables are expected to be collected within one year or during the current operating cycle, whichever is longer.

3. Receivables are initially measured at their fair value (their present value rather than their *future* value) with interest recognized as the future value is reached at collection. This principle however is generally not applied to short term receivables, as the interest element is usually not material when compared with the net income for the period.

4. The potential impairment is assessed based on management’s estimate of uncollectible accounts. This is commonly accomplished through a review of an aged receivables report, with special consideration given to older items. Based on that review, an allowance account is then set up that reduces the value of reported receivables accordingly. Companies often use a mix of procedures whereby uncollectibles are initially estimated based on a percentage of sales and are then adjusted based on the aged receivables report.

5. This can be accomplished through a secured borrowing arrangement or through the sale of the underlying receivables. In secured borrowing, the receivables are merely used as collateral for a loan. In a sale, the receivables are either sold outright to “factors” or “securitized” whereby the seller usually retains some involvement.

Solution 7-58 (Continued)

6. Receivables are analyzed in terms of their turnover, age and their change relative to related accounts. A key ratio used by analysts is the receivables turnover ratio. It is calculated by dividing net sales by average net receivables outstanding and is a measurement of the liquidity of a company's receivables.

7. The two standards are for the most part very similar. Differences include the disclosure requirements, which are more extensive under IFRS, and the use of the effective interest method for the amortization of discounts and premiums for financial assets (mandated by IFRS, but optional under private entity GAAP).

Ex. 7-59 - Terminology.

In the space provided at right, write the word or phrase that is defined or indicated.

1. The minimum balances that may have to be kept in chequing or savings accounts.	1. ______________________
2. Cash that has been set aside for investment or financing purposes.	2. ______________________
3. Receivables with underlying *contractual* rights to receive cash.	3. ______________________
4. The reduction from a supplier's list price.	4. ______________________
5. The method used to record receivables and recognizes a deduction from sales when a discount is taken.	5. ______________________
6. The method used to amortize discounts and premiums for notes receivable that results in the recognition of equal amounts of interest expense or interest income over the term of the notes.	6. ______________________
7. The value at which receivables should be reported.	7. ______________________
8. The method used to account for the estimated impairment of receivables.	8. ______________________
9. The approach that specifically recognizes the assets and liabilities when receivables are sold.	9. ______________________

Solution 7-59

1. Compensating balances.
2. Restricted cash.
3. A financial asset.
4. A trade discount.
5. The gross method.
6. The straight-line method.
7. Their net realizable value.
8. The allowance method.
9. The financial components approach.

Ex. 7-60—Entries for bad debt expense.

A trial balance before adjustment included the following:

	Debit	Credit
Accounts receivable	$90,000	
Allowance for doubtful accounts		$ 730
Sales		360,000
Sales returns and allowances	8,000	

Give journal entries assuming that the estimate of uncollectibles is determined by taking (1) five percent of gross accounts receivable and (2) one percent of net sales.

Solution 7-60

(1)	Bad Debts Expense..		3,770	
	Allowance for Doubtful Accounts............................			3,770
	Gross receivables	$90,000		
	Rate	5%		
	Total allowance needed	4,500		
	Present allowance	(730)		
	Adjustment needed	$ 3,770		
(2)	Bad Debts Expense..		3,520	
	Allowance for Doubtful Accounts............................			3,520
	Sales	$360,000		
	Sales returns and allowances	8,000		
	Net sales	352,000		
	Rate	1%		
	Bad debts expense	$ 3,520		

Ex. 7-61—Accounts receivable assigned.

Accounts receivable in the amount of $520,000 were assigned to the Fork Finance Company by Nasser, Ltd., as security for a loan of $430,000. The finance company charged a 3.5 percent commission on the face amount of the loan, and the note bears interest at 9 percent per year.

During the first month, Nasser collected $260,000 on assigned accounts. This amount was remitted to the finance company along with one month's interest on the note.

Instructions
Make all the entries for Nasser, Ltd. associated with the transfer of the accounts receivable, the loan, and the remittance to the finance company.

Solution 7-61

Cash	414,950	
Finance Charge	15,050	
Notes Payable		430,000
$430,000 x 3.5% = $15,050		
Cash	260,000	
Accounts Receivable		260,000
Notes Payable	260,000	
Interest Expense	3,225	
Cash		263,225
$430,000 x 9% / 12 = $3,225		

Ex. 7-62— Accounts receivable analysis and securitization.

Discuss why adjustments might have to be made and caution has to be exercised when analysing accounts receivable due to the increased use of securitization transactions.

Solution 7-62

Securitization is a financing transaction, so the cash flows are actually from financing not from operations. When the company has engaged in securitization transactions, adjustments would have to be made to receivables on the balance sheet for accounts sold but not yet collected. These adjustments would be required before you could assess ratios such as receivables turnover and days sales uncollected. Liquidity ratios would also be affected. The sheer complexity of these transactions requires that the analyst exercise caution and read carefully all disclosures related to securitizations.

PROBLEMS

Pr. 7-63 - Amortization of discount under the straight-line and effective interest methods

On January 1, 2010, Mahler Corporation receives a four-year, $100,000 zero-interest bearing note in payment of goods sold. The present value of the note equals the agreed upon sales price of $65,873. Mahler is a privately held company and follows private entity GAAP.

Instructions

(a)
Assuming Mahler uses the straight-line method to amortize the note's discount, prepare the journal entry to record the sale on January 1, and the interest accrual on December 31, 2010.

(b)
Assuming Mahler uses the *effective interest* method to amortize the note's discount, prepare the journal entry to record the sale on January 1, and the interest accrual on December 31, 2010.

Solution 7-63

(a)
To record the sale and issue of the note on January 1:

Note Receivable...	65,873	
Sales		65,873

To record the interest accrual on December 31:

Note Receivable...	8,531.75	
Interest Income...		8,531.75

($100,000 - $65,873)/4 = $8,531.75

(b)
To record the sale and issue of the note on January 1:

This entry would be identical to the one prepared under part (a) above.

To record the interest accrual on December 31:

Note Receivable...	7,246.03	
Interest Income...		7,246.03

$65,873 x 11%* = $7,246.03
*Implicit rate of interest
$65,873 = $100,000 x PVF $_{4, ?\%}$
PVF $_{4, ?\%}$ = $65,873 / $100,000
PVF $_{4, ?\%}$ = 0.65873 (Table A2)
PVF $_{4, ?\%}$ = 11%

Pr. 7-64—Entries for bad debts expense.

The trial balance before adjustment of Rosen Company reports the following balances:

	Dr.	Cr.
Accounts receivable	$100,000	
Allowance for doubtful accounts		$ 2,500
Sales (all on credit)		650,000
Sales returns and allowances	40,000	

Instructions

(a) Prepare the entries for estimated bad debts assuming that doubtful accounts are estimated to be (1) seven percent of gross accounts receivable and (2) one percent of net sales. Note that the estimate based on net credit sales is only appropriate as an estimate for internal purposes. At year-end, management must make an estimate based on the year-end receivables balance for the external statements.

(b) Assume that all the information above is the same, except that the Allowance for Doubtful Accounts has a debit balance of $2,500 instead of a credit balance. How will this difference affect the journal entries in part (a)?

Solution 7-64

(a) (1)	Bad Debts Expense	4,500	
	Allowance for Doubtful Accounts		4,500

Gross receivables	$100,000
Rate	7%
Total allowance needed	7,000
Present allowance	(2,500)
Bad debts expense	$ 4,500

(2)	Bad Debts Expense	6,100	
	Allowance for Doubtful Accounts		6,100

Sales	$650,000
Sales returns and allowances	(40,000)
Net sales	610,000
Rate	1%
Bad debts expense	$ 6,100

Solution 7-64 (Continued)

(b) The percentage of receivables approach would be affected as follows:

Gross receivables	$100,000
Rate	7%
Total allowance needed	7,000
Present allowance	2,500
Additional amount required	$ 9,500

The journal entry is therefore as follows:

Bad Debts Expense	9,500	
Allowance for Doubtful Accounts		9,500

The entry would not change for the estimate of monthly uncollectible accounts.

Pr. 7-65—Accounts receivable assigned.

Prepare journal entries for Lorch Co. for:

(a) Accounts receivable in the amount of $700,000 were assigned to Chan Finance Co. by Lorch as security for a loan of $580,000. Chan charged a four percent commission on the accounts; the interest rate on the note is 11 percent.

(b) During the first month, Lorch collected $300,000 on assigned accounts after deducting $1,500 of discounts. Lorch wrote off a $1,100 assigned account.

(c) Lorch paid to Chan the amount collected plus one month's interest on the note.

Solution 7-65

(a) Cash	552,000	
Finance Charge	28,000	
Notes Payable		580,000

$700,000 x 4% = $28,000

(b) Cash	300,000	
Sales Discounts	1,500	
Allowance for Doubtful Accounts	1,100	
Accounts Receivable		302,600

(c) Notes Payable	300,000	
Interest Expense	5,317	
Cash		305,317

$580,000 x 11% / 12 = $5,317

Pr. 7-66—Factoring Accounts Receivable.

On April 1, Cobra, Ltd. factored $600,000 of accounts receivable with Milton Finance on a without recourse basis. Under the arrangement, Cobra was to handle disputes concerning service, and Milton Finance was to make the collections, handle the sales discounts, and absorb the credit losses. Milton Finance assessed a finance charge of six percent of the total accounts receivable factored and retained an amount equal to two percent of the total receivables to cover sales discounts.

Instructions

(a) Prepare the journal entry required on Cobra's books on April 1.

(b) Prepare the journal entry required on Milton Finance's books on April 1.

(c) Assume Cobra factors the $600,000 of accounts receivable with Milton Finance on a *with* recourse basis instead. The recourse provision has a fair value of $10,000. Prepare the journal entry required on Cobra's books on May 1.

Solution 7-66

(a)	Cash	552,000	
	Due from Factor (2% × $600,000)	12,000	
	Loss on Sale of Receivables (6% × $600,000)	36,000	
	Accounts Receivable		600,000
(b)	Accounts Receivable	600,000	
	Due to Cobra		12,000
	Financing Revenue		36,000
	Cash		552,000
(c)	Cash	552,000	
	Due from Factor	12,000	
	Loss on Sale of Receivables	46,000	
	Accounts Receivable		600,000
	Recourse Liability		10,000

***Pr. 7-67**—Bank reconciliation.

Wong Plastics Company deposits all receipts and makes all payments by cheque. The following information is available from the cash records:

MARCH 31 BANK RECONCILIATION

Balance per bank	$27,895
Add: Deposits in transit	2,400
Deduct: Outstanding cheques	(4,100)
Balance per books	$26,195

Month of April Results

	Per Bank	Per Books
Balance April 30	$28,010	$32,146
April deposits	11,200	17,089
April cheques	12,010	11,320
April note collected (not included in April deposits)	4,000	-0-
April bank service charge	50	-0-
April NSF cheque of a customer returned by the bank (recorded by bank as a charge)	1,200	-0-

Instructions

(a) Calculate the amount of the April 30:
   1. Deposits in transit
   2. Outstanding cheques

(b) What is the April 30 adjusted cash balance? Show all work.

***Solution 7-67**

(a) 1. Deposits in transit, $8,289 [$17,089 – ($11,200 – $2,400)]

   2. Outstanding cheques, $3,410 [$11,320 – ($12,010 – $4,100)]

(b) Adjusted cash balance at April 30, $34,896
   $32,146 + $4,000 - $50 - $1,200 = $34,896

LEGAL NOTICE

CHAPTER 8

INVENTORY

MULTIPLE CHOICE—Conceptual

Answer	No.	Description
d	1.	Entries under perpetual inventory system.
b	2.	Classification of goods in transit.
a	3.	Classification of goods in transit.
d	4.	Identify inventory ownership.
d	5.	Identify a product financing arrangement.
a	6.	Identify ownership under product financing arrangement.
b	7.	Classification of goods on consignment.
b	8.	Effect of recording merchandise on consignment.
a	9.	Effect of ending inventory overvaluation.
a	10.	Effect of inventory errors on income.
d	11.	Effect of understating purchases and ending inventory.
b	12.	Identification of product costs.
c	13.	Inventory categories.
d	14.	Determine product costs.
b	15.	Interest capitalization in manufacturing inventory.
a	16.	Classification of factory overhead costs.
b	17.	Classification of fixed overhead costs.
b	18.	Absorption and variable costing.
c	19.	Cost components of finished goods inventory.
a	20.	Determine cost of purchased inventory, using gross method.
d	21.	Calculation of ending inventory.
c	22.	Recording inventory purchases at gross or net amounts.
c	23.	Special sales arrangements.
a	24.	Average cost inventory valuation.
a	25.	Product costs.
a	26.	Nature of FIFO valuation of inventory.
c	27.	Borrowing costs.
a	28.	Standard costs.
c	29.	FIFO and increasing prices.
d	30.	Costs excluded from inventory.
c	31.	Basket purchases.
c	32.	Inventory systems - perpetual
c	33.	Unit cost for perpetual inventories.
a	34.	Inventory systems - periodic
b	35.	Costs formulas – specific identification
d	36.	Accounting for Inventories
a	37.	Cost formulas – weighted average
b	38.	Appropriate use of LCM valuation.

MULTIPLE CHOICE—Conceptual (Continued)

Answer	No.	Description
	b	39. Cost formula - FIFO
c	40.	Application of lower of cost and market valuation.
b	41.	Net realizable value under LCM.
b	42.	Definition of "net realizable value."
a	43.	Valuation of inventory at net realizable value.
a	44.	Purchase commitments.
a	45.	Material purchase commitments.
d	46.	Exceptions to LCM.
d	47.	Appropriate use of the gross profit method.
b	48.	Appropriate use of the gross profit method.
c	49.	Gross profit percentage.
b	50.	Appropriate use of the gross profit method.
a	51.	Effects of inventory errors.
c	52.	Conventional retail inventory method.
b	53.	Estimating inventory using the gross profit method.
b	54.	Appropriate use of the retail inventory method.
b	55.	Markdowns and the conventional retail method.
a	56.	Mark-ups and the conventional retail method.
a	57.	Inventory ratios
c	58.	Inventory turnover ratio.

MULTIPLE CHOICE—Computational

Answer	No.	Description
d	59.	Effect of inventory and amortization errors on income.
a	60.	Effect of inventory and amortization errors on retained earnings.
a	61.	Effect of inventory errors on working capital.
b	62.	Inventory shortages and overages.
c	63.	Calculate cost of goods available for sale.
d	64.	Calculate sales given manufacturing cost information.
d	65.	Accounting for a purchase return (net method).
d	66.	Adjust Accounts Payable using the net method.
b	67.	Calculate ending inventory using weighted-average.
d	68.	Calculate ending inventory using moving average.
d	69.	Calculate cost of goods sold using FIFO.
c	70.	Perpetual inventory—FIFO valuation.
b	71.	Perpetual inventory—average cost valuation.
b	72.	Interrelationships of cost of goods sold accounts.
c	73.	Interrelationships of cost of goods sold accounts.
a	74.	Valuation of inventory at NRV.
c	75.	Valuation of inventory at NRV.
c	76.	Calculate total sales from cost information.
b	77.	Mark-up on cost equivalent to a mark-up on selling price.

MULTIPLE CHOICE—Computational (Continued)

Answer	No.	Description
b	78.	Estimate ending inventory using gross profit method.
b	79.	Calculate ending inventory using gross profit method
d	80.	Calculate ending inventory using gross profit method.
b	81.	Estimate cost of inventory destroyed by fire.
a	82.	Account for inventory errors.
b	83.	Account for inventory errors.
b	84.	Journal entries for periodic inventory system.
a	85.	Journal entries for perpetual inventory system.
d	86.	Journal entries for perpetual inventory system.
c	87.	Calculate inventory turnover ratio.
d	88.	Determine cost to retail ratio to approximate LCM.
d	89.	Calculate ending inventory at retail.
a	90.	Calculate ending inventory using conventional retail.

MULTIPLE CHOICE—CPA Adapted

Answer	No.	Description
a	91.	Identification of inventory costs.
b	92.	Determine cost of purchased inventory.
c	93.	Determine cost of purchased inventory.
b	94.	Determine cost of purchased inventory.
a	95.	Determine cost of sales.
c	96.	Calculate Accounts Payable at year end.
a	97.	Calculate Accounts Payable at year end.
d	98.	Calculate Accounts Payable at year end.
b	99.	Calculate unit cost using moving-average method.
c	100.	Periodic and perpetual inventory methods.
b	101.	Calculate ending inventory using FIFO.
a	102.	Recognizing a loss due to LCM.
b	103.	Appropriate use of replacement costs in LCM.
a	104.	Estimate cost of inventory lost by theft.
d	105.	Determine cost of ending inventory using retail method.
a	106.	Determine cost of ending inventory using retail method.

EXERCISES

Item	Description
E8-107	Definitions.
E8-108	Terminology.
E8-109	Recording purchases at net amounts.
E8-110	Adjustments to lower of cost and NRV using allowance method.
E8-111	FIFO inventory methods.
E8-112	Perpetual FIFO.
E8-113	Periodic FIFO.

EXERCISES (Continued)

Item	Description
E8-114	Journal entries for perpetual inventory system
E8-115	Lower of cost and market.
E8-116	Lower of cost and market.
E8-117	Year-end entries to update inventory for periodic system
E8-118	Gross profit method.
E8-119	Gross profit method.
E8-120	Gross profit method.
E8-121	Comparison of inventory methods.

PROBLEMS

Item	Description
P8-122	Accounting for purchase discounts.
P8-123	Analysis of errors.
P8-124	Inventory cut-off.
P8-125	Year-end entries to update inventory accounts under periodic system.
P8-126	Gross profit method.
P8-127	Retail inventory method.
P8-128	Retail inventory method.
P8-129	Conventional retail inventory method.
P8-130	Inventory errors.

MULTIPLE CHOICE—Conceptual

1. When using a perpetual inventory system,
   a. no Purchases account is used.
   b. a Cost of Goods Sold account is used.
   c. two entries are required to record a sale.
   d. all of these.

2. Goods in transit which are shipped f.o.b. shipping point should be
   a. included in the inventory of the seller.
   b. included in the inventory of the buyer.
   c. included in the inventory of the shipping company.
   d. none of these.

3. Goods in transit which are shipped f.o.b. destination should be
   a. included in the inventory of the seller.
   b. included in the inventory of the buyer.
   c. included in the inventory of the shipping company.
   d. none of these.

4. Which of the following items should be included in a company's inventory at the balance sheet date?
   a. Goods in transit which were purchased f.o.b. destination.
   b. Goods received from another company for sale on consignment.
   c. Goods sold to a customer, which are being held for the customer to call for at his or her convenience.
   d. None of these.

Use the following information for questions 5 and 6.

During 2010 Ebert Corporation transferred inventory to Holger Corporation and agreed to repurchase the merchandise early in 2011. Holger then used the inventory as collateral to borrow from Norwalk Bank, remitting the proceeds to Ebert. In 2011 when Ebert repurchased the inventory, Holger used the proceeds to repay its bank loan.

5. This transaction is known as a(n)
   a. consignment.
   b. instalment sale.
   c. assignment for the benefit of creditors.
   d. product financing arrangement.

6. On whose books should the cost of the inventory appear at the December 31, 2010 balance sheet date?
   a. Ebert Corporation
   b. Holger Corporation
   c. Norwalk Bank
   d. Holger Corporation, with Ebert making appropriate note disclosure of the transaction

7. Goods on consignment are
   a. included in the consignee's inventory.
   b. recorded in a Consignment Out account which is an inventory account.
   c. recorded in a Consignment In account which is an inventory account.
   d. all of these

8. Dubb Co. received merchandise on consignment. As of March 31, Dubb had recorded the transaction as a purchase and included the goods in inventory. The effect of this on its financial statements for March 31 would be
   a. no effect.
   b. net income was correct and current assets and current liabilities were overstated.
   c. net income, current assets, and current liabilities were overstated.
   d. net income and current liabilities were overstated.

9. Eskins Co. received merchandise on consignment. As of January 31, Eskins included the goods in inventory, but did not record the transaction. The effect of this on its financial statements for January 31 would be
   a. net income, current assets, and retained earnings were overstated.
   b. net income was correct and current assets were understated.
   c. net income and current assets were overstated and current liabilities were understated.
   d. net income, current assets, and retained earnings were understated.

10. Chen Co. accepted delivery of merchandise which it purchased on account. As of December 31, Chen had recorded the transaction, but did not include the merchandise in its inventory. The effect of this on its financial statements for December 31 would be
    a. net income, current assets, and retained earnings were understated.
    b. net income was correct and current assets were understated.
    c. net income was understated and current liabilities were overstated.
    d. net income was overstated and current assets were understated.

11. On June 15, 2010, Solder Corporation accepted delivery of merchandise which it purchased on account. As of June 30, Solder had not recorded the transaction or included the merchandise in its inventory. The effect of this on its balance sheet for June 30, 2010 would be
    a. assets and shareholders' equity were overstated but liabilities were not affected.
    b. shareholders' equity was the only item affected by the omission.
    c. assets, liabilities, and shareholders' equity were understated.
    d. none of these.

12. Which of the following is correct?
    a. Selling costs are product costs.
    b. Manufacturing overhead costs are product costs.
    c. Interest costs for routine inventories are product costs.
    d. All of these.

13. A manufacturing company typically has the following inventory accounts:
    a. Accounts Receivable, purchases and freight-in.
    b. Beginning inventory and ending inventory
    c. Raw materials, work in process and finished goods.
    d. None of these

14. All of the following costs should be charged against revenue in the period in which costs are incurred *except* for
    a. manufacturing overhead costs for a product manufactured and sold in the same accounting period.
    b. costs which will not benefit any future period.
    c. costs from idle manufacturing capacity resulting from an unexpected plant shutdown.
    d. costs of normal shrinkage and scrap incurred for the manufacture of a product in ending inventory.

15. Which of the following types of interest cost incurred in connection with the purchase or manufacture of inventory should be capitalized as a product cost?
    a. Purchase discounts lost
    b. Interest incurred during the production of discrete projects such as ships or real estate projects
    c. Interest incurred on notes payable to vendors for routine purchases made on a repetitive basis
    d. All of these should be capitalized.

16. An *exception* to the general rule that costs should be charged to expense in the period incurred is
    a. factory overhead costs incurred on a product manufactured but not sold during the current accounting period.
    b. interest costs for financing of inventories that are routinely manufactured in large quantities on a repetitive basis.
    c. general and administrative fixed costs incurred in connection with the purchase of inventory.
    d. sales commission and salary costs incurred in connection with the sale of inventory.

17. Under variable costing, fixed manufacturing overhead costs are
    a. product costs.
    b. period costs.
    c. charged to work in process and finished goods.
    d. part of cost of goods sold.

18. Other things being equal, income calculated by the variable costing method will exceed that calculated by the absorption method if
    a. units produced exceed units sold.
    b. units sold exceed units produced.
    c. fixed manufacturing costs increase.
    d. variable manufacturing costs increase.

19. The cost of raw material plus direct labour cost plus overhead
    a. Constitutes the work-in-process inventory, when the process has not yet been completed.
    b. Constitutes the finished goods inventory, when the process has been completed.
    c. (a) and (b)
    d. None of these.

20. The use of a Purchase Discounts account implies that the recorded cost of a purchased inventory item is its
    a. invoice price.
    b. invoice price plus any purchase discount lost.
    c. invoice price less the purchase discount taken.
    d. invoice price less the purchase discount allowable whether taken or not.

21. Which of the following should usually be considered when calculating the cost of ending inventory?
    a. Inventory that is subject to special sales agreements.
    b. The ownership for inventory in transit at the balance sheet date.
    c. Discounts and vendor rebates.
    d. All of these

During 2010, which was the first year of operations, Landers Company had merchandise purchases of $985,000 before cash discounts. All purchases were made on terms of 2/10, n/30. Three-fourths of the items purchased were paid for within ten days of purchase. All of the goods available had been sold at year end.

22. Which of the following recording procedures would result in the highest net income for 2010?
    1. Recording purchases at gross amounts
    2. Recording purchases at net amounts, with the amount of discounts not taken shown under "other expenses" in the income statement

    a. 1
    b. 2
    c. Either 1 or 2 will result in the same net income.
    d. Cannot be determined from the information provided.

23. Which of the following is *least* likely an example of a special sales agreement?
    a. A sale with a buyback agreement
    b. A sale with delayed payment terms
    c. A cash sale where title to the goods passes as the cash is received.
    d. A sale with a high rate of return

24. In situations where there is a rapid turnover, an inventory method which produces a balance sheet valuation similar to the first-in, first-out method is
    a. average cost.
    b. base stock.
    c. joint cost.
    d. prime cost.

25. Which of the following best describes the concept of product costs?
    a. They are costs that are "attached" to inventory.
    b. They are costs that are usually expenses.
    c. They usually don't include freight charges
    d. They usually don't include conversion costs.

26. An inventory pricing procedure in which the oldest costs incurred rarely have an effect on the ending inventory valuation is
    a. FIFO.
    b. moving average.
    c. base stock.
    d. weighted-average.

27. Which of the following statements regarding borrowing costs is correct?
    a. Neither Private entity GAAP nor IFRS usually require disclosure these items.
    b. They are usually amortized until the majority (51%) of the underlying products have been sold.
    c. They are usually treated as product costs if they are incurred to bring inventories to a condition ready for sale.
    d. All of these

28. Which of the following best describes the concept of standard costs?
    a. They are the costs that *should* be incurred per unit of finished goods inventory.
    b. They are the costs that are *actually* incurred per unit of finished goods inventory.
    c. They are the costs that were incurred when current Canadian Accounting Standards were applied.
    d. Standard costs are acceptable for reporting purposes

29. Which of the following statements is correct for a company that uses the FIFO costing method under a perpetual inventory system?
    All else being equal
    a. The value of the ending inventory would be *higher* under a periodic system.
    b. The value of the ending inventory would be *lower* under a periodic system.
    c. The value of the ending inventory would be the *same* under a periodic system.
    d. The periodic system would not require any additional entries at the end of the period.

30. Which of the following statements best describes the treatment of selling expenses with respect to inventories?
    a. They are generally treated as period costs.
    b. They are generally unlikely to be related to unsold inventory.
    c. None of these
    d. (a) and (b)

31. Which of the following best describes the concept of a basket purchase?
   a. The purchase of a group of units with *similar* characteristics at a single lump-sum price.
   b. The purchase of individual units with *similar* characteristics priced individually.
   c. The purchase of a group of units with *different* characteristics at a single lump-sum price.
   d. The purchase of individual units with *different* characteristics priced individually.

32. Which of the following does *not* correctly describe a perpetual inventory accounting system?
   a. In a perpetual system cost of goods sold are calculated every time a sale is made.
   b. In a perpetual system, assuming shrinkage of zero, inventory and cost of goods sold do *not* have to be updated at the end of the period.
   c. The use of this system eliminates the requirement for an annual physical inventory count.
   d. In a perpetual system, assuming a FIFO cost flow, the cost of goods sold would equal those from a *periodic* system

33. Which of the following is correct for the use of the average cost method with a perpetual system?
   a. A weighted-average cost is calculated at year end.
   b. A new unit cost is calculated each time a sale is made.
   c. A new unit cost is calculated each time a purchase is made.
   d. All of these.

34. Which of the following does *not* correctly describe a periodic inventory accounting system?
   a. In a periodic system cost of goods sold are calculated every time a sale is made.
   b. In a periodic system, costs of goods sold are a residual amount.
   c. In a periodic system assuming a FIFO cost flow, the cost of goods sold would equal those from a *perpetual* system
   d. In a periodic system, inventory and cost of goods sold must be updated at the end of the period.

35. Which of the following does *not* correctly describe the specific identification costing method?
   a. This method is most appropriate when goods are *not* interchangeable
   b. This method is most appropriate when goods are interchangeable
   c. This method is generally used for expensive, one-of-a-kind merchandise
   d. None of these

36. The primary basis of accounting for inventories is cost. A departure from the cost basis of pricing the inventory is required where there is evidence that when the goods are sold in the ordinary course of business their
   a. selling price will be less than their replacement cost.
   b. replacement cost will be more than their net realizable value.
   c. cost will be less than their replacement cost.
   d. future utility will be less than their cost.

37. Which of the following does *not* correctly describe the weighted average costing method?
    a. This method prices items in inventory on the basis of the average cost of beginning inventory.
    b. This method prices items in inventory on the basis of the average cost of goods available for sale during the period.
    c. This method takes into account that the volumes of goods acquired at each price are different.
    d. None of these

38. In no case can "market" in the lower of cost and market rule be more than
    a. estimated selling price in the ordinary course of business.
    b. estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal.
    c. estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal and an allowance for an approximately normal profit margin.
    d. estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal, an allowance for an approximately normal profit margin, and an adequate reserve for possible future losses.

39. Which of the following does *not* correctly describe the FIFO costing method?
    a. This method assumes that the oldest inventory costs are the first costs recorded for cost of goods sold.
    b. This method assumes that most current inventory costs are the first costs recorded for cost of goods sold.
    c. This method approximates the physical flow of most types of goods.
    d. This method is permitted under private entity GAAP

40. Lower of cost and market
    a. is most conservative if applied to the total inventory.
    b. is most conservative if applied to major categories of inventory.
    c. is most conservative if applied to individual items of inventory.
    d. must be applied to major categories for taxes.

41. When inventory declines in value below original (historical) cost, and this decline is considered other than temporary, what is the maximum amount that the inventory can be valued at?
    a. Sales price
    b. Net realizable value
    c. Historical cost
    d. Net realizable value reduced by a normal profit margin

42. Which of the following does *not* correctly describe the concept of net realizable value (NRV)?
    a. Estimates of NRV are based on the best evidence available at and shortly after the balance sheet date.
    b. NRV generally does *not* change over time
    c. NRV generally changes over time
    d. A new estimate of NRV is required at each balance sheet date.

43. If a unit of inventory has declined in value below original cost, but the market value exceeds net realizable value, the amount to be used for purposes of inventory valuation is
    a. net realizable value.
    b. original cost.
    c. market value.
    d. net realizable value less a normal profit margin.

44. Which of the following does *not* correctly describe the implications of an executory contract on the accounting entries and/or disclosures to be made by the purchaser and/or seller?
    a. Assets and liabilities are usually recorded at inception of the contract.
    b. Assets and liabilities are usually *not* recorded at inception of the contract.
    c. Contract details should be disclosed if the amounts are abnormal in relation to the entity's normal business operations.
    d. Assets and liabilities are recognized as performance has occurred.

45. If a material amount of inventory has been ordered through a formal purchase contract at the balance sheet date for future delivery at firm prices,
    a. this fact must be disclosed.
    b. disclosure is required only if prices have declined since the date of the order.
    c. disclosure is required only if prices have since risen substantially.
    d. an appropriation of retained earnings is necessary.

46. Which of the following criteria does *not* have to be met in order to be able to value inventory *above* cost?
    a. The cost of disposal can be estimated.
    b. The sale is assured.
    c. There is an active market for the product
    d. The sale must already have occurred

47. The gross profit method of inventory valuation is *invalid* when
    a. a portion of the inventory is destroyed.
    b. there is a substantial increase in inventory during the year.
    c. there is no beginning inventory because it is the first year of operation.
    d. none of these.

48. Which statement is *not* true about the gross profit method of inventory valuation?
    a. It may be used to estimate inventories for interim statements.
    b. It may be used to estimate inventories for annual statements.
    c. It may be used by auditors.
    d. None of these.

49. The gross profit percentage is calculated by
    a. dividing cost of goods sold by net sales.
    b. dividing gross profit on sales by cost of goods sold.
    c. dividing gross profit on sales by net sales.
    d. dividing gross profit on sales by goods available for sale.

50. Which statement is true about the gross profit method of inventory valuation?
    a. It can be used as a substitute for the annual physical count of inventory.
    b. It assumes past percentages are appropriate for the current period.
    c. It uses mark-ups but not markdowns.
    d. It is designed to approximate inventory valuation at the lower of cost and market.

51. Which of the following statements with respect to the impact of inventory errors is *not* correct?
    All else being equal,
    a. An overstatement of ending inventory will result in an understatement of income.
    b. An overstatement of ending inventory will result in an overstatement of income.
    c. An overstatement of beginning inventory will result in an understatement of income.
    d. An understatement of beginning inventory will cause cost of goods sold to be understated

52. An inventory method which is designed to approximate inventory valuation at the lower of average cost and market is
    a. last-in, first-out.
    b. weighted average.
    c. conventional retail method.
    d. specific identification.

53. Which of the following statements with respect to the gross profit method of estimating inventory is *not* correct?
    a. This method is sometimes used by auditors to confirm a physical count.
    b. The use of this method eliminates the need for performing an actual inventory count.
    c. This method utilizes the interrelationship between the accounts used in the cost of goods sold calculation.
    d. It may be used to estimate ending inventory when inventory has been destroyed.

54. Which statement is true about the retail inventory method?
    a. It may not be used to estimate inventories for interim statements.
    b. It may not be used to estimate inventories for annual statements.
    c. It may not be used by auditors.
    d. None of these.

55. When the conventional retail inventory method is used, markdowns are commonly ignored in the calculation of the cost to retail ratio because
    a. there may be no markdowns in a given year.
    b. this tends to give a better approximation of the lower of cost and market.
    c. mark-ups are also ignored.
    d. this tends to result in the showing of a normal profit margin in a period when no markdown goods have been sold.

56. To produce an inventory valuation which approximates the lower of average cost and market using the conventional retail inventory method, the calculation of the ratio of cost to retail should
    a. include mark-ups but not markdowns.
    b. include mark-ups and markdowns.
    c. ignore both mark-ups and markdowns.
    d. include markdowns but not mark-ups.

57. Which of the following formulas is used to determine a company's inventory turnover?
    a. Cost of goods sold / Average inventory
    b. Average inventory / Cost of goods sold
    c. Cost of goods sold x Average inventory
    d. Average assets / Cost of goods sold

58. The inventory turnover ratio is calculated by dividing the cost of goods sold by
    a. beginning inventory.
    b. ending inventory.
    c. average inventory.
    d. number of days in the year.

Multiple Choice Answers—Conceptual

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.
1.	d	10.	a	19.	c	28.	a	37.	a	46.	d	55.	b
2.	b	11.	d	20.	a	29.	c	38.	b	47.	d	56.	a
3.	a	12.	b	21.	d	30.	d	39.	b	48.	b	57.	a
4.	d	13.	c	22.	c	31.	c	40.	c	49.	c	58.	c
5.	d	14.	d	23.	c	32.	c	41.	b	50.	b		
6.	a	15.	b	24.	a	33.	c	42.	b	51.	a		
7.	b	16.	a	25.	a	34.	a	43.	a	52.	c		
8.	b	17.	b	26.	a	35.	b	44.	a	53.	b		
9.	a	18.	b	27.	c	36.	d	45.	a	54.	b		

Solutions to those Multiple Choice questions for which the answer is "none of these."

4. Goods in transit which were purchased f.o.b. shipping point.
11. Assets and liabilities were understated but shareholders' equity was not affected.
47. The gross profit percentage applicable to the goods in ending inventory is different from the percentage applicable to the goods sold during the period.

MULTIPLE CHOICE—Computational

Use the following information for questions 59 through 61.

Tessari, Ltd. is a calendar-year corporation. Its financial statements for the years 2011 and 2010 contained errors as follows:

	2011	2010
Ending inventory	$4,000 overstated	$7,000 overstated
Amortization expense	$2,000 understated	$8,000 overstated

59. Assume that the proper correcting entries were made at December 31, 2010. By how much will 2011 income before taxes be overstated or understated?
    a. $2,000 understated
    b. $2,000 overstated
    c. $4,000 overstated
    d. $6,000 overstated

60. Assume that *no* correcting entries were made at December 31, 2010. *Ignoring income taxes,* by how much will retained earnings at December 31, 2011 be overstated or understated?
    a. $2,000 understated
    b. $6,000 overstated
    c. $6,000 understated
    d. $9,000 understated

61. Assume that *no* correcting entries were made at December 31, 2010, or December 31, 2011 and that *no* additional errors occurred in 2011. *Ignoring income taxes*, by how much will working capital, at December 31, 2011 be overstated or understated?
    a. $0
    b. $4,000 overstated
    c. $4,000 understated
    d. $3,000 understated

62. At the end of its accounting year, Getz Corporation's physical inventory count indicated that 543,345 units of inventory, costing $1.50 each were on hand. The company's perpetual inventory system reported a balance of $817,135.
    The year end adjusting entry is:
    a. Debit inventory and credit "inventory over and short" $2,117.50
    b. Debit "inventory over and short" and credit inventory $2,117.50
    c. Debit inventory and credit "inventory over and short" $273,790
    d. Debit "inventory over and short" and credit inventory $273,790

63. The following information is available for Kobold Company for 2010:

Freight-in	$ 20,000
Purchase returns	62,000
Selling expenses	110,000
Ending inventory	310,000

The cost of goods sold is equal to 400% of selling expenses. What is the cost of goods available for sale?

a. $420,000.
b. $390,000.
c. $750,000.
d. $720,000.

64. For the year 2010, the gross profit of Altman Company was $350,000; the cost of goods manufactured was $890,000; the beginning inventories of goods in process and finished goods were $76,000 and $112,000, respectively; and the ending inventories of goods in process and finished goods were $92,000 and $143,000, respectively. The sales of Altman Company for 2010 must have been

a. $730,000.
b. $894,000.
c. $1,101,000.
d. $1,209,000.

Use the following information for questions 65 and 66.

Chi Co. records purchases at net amounts. On May 5 Chi purchased merchandise on account, $8,000, terms 2/10, n/30. Pye returned $500 of the May 5 purchase and received credit on account. At May 31 the balance had not been paid.

65. The amount to be recorded as a purchase return is

a. $450.
b. $510.
c. $500.
d. $490.

66. By how much should the account payable be adjusted on May 31?

a. $0.
b. $170.
c. $160.
d. $150.

Use the following information for questions 67 and 68.

The following information was available from the inventory records of Lock Company for January:

	Units	Unit Cost	Total Cost
Balance at January 1	3,000	$9.77	$29,310
Purchases:			
January 6	2,000	10.30	20,600
January 26	2,700	10.71	28,917
Sales:			
January 7	(2,500)		
January 31	(4,200)		
Balance at January 31	1,000		

67. Assuming that Lock does *not* maintain perpetual inventory records, what should be the inventory at January 31, using the weighted-average inventory method, rounded to the nearest dollar?
    a. $10,505.
    b. $10,237.
    c. $10,260.
    d. $10,360.

68. Assuming that Lock maintains perpetual inventory records, what should be the inventory at January 31, using the moving-average inventory method, rounded to the nearest dollar?
    a. $10,505.
    b. $10,237.
    c. $10,260.
    d. $10,360.

69. Idle Co. has the following data related to an item of inventory:

Inventory, March 1	100 units @ $4.20
Purchase, March 7	350 units @ $4.40
Purchase, March 16	70 units @ $4.50
Inventory, March 31	150 units

The value assigned to cost of goods sold if Idle uses FIFO is
    a. $667.
    b. $640.
    c. $1,635.
    d. $1,608.

Use the following information for questions 70 and 71.

Transactions for the month of June were:

Purchases				Sales	
June 1	(balance)	400 @ $3.20		June 2	300 @ $5.50
3		1,100 @ 3.10		6	800 @ 5.50
7		600 @ 3.30		9	500 @ 5.50
15		900 @ 3.40		10	200 @ 6.00
22		250 @ 3.50		18	700 @ 6.00
				25	150 @ 6.00

70. Assuming that perpetual inventory records are kept in dollars, the ending inventory on a FIFO basis is
    a. $1,900.
    b. $1,920.
    c. $2,065.
    d. $2,100.

71. Assuming that perpetual inventory records are kept in units only, the ending inventory on an average-cost basis, rounded to the nearest dollar, is
    a. $1,980.
    b. $1,956.
    c. $1,970.
    d. $1,995.

72. Wendling Company's net sales and gross profit were $1,341,000 and $471,000 respectively. Assuming the cost of goods available were $1,084,00, what was the cost of Wendling's ending inventory?
    a. $471,000
    b. $214,000
    c. $247,000
    d. $870,000

73. Peskari Company's cost of goods sold and ending inventory were $100,000 and $150,000 respectively. Assuming Peskari had neither purchases nor returns, what was the cost of its beginning inventory?
    a. $50,000
    b. $150,000
    c. $250,000
    d. undeterminable

Use the following information for questions 74 and 75.

The following information is available for Peak Corporation's inventories:
December 31, 2010:
At cost: $725,000
At lower of cost and net realizable value (NRV): $675,000
December 31, 2011:
At cost: $820,000
At lower of cost and net realizable value (NRV): $780,000
Peak uses a periodic inventory system and uses an allowance account to adjust its inventory from cost to the lower of cost and NRV.

74. Peak's 2010 entry to record to adjust its inventory from cost to the lower of cost and net realizable value (NRV) is
    a. Debit: "Loss-NRV" and credit: "Allowance-NRV" $50,000
    b. Debit: "Allowance-NRV" and credit: "Loss-NRV" $50,000
    c. Debit: "Loss-NRV" and credit: "Inventory" $50,000
    d. Debit: "Inventory" and credit: "Loss-NRV" $50,000

75. Peak's 2011 entry to record to adjust its inventory from cost to the lower of cost and net realizable value (NRV) is
    a. Debit: "Loss-NRV" and credit: "Allowance-NRV" $40,000
    b. Debit: "Allowance-NRV" and credit: "Loss-NRV" $40,000
    c. Debit: "Allowance" and credit "Recovery of loss" $10,000
    d. Debit: "Recovery of loss" and credit "Allowance" $10,000

76. Hoskins Company had a gross profit of $270,000, total purchases of $320,000, and an ending inventory of $150,000 in its *first* year of operations as a retailer. Hoskins' sales in its first year must have been
    a. $120,000.
    b. $160,000.
    c. $440,000.
    d. $360,000.

77. A mark-up of 35% on cost is equivalent to what percentage of gross profit on selling price?
    a. 60%
    b. 26%
    c. 29%
    d. 40%

78. Danner, Ltd. estimates the cost of its physical inventory at March 31 for use in an interim financial statement. The rate of mark-up on cost is 25%. The following account balances are available:

Inventory, March 1	$220,000
Purchases	172,000
Purchase returns	8,000
Sales during March	350,000

The estimate of the cost of inventory at March 31 would be
a. $34,000.
b. $104,000.
c. $121,500.
d. $78,000.

79. On January 1, 2010, the merchandise inventory of Morton, Ltd. was $1.2 million. During 2010 Morton purchased $2,300,000 of merchandise and recorded sales of $2.7 million. The gross profit rate on these sales was 35%.

What is the merchandise inventory of Morton at December 31, 2010?
a. $1,125,000.
b. $1,745,000.
c. $1,765,000.
d. $945,000.

80. For 2010, cost of goods available for sale for Volker Corporation was $870,000. The gross profit rate was 40%. Sales for the year were $600,000. What was the amount of the ending inventory?
a. $260,000.
b. $320,000.
c. $0.
d. $510,000.

81. On April 15 of the current year, a fire destroyed the entire uninsured inventory of a retail store. The following data are available:

Sales, January 1 through April 15	$485,000
Inventory, January 1	80,000
Purchases, January 1 through April 15	391,000
Mark-up on cost	20%

The amount of the inventory loss is estimated to be
a. $75,000.
b. $66,833.
c. $111,500.
d. $90,000.

82. In 2010, Garrison Corporation reported net income of $70,000. A recount of the company's inventories revealed that 2010 ending inventory was overstated by $10,000. What is Garrison's corrected net income?
    a. $60,000
    b. $80,000
    c. $70,000
    d. $75,000

83. In 2010, Frobisher Corporation reported net income of $245,000. You have been made aware that the company's beginning inventory was overstated by $12,000 and ending inventory was understated by $11,000. What is Frobisher's corrected net income for 2010?
    a. $244,000
    b. $268,000
    c. $246,000
    d. $222,000

Use the following information for questions 84 to 86.

Chu Company uses FIFO to cost its inventory. The following information is available for Chu's inventory of product # 101:
Beginning inventory: 120 units @ $3.14 per unit
March 1, 2010: Purchase of 250 units @ $3.50 per unit
April 10, 2010: Sale of 100 units @ $5.10 per unit

84. Assuming Chu uses a *periodic* inventory system, the entry to account for the March 1 purchase is:
    a. Debit: "Inventory" and Credit: "Accounts Payable" $875
    b. Debit: "Purchases" and Credit: "Accounts Payable" $875
    c. Debit: "Accounts Payable" and Credit: "Purchases" $875
    d. Debit: "Accounts Payable" and Credit: "Inventory" $875

85. Assuming Chu uses a *perpetual* inventory system, the entry to account for the March 1 purchase is
    a. Debit: "Inventory" and Credit: "Accounts Payable" $875
    b. Debit: "Purchases" and Credit: "Accounts Payable" $875
    c. Debit: "Accounts Payable" and Credit: "Purchases" $875
    d. Debit: "Accounts Payable" and Credit: "Inventory" $875

86. Assuming Chu uses a *perpetual* inventory system, which entry would have been made to account for the April 1 sale?
    a. Debit: "Cost of goods sold" and Credit: "Inventory" $350
    b. Debit: "Cost of goods sold" and Credit: "Purchases" $350
    c. Debit: "Cost of goods sold" and Credit: "Purchases" $314
    d. Debit: "Cost of goods sold" and Credit: "Inventory" $314

87. The 2010 financial statements of Hurley Company reported a beginning inventory of $130,000, an ending inventory of $140,000, and cost of goods sold of $650,000 for the year. Hurley's inventory turnover ratio for 2010 is
   a. 2.9 times.
   b. 3.4 times.
   c. 4.8 times.
   d. 4.0 times.

Use the following information for questions 88 through 90.

Toby Co. uses the retail inventory method. The following information is available for the current year.

	Cost	Retail
Beginning inventory	$117,000	$183,000
Purchases	442,000	623,000
Freight-in	8,000	—
Employee discounts	—	3,000
Net mark-ups	—	22,000
Net Markdowns	—	30,000
Sales	—	585,000

88. If the ending inventory is to be valued at approximately lower of average cost and market, the calculation of the cost ratio should be based on cost and retail of
   a. $450,000 and $645,000.
   b. $450,000 and $642,000.
   c. $559,000 and $825,000.
   d. $567,000 and $828,000.

89. The ending inventory at retail should be
   a. $240,000.
   b. $225,000.
   c. $216,000.
   d. $210,000.

90. The approximate cost of the ending inventory by the conventional retail method is
   a. $143,850.
   b. $142,380.
   c. $147,000.
   d. $153,720.

Multiple Choice Answers—Computational

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.
59	d	65	d	71	b	77	b	83	b	89	d
60	a	66	d	72	b	78	b	84	b	90	a
61	a	67	b	73	c	79	b	85	a		
62	b	68	d	74	a	80	d	86	d		
63	c	69	d	75	c	81	b	87	c		
64	d	70	c	76	c	82	a	88	d		

MULTIPLE CHOICE—CPA Adapted

91. How should the following costs affect a retailer's inventory valuation?

	Freight-in	Interest on Inventory Loan
a.	Increase	No effect
b.	Increase	Increase
c.	No effect	Increase
d.	No effect	No effect

92. The following information applied to Mark, Inc. for 2010:

Merchandise purchased for resale	$200,000
Freight-in	8,000
Freight-out	5,000
Purchase returns	2,000

Mark's 2010 inventoriable cost was
a. $211,000.
b. $206,000.
c. $203,000.
d. $200,000.

93. Oxley Retailers purchased merchandise with a list price of $30,000, subject to trade discounts of 20 percent and 10 percent, with no cash discounts allowable. Oxley should record the cost of this merchandise as
a. $30,000.
b. $23,400.
c. $21,600.
d. $21,000.

94. On June 1, 2006, Meisner Corp. sold merchandise with a list price of $15,000 to Metz on account. Meisner allowed trade discounts of 30 percent and 20 percent. Credit terms were 2/15, n/40 and the sale was made f.o.b. shipping point. Meisner prepaid $300 of delivery costs for Metz as an accommodation. On June 12, 2010, Meisner received from Metz a remittance in full payment amounting to
a. $8,397.
b. $8,532.
c. $8,526.
d. $8,232.

95. The following information was derived from the 2010 accounting records of Beck Co.:

	Beck's Central Warehouse	Beck's Goods Held by Consignees
Beginning inventory	$130,000	$14,000
Purchases	475,000	70,000
Freight-in	10,000	
Transportation to consignees		5,000
Freight-out	30,000	8,000
Ending inventory	145,000	20,000

Beck's 2010 cost of sales was
a. $539,000.
b. $534,000.
c. $500,000.
d. $470,000.

96. Teel Corp.'s accounts payable at December 31, 2010, totalled $900,000 before any necessary year-end adjustments relating to the following transactions:

- On December 27, 2010, Teel wrote and recorded cheques to creditors totalling $350,000 causing an overdraft of $100,000 in Teel's bank account at December 31, 2010. The cheques were mailed out on January 10, 2011.
- On December 28, 2010, Teel purchased and received goods for $200,000, terms 2/10, n/30. Teel records purchases and accounts payable at net amounts. The invoice was recorded and paid January 3, 2011.
- Goods shipped f.o.b. destination on December 20, 2010 from a vendor to Teel were received January 2, 2011. The invoice cost was $65,000.

At December 31, 2010, what amount should Teel report as total accounts payable?
a. $1,100,000.
b. $1,150,000
c. $1,446,000.
d. $1,511,000

97. The balance in Jordan Co.'s accounts payable account at December 31, 2010 was $600,000 before any necessary year-end adjustments relating to the following:

- Goods were in transit to Jordan from a vendor on December 31, 2010. The invoice cost was $50,000. The goods were shipped f.o.b. shipping point on December 29, 2011 and were received on January 4, 2011.
- Goods shipped f.o.b. destination on December 21, 2010 from a vendor to Jordan were received on January 6, 2011. The invoice cost was $25,000.
- On December 27, 2010, Jordan wrote and recorded cheques to creditors totalling $30,000 that were mailed on January 10, 2011.

In Jordan's December 31, 2010 balance sheet, the accounts payable should be
a. $680,000
b. $675,000
c. $650,000
d. $630,000

98. House Co.'s accounts payable balance at December 31, 2010 was $1,200,000 before considering the following transactions:

- Goods were in transit from a vendor to House on December 31, 2010. The invoice price was $80,000, and the goods were shipped f.o.b. shipping point on December 29, 2010. The goods were received on January 4, 2011.
- Goods shipped to House, f.o.b. shipping point on December 20, 2010, from a vendor were lost in transit. The invoice price was $50,000. On January 5, 2011, Howe filed a $50,000 claim against the common carrier.

In its December 31, 2010 balance sheet, House should report accounts payable of
a. $1,200,000
b. $1,250,000
c. $1,280,000
d. $1,330,000

99. Biehl Co. recorded the following data pertaining to raw material X during January 2010:

		Units			
Date		Received	Cost	Issued	On Hand
1/1/10	Inventory		$4.00		3,200
1/11/10	Issue			1,600	1,600
1/22/10	Purchase	4,000	$4.70		5,600

The moving-average unit cost of X inventory at January 31, 2010 is
a. $4.70.
b. $4.50.
c. $4.43
d. $4.35

100. A company's cost of goods sold and sales were $281,250 and $1.2 million respectively. Assuming an inventory turnover of 3.5 what was the company's average inventory? (round to the nearest dollar)
   a. $342,857
   b. $85,341
   c. $80,357
   d. $61,433

101. Napier Co. had 150 units of product A on hand at January 1, 2010, costing $42 each. Purchases of product A during January were as follows:

Date	Units	Unit Cost
Jan. 10	200	$44
18	250	46
28	100	48

   A physical count on January 31, 2010 shows 200 units of product A on hand. The cost of the inventory at January 31, 2010 under the FIFO method is
   a. $8,200.
   b. $9,400.
   c. $8,900.
   d. $9,400.

102. Walter Distribution Co. has determined its December 31, 2010 inventory on a FIFO basis at $240,000. Information pertaining to that inventory follows:

Estimated selling price	$255,000
Estimated cost of disposal	10,000
Normal profit margin	30,000

   Walter records losses that result from applying the lower of cost and market rule. At December 31, 2010, the loss that Walter should recognize is
   a. $0.
   b. $5,000.
   c. $15,000.
   d. $25,000.

103. According to U. S. GAAP, under the lower of cost and market method, the replacement cost of an inventory item would be used as the designated market value
   a. when it is below the net realizable value less the normal profit margin.
   b. when it is below the net realizable value and above the net realizable value less the normal profit margin.
   c. when it is above the net realizable value.
   d. regardless of net realizable value.

104. Greer Company's accounting records indicated the following information:

Inventory, 1/1/10	$ 600,000
Purchases during 2010	3,000,000
Sales during 2010	4,000,000

A physical inventory taken on December 31, 2010, resulted in an ending inventory of $700,000. Greer's gross profit on sales has remained constant at 30% in recent years. Greer suspects some inventory may have been taken by a new employee. At December 31, 2010, what is the estimated cost of missing inventory?

a. $100,000.
b. $150,000.
c. $200,000.
d. $800,000.

105. Chin Co. uses the retail inventory method to estimate its inventory for interim statement purposes. Data relating to the calculation of the inventory at July 31, 2010, are as follows:

	Cost	Retail
Inventory, 2/1/10	$ 200,000	$ 250,000
Purchases	1,200,000	1,575,000
Mark-ups, net		175,000
Sales		1,700,000
Estimated normal shoplifting losses		20,000
Markdowns, net		110,000

Under the lower of average cost and market method, Eaton's estimated inventory at July 31, 2010 is

a. $170,000
b. $136,000
c. $133,000
d. $119,000

106. At December 31, 2010, the following information was available from Roll Co.'s accounting records:

	Cost	Retail
Inventory, 1/1/10	$147,000	$ 205,000
Purchases	833,000	1,155,000
Additional mark-ups		40,000
Available for sale	$980,000	$1,400,000

Sales for the year totalled $1.1 million. Markdowns amounted to $10,000. Under the lower of average cost and market method, Roll's inventory at December 31, 2010 was

a. $203,000.
b. $217,000
c. $210,000
d. $257,000

Multiple Choice Answers—CPA Adapted

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.
91	a	94	b	97	a	100	c	103	b	106	a
92	b	95	a	98	d	101	b	104	a		
93	c	96	c	99	b	102	a	105	d		

DERIVATIONS — Computational

No.	Answer	Derivation
59.	d	\$4,000 + \$2,000 = \$6,000.
60.	a	\$8,000 – (\$4,000 + \$2,000) = \$2,000.
61.	a	The effect of the errors in ending inventories reverse themselves in the following year.
62.	b	\$817,135 - (543,345 x \$1.50) = \$2,117.50
63.	c	\$310,000 + (400% x \$110,000) = \$750,000
64.	d	\$890,000 + \$112,000 - \$143,000 = \$859,000 (COGS) \$859,000 + \$350,000 = \$1,209,000
65.	d	\$500 – (\$500 × .02) = \$490.
66.	d	(\$8,000 – \$500) × .02 = \$150.
67.	b	(\$29,310 + \$20,600 + \$28,917) ÷ (3,000 + 2,000 + 2,700) = \$10.237/unit \$10.237 × 1,000 = \$10,237.
68.	d	Avg. on 1/6 \$49,910 ÷ 5,000 = \$9.982/unit 1/26 \$53,872 ÷ 5,200 = \$10.36/unit \$10.36 × 1,000 = \$10,360.
69.	d	100 + 350 + 70 – 150 = 370 units (100 × \$4.20) + (270 × \$4.40) = \$1,608.
70.	c	(250 × \$3.5) + (350 × \$3.4) = \$2,065.
71.	b	\$10,605 ÷ 3,250 units = \$3.26 \$3.26 × 600 = \$1,956.
72.	b	\$1,084,000 - (\$1,341,000 - \$471,000) = \$214,000
73.	c	\$100,000 + \$150,000 = \$250,000
74.	a	\$725,000 - \$675,000 = \$50,000
75.	c	Existing balance in allowance account must decreased from \$50,000 to \$40,000. This is accomplished by debiting the allowance account. After that adjustment net inventory will be \$820,000 - \$40,000 = \$780,000.
76.	c	\$270,000 + (\$320,000 - \$150,000) = \$440,000

DERIVATIONS — Computational (Continued)

No.	Answer	Derivation
77.	b	35% / 1 + 35% = 26%
78.	b	COGS = $350,000 ÷ 1.25 = $280,000 ($220,000 + $172,000 – $8,000) – $280,000 = $104,000.
79.	b	COGS = $2,700,000 x 0.65 = $1,755,000 $1,200,000 + $2,300,000 - $1,755,000 = $1,745,000
80.	d	$870,000 - ($600,000 x 0.60) = $510,000
81.	b	$80,000 + $391,000 - ($485,000 / 1.20) = $66,833
82.	a	$70,000 - $10,000 = $60,000
83.	b	$245,000 + $12,000 + $11,000 = $268,000
84.	b	Under the periodic system, the "purchases" account is used. 250 x $3.50 = $875
85.	a	Under the perpetual system, the "inventory" account is used. 250 x $3.50 = $875
86.	d	Under FIFO, the unsold units in beginning inventory are the units to be considered for this entry 100 x $3.14 = $314
87.	c	$650,000 / [($130,000 + $140,000) / 2] = 4.81 times
88.	d	Cost: $117,000 + $442,000 + $8,000 = $567,000. Retail: $183,000 + $623,000 + $22,000 = $828,000.
89.	d	$183,000 + $623,000 – $3,000 + $22,000 – $30,000 – $585,000 = $210,000.
90.	a	$210,000 × .685 = $143,850.

DERIVATIONS — CPA Adapted

No.	Answer	Derivation
91.	a	Conceptual.
92.	b	$200,000 + $8,000 – $2,000 = $206,000.
93.	c	$30,000 × .8 × .9 = $21,600.
94.	b	$15,000 × .7 × .8 = $8,400 ($8,400 × .98) + 300 = $8,532.
95.	a	$130,000 + $14,000 + $475,000 + $70,000 + $10,000 + $5,000 – $145,000 – $20,000 = $539,000.
96.	c	$900,000 + $350,000 + $196,000 = $1,446,000.
97.	a	$600,000 + $50,000 + $30,000 = $680,000.
98.	d	$1,200,000 + $80,000 + $50,000 = $1,330,000.
99.	b	[(1,600 × $4.00) + (4,000 × $4.70)] ÷ 5,600 = $4.50.
100.	c	$281,250 ÷ 3.5 = $80,357
101.	b	(100 × $48) + (100 × $46) = $9,400.
102.	a	NRV = $255,000 - $10,000 = $245,000; Cost = $240,000; Therefore no loss.
103.	b	Conceptual.
104.	a	$4,000,000 × .70 = $2,800,000 (COGS) $600,000 + $3,000,000 – $2,800,000 – $700,000 = $100,000.
105.	d	($200,000 + $1,200,000) ÷ ($250,000 + $1,575,000 + $175,000) = 0.7 ($250,000 + $1,575,000 + $175,000 – $20,000 – $110,000 – $1,700,000) × 0.7 = $119,000.
106.	a	$980,000 ÷ $1,400,000 = 0.7 ($1,400,000 – $10,000 – $1,100,000) × 0.7 = $203,000.

EXERCISES

Ex. 8-107 - Definitions.

Provide clear, concise answers for the following.

1. Identify the inventory categories of a manufacturing company and describe how they related.
2. What is a perpetual inventory system?
3. What is a periodic inventory system?
4. What is the specific identification cost flow method?
5. What is the average cost inventory costing method?
6. What is the FIFO method of costing inventory?

Solution 8-107

1. Manufacturing companies typically have three inventory categories: raw materials, work-in-process and finished goods. Their relationship can be seen in that both the raw materials and the finished goods are included in the finished goods inventory. Specifically the raw materials can be traced directly to the end product.

2. In a perpetual inventory system, all purchases and sales are recorded directly in the inventory account as they occur. Cost of goods sold is calculated every time goods are sold. As a result, up-to-date information as to the number of units on hand and cost of sales are always available.

3. In a periodic inventory system, detailed records of purchases and sales are not kept in the inventory accounts. Cost of goods sold is a residual amount and is only available after a physical inventory count has been performed.

4. This method is used to assign costs to individual inventory items that are not interchangeable and are identifiable. Examples include special orders and custom automobiles.

5. This method prices items in inventory on the basis of average cost of goods available for sale during the period. The weighted average cost formula takes into account that the volume of goods purchased at each price is different.

6. This method assumes that the oldest inventory costs are the first costs recorded for goods sold. As a result, it matches the physical flow of goods for most types of inventory.

Ex. 8-108 - Terminology.

In the space provided at right, write the word or phrase that is defined or indicated.

1. An approach whereby a company finances its inventory without reporting either the liability or the inventory asset on its balance sheet. — 1. ____________________

2. The method of initially recording purchases at the full invoice amount. — 2. ____________________

3. The method of initially recording purchases at an amount that assumes that discounts will be taken. — 3. ____________________

4. The difference between the expected number of inventory units and the actual number revealed after a physical count. — 4. ____________________

5. The costs that are "attached" to Inventory. — 5. ____________________

6. Direct costs and allocated overhead that are incurred to process raw materials into finished goods. — 6. ____________________

7. The predetermined costs to produce one unit of a given item of inventory. — 7. ____________________

8. The purchase of a group of units with different characteristics at a single lump sum price. — 8. ____________________

9. An inventory estimation method that uses the interrelationships between the accounts used in the calculation of cost of goods sold. — 9. ____________________

Solution 8-108

1. A product financing arrangement.
2. The gross method.
3. The net method.
4. Shrinkage.
5. Product costs.
6. Conversion costs.
7. Standard costs.
8. Basket purchase.
9. The gross profit method.

Ex. 8-109—Recording purchases at net amounts.

Faulkner Co. records purchases at net amounts and uses periodic inventories. Prepare entries for the following:

May 11 Purchased merchandise on account, $8,000, terms 2/10, n/30.
15 Returned part of May 11 purchase, $2,000, and received credit on account.
30 Prepared the adjusting entry required for financial statements.

Solution 8-109

May	11	Purchases (.98 × $8,000)	7,840	
		Accounts Payable		7,840
	15	Accounts Payable (.98 × $2,000)	1,960	
		Purchase Returns and Allowances		1,960
	30	Purchase Discounts Lost [0.02 x (7,840 – 1,960)]	117.60	
		Accounts Payable		117.60

Ex. 8-110 – Adjustment to lower of cost and NRV

The controller of Hedak Corporation has provided you with the following information relating to its inventory:

	Cost	Lower of cost and NRV
Dec-31-2010	$657,000	$610,750
Dec-31-2011	$715,000	$655,250

Hedak records its inventory at cost under a periodic system. An allowance account is adjusted at the end of each year to adjust the value of its inventories to the lower of cost and NRV.

Instructions

Prepare the journal entries that Hedak would have prepared for its 2010 and 2011 year ends, assuming that 2010 was its first year of operations.

Solution 8-110

December 2010:
Loss – NRV 46,250
    Allowance - NRV 46,250
To set-up allowance to decrease inventory from cost to the lower of cost and NRV ($657,000 - $610,750 = $46,250)

December 2011:
Loss - NRV 13,500
    Allowance – NRV 13,500
To increase the balance in the allowance account by $13,500
($715,000 - $46,250) - $655,250 = $13,500

Ex. 8-111—FIFO inventory method.

The Beetle Shop shows the following data related to an item of inventory:

Inventory, February 1	100 units @ $7.00
Purchase, February 9	300 units @ $7.60
Purchase, February 19	90 units @ $7.90
Inventory, February 31	150 units

Instructions
What value should be assigned to the ending inventory using FIFO?

Solution 8-111

90 @ $7.90 =	$711
60 @ $7.60 =	456
	$1,167

Ex. 8-112—Perpetual FIFO.

A record of transactions for the month of May was as follows:

Purchases					Sales			
May 1	(balance)	400	@	$4.00	May 3	300	@	$7.00
4		1,300	@	$4.10	6	1,000	@	7.00
8		800	@	$4.30	12	900	@	7.50
14		700	@	$4.40	18	400	@	7.50
22		1,200	@	$4.50	25	1,400	@	8.00
29		500	@	$4.75				

Assuming that perpetual inventory records are kept in dollars, determine the ending inventory using FIFO.

Solution 8-112

500 @ $4.75 =	$2,375
400 @ $4.50 =	1,800
	$4,175

Ex. 8-113—Periodic FIFO.

Max Corporation sells item A as part of its product line. Information as to balances on hand, purchases, and sales of item A are given in the following table for the first six months of 2010.

	Quantities			
Date	Purchased	Sold	Balance	Unit Price of Purchase
January 11	—	—	300	$2.50
January 24	1,300	—	1,600	$2.60
February 8	—	300	1,300	—
March 16	—	560	740	—
June 11	600	—	1,340	$2.80

Instructions

Calculate the *cost of goods sold* for the first six months under the periodic FIFO inventory pricing method.

Solution 8-113

300	@ $2.50 =	$ 750
560	@ $2.60 =	1,456
860		$2,206

Ex. 8-114 – Journal entries for perpetual inventory system

Chantal Corporation is a wholesale company that specializes in rubberized parts that are used in the automotive industry. The company uses FIFO in a perpetual inventory system. Its inventory records for part SA-123 show the following transactions for the month of May 2010:

Date	Transaction	Units Purchased	Unit Cost	Units Sold	Unit Selling Price
May-1	Balance	120	$3.50		
May-10	Purchase	500	$3.60		
May-15	Sale			(100)	$6.20
May-21	Sale			(150)	$6.20
May-23	Purchase	250	$3.65		

Instructions

Assuming Chantal makes all sales and purchases of inventory on account, prepare the journal entries for each of the above listed transactions.

Solution 8-114

May-10:
Inventory 1,800
Accounts Payable 1,800
To account for purchase (500 x $3.60 = $1,800)

May-15:
Accounts Receivable 620
Sales 620
To record sale (100 x $6.20 = $620)

Cost of goods sold 350
Inventory 350
To update inventory and cost of goods sold
(100 x $3.50 = $350)

Solution 8-114 (Continued)

May-21:
Accounts Receivable 930
Sales 930
To record sale (150 x $6.20 = $930)

Cost of goods sold............................ 538
Inventory.. 538
To update inventory and cost of goods sold
(20 x $3.50) + (130 x $3.60) = $538

May-23:
Inventory 912.50
Accounts Payable 912.50
To account for purchase (250 x $3.65 = $912.50)

Ex. 8-115—Lower of cost and market.

Determine the unit value that should be used for inventory costing following "lower of cost and market value" most frequently used in Canada.

	A	B	C	D	E	F
Cost	$2.40	$2.40	$2.30	$2.54	$2.44	$2.33
Replacement cost	2.20	2.60	2.20	2.50	2.42	2.36
Net realizable value	2.50	2.50	2.25	2.45	2.50	2.50
Net realizable value less normal profit	2.25	2.30	2.35	2.30	2.30	2.30

Solution 8-115

Case A	$2.40	Case D	$2.45
Case B	$2.40	Case E	$2.44
Case C	$2.25	Case F	$2.33

Ex. 8-116—Lower of cost and market.

The December 31, 2010 inventory of Riley Company consisted of four products, for which certain information is provided below.

Product	Original Cost	Replacement Cost	Estimated Disposal Cost	Expected Selling Price	Normal Profit on Sales
A	$26.00	$22.00	$6.50	$40.00	15%
B	$42.00	$40.00	$8.00	$48.00	25%
C	$130.00	$125.00	$25.00	$190.00	30%
D	$19.00	$15.80	$3.00	$28.00	20%

Instructions
Using the lower of cost and market approach applied on an individual-item basis; calculate the inventory valuation that should be reported for each product on December 31, 2010. Apply the valuation of market used most frequently in Canada.

Solution 8-116

Product	Market	Cost	Lower of Cost And Market
A	$40.00 – $6.50 = $33.50	$26.00	$26.00
B	$48.00 – $8.00 = $40.00	$42.00	$40.00
C	$190.00 – $25.00 = $165.00	$130.00	$130.00
D	$28.00 – $3.00 = $25.00	$19.00	$19.00

Ex. 8-117 - Year-end entries to update inventory accounts

Basten Corporation uses FIFO in a periodic inventory system. You have been provided with the following information relating to the company's inventory for the year ended December 2010:

Beginning inventory Jan-1:	12,250
Ending inventory Dec-31:	54,540
Total purchases recorded during 2010:	65,000

Instructions

Record the journal entr(ies) that are required to bring Basten's inventory accounts and cost of goods sold up-to-date for 2010.

Solution 8-117

Ending inventory (Note 1)................ 54,540
Cost of goods sold (Note 2) 22,710
    Beginning inventory (Note 3) 12,250
    Purchases (Note 4).................................... 65,000

Note 1: To record ending inventory
Note 2: To record cost of goods sold (this is a residual amount, i.e. to balance the entry)
Note 3: To remove beginning inventory
Note 4: To clear purchases account

Ex. 8-118—Gross profit method.

An inventory taken the morning after a large theft discloses $55,000 of goods on hand as of March 12. The following additional data is available from the books:

Inventory on hand, March 1	$ 84,000
Purchases received, March 1 – 11	72,000
Sales (goods delivered to customers)	135,000

Past records indicate that sales are made at 50% above cost.

Instructions
Estimate the inventory of goods on hand at the close of business on March 11 by the gross profit method and determine the amount of the theft loss. Show appropriate titles for all amounts in your presentation.

Solution 8-118

Beginning Inventory	$ 84,000
Purchases	72,000
Goods Available	156,000
Goods Sold ($135,000 ÷ 150%)	90,000
Estimated Ending Inventory	66,000
Physical Inventory	55,000
Theft Loss	$ 11,000

Ex. 8-119—Gross profit method.

On January 1, a store had inventory of $62,000. January purchases were $39,000 and January sales were $110,000. On February 1, a fire destroyed most of the inventory. The rate of gross profit was 25% of cost. Merchandise with a selling price of $8,000 remained undamaged after the fire.

Instructions
Calculate the amount of the fire loss, assuming the store had no insurance coverage. Label all figures.

Solution 8-119

Beginning Inventory	$ 62,000
Purchases	39,000
Goods available	101,000
Cost of sale ($110,000 ÷ 125%)	(88,000)
Estimated ending inventory	13,000
Cost of undamaged inventory ($8,000 ÷ 125%)	(6,400)
Estimated fire loss	$6,600

Ex. 8-120—Gross profit method.

Beringer Co. prepares monthly income statements. Inventory is counted only at year end; thus, month-end inventories must be estimated. All sales are made on account. The rate of mark-up on cost is 20%. The following information relates to the month of May.

Accounts receivable, May 1	$21,000
Accounts receivable, May 31	27,000
Collections of accounts during May	84,000
Inventory, May 1	47,000
Purchases during May	65,000

Instructions
Calculate the estimated cost of the inventory on May 31.

Solution 8-120

Collections of accounts	$ 84,000
Add accounts receivable, May 31	27,000
Deduct accounts receivable, May 1	(21,000)
Sales during May	$ 90,000

Inventory, May 1	$ 47,000
Purchases during May	65,000
Goods available	112,000
Cost of sales ($90,000 ÷ 120%)	(75,000)
Estimated cost of inventory, May 31	$ 37,000

Ex. 8-121—Comparison of inventory methods.

In the cases cited below, five different conditions are possible when X is compared with Y. These possibilities are as follows:

a. X equals Y
b. X is greater than Y
c. X is less than Y
d. X is equal to or greater than Y
e. X is equal to or less than Y

Instructions
In the space provided show the relationship of X and Y for each of the following independent statements.

____ 1. "Cost and market, whichever is lower," may be applied to (1) the inventory as a whole or to (2) categories of inventory items. Compare (X) the reported value of inventory when procedure (1) is used with (Y) the reported value of inventory when procedure (2) is used.

____ 2. The retail inventory method has been used by a store during its first year of operation. Compare (X) markdown cancellations with (Y) markdowns.

____ 3. Prices have been rising steadily. Physical turnover of goods has occurred five times in the last year. Compare (X) unit prices of ending inventory items at moving average pricing with (Y) those at weighted average pricing.

Solution 8-121

1. d 2. e 3. b

PROBLEMS

Pr. 8-122—Accounting for purchase discounts.

Lapp Corp. purchased merchandise during 2010 on credit for $150,000; terms 2/10, n/30. All of the gross liability except $30,000 was paid within the discount period. The remainder was paid within the 30-day term. At the end of the annual accounting period, December 31, 2010, 90% of the merchandise had been sold and 10% remained in inventory. The company uses a periodic system.

Instructions

(a) Assuming that the net method is used for recording purchases, prepare the entries for the purchase and two subsequent payments.

(b) What dollar amounts should be reported for the final inventory and cost of goods sold under the (1) net method; (2) gross method? Assume that there was no beginning inventory.

Solution 8-122

(a) Purchases	147,000	
Accounts Payable		147,000
(To record the purchase at net amount: .98 × $150,000 = $147,000.)		
Accounts Payable	117,600	
Cash		117,600
(To record payment within the discount period: $150,000 – $30,000 = $120,000; .98 × $120,000 = $117,600.)		
Accounts Payable	29,400	
Purchase Discounts Lost	600	
Cash		30,000
(To record the final payment.)		

Solution 8-122 (Continued)

(b) (1) Net method:

Purchases:	$147,000
Final inventory: 10% × $147,000 =	14,700
Cost of goods sold: 90% × $147,000 =	$132,300

(The $600 discount lost is reported in the other expense section of the income statement.)

(2) Gross method:

Purchases:	$150,000		Purchases:	$150,000
Less purchase discounts:			Less purchase discounts:	
.02 × $120,000 =	2,400		.02 × $120,000 =	2,400
Goods available	147,600	OR	Goods available	147,600
Final inventory:			Final inventory:	
10% × $147,600 =	14,760		10% × $150,000 =	15,000
Cost of goods sold:			Cost of goods sold:	
90% × $147,600 =	$132,840		$147,600 – $15,000 =	$132,600

(Assuming that the $2,400 discount is prorated between the cost of goods sold, 90 percent, and the final inventory, 10 percent.)

(Assuming that the $2,400 discount is used to reduce cost of goods sold. Final inventory is carried at the gross amount.)

Pr. 8-123—Analysis of errors.

(All sales and purchases are on credit.)
Indicate in each of the spaces provided the effect of the described errors on the various elements of a company's financial statements. Use the following codes: O = amount is overstated; U = amount is understated; NE = no effect. Assume a periodic inventory system.

	Accounts Receivable	Inventory	Accounts Payable	Sales	Cost of Goods Sold
EXAMPLE: Excluded goods in rented warehouse from inventory count.	NE	U	NE	NE	O
1. Goods in transit shipped "f.o.b. destination" by supplier were recorded as a purchase but were excluded from ending inventory.					
2. Goods held on consignment were included in inventory count and recorded as a purchase.					
3. Goods in transit shipped "f.o.b. shipping point" were not recorded as a sale and were included in ending inventory.					
4. Goods were shipped and appropriately excluded from ending inventory but sale was not recorded.					

Solution 8-123

1.	NE	NE	O	NE	O
2.	NE	O	O	NE	NE
3.	U	O	NE	U	U
4.	U	NE	NE	U	NE

Pr. 8-124—Inventory cut-off.

Morgan Company sells laptop computers. The perpetual inventory was stated as $43,100 on the books at December 31, 2010. At the close of the year, a new approach for compiling inventory was used and apparently a satisfactory cut-off for preparation of financial statements was not made. Some events that occurred are as follows.

1. Units shipped to a customer January 2, 2011, costing $7,000 were included in inventory at December 31, 2010. The sale was recorded in 2011.
2. Units costing $17,000 received December 30, 2010, were recorded as received on January 2, 2011.
3. Units received during 2010 costing $5,300 were recorded twice in the inventory account.
4. Units shipped to a customer December 28, 2010, f.o.b. shipping point, which cost $11.000, were not received by the customer until January, 2011. The units were included in the ending inventory.
5. Units on hand that cost $5,600 were never recorded on the books.

Instructions

Calculate the correct inventory at December 31, 2010.

Solution 8-124

Inventory per books			$43,100
Add:	Shipment received 12/30/10	$17,000	
	Units on hand	5,600	22,600
			65,700
Deduct:	Units recorded twice	5,300	
	Units shipped 12/28/10	11,000	16,300
Correct inventory 12/31/10			$49,400

Pr. 8-125 – Year end entries to update inventory under periodic system

The Accountant of the Osgood chain of retail stores is getting ready to prepare the year end inventory entries for its periodic inventory system. His assistant has provided him with the following information:

Beginning inventory January-1: $98,000
Inventory purchases January 1 to December 31: $1,200,000

Schedule of inventory purchases and sales for December:

Date	Transaction	Units Purchased	Unit Cost	Units Sold	Unit Selling Price
Dec-1	Balance	nil			
Dec-8	Purchase	2500	$51.41		
Dec-10	Sale			(500)	$72.31
Dec-11	Sale			(1,500)	$73.54
Dec-12	Purchase	500	$55.39		
Dec-19	Sale			(1,000)	$75.01

Instructions

Record the journal entr(ies) that Osgood's Accountant would have prepared to bring the inventory and cost of goods sold up-to-date for 2010.

Solution 8-125

Cost of goods sold (Note 1) 1,298,000
    Beginning inventory (Note 2) 98,000
    Purchases (Note 3) 1,200,000

Note 1: To record cost of goods sold (this is a residual amount, i.e. to balance the entry)
Note 2: To clear beginning inventory
Note 3: To clear purchases account
Also note that, after the December transactions, the company will have a year-end inventory balance of zero.

Pr.8-126—Gross profit method.

On December 31, 2010 McKenzie Company's inventory burned. Sales and purchases for the year had been $2.1 million and $1.2 million, respectively. The beginning inventory (Jan. 1, 2010) was $220,000; in the past McKenzie's gross profit has averaged 35% of selling price.

Instructions
Calculate the estimated cost of inventory burned, and give entries as of December 31, 2010 to close merchandise accounts.

Solution 8-126

Beginning inventory		$ 220,000
Add: Purchases		1,200,000
Cost of goods available		1,420,000
Sales	$2,100,000	
Less 35%	(735,000)	1,365,000
Estimated inventory lost		$ 55,000

Sales	2,100,000	
Income Summary		2,100,000
Cost of Goods Sold	1,365,000	
Fire Loss	55,000	
Beginning Inventory		220,000
Purchases		1,200,000

Pr. 8-127—Retail inventory method.

When you undertook the preparation of the financial statements for Becker Company at January 31, 2011, the following data were available:

	At Cost	At Retail
Inventory, February 1, 2010	$83,400	$ 103,400
Markdowns		47,000
Mark-ups		71,000
Markdown cancellations		22,000
Mark-up cancellations		9,000
Purchases	241,200	294,300
Sales		329,000
Purchases returns and allowances	5,150	6,700
Sales returns and allowances		9,000

Instructions
Calculate the ending inventory at cost as of January 31, 2011, using the retail method that approximates lower of average cost and market. Your solution should be in good form with amounts clearly labelled. Carry the cost ratio to two decimals.

Solution 8-127

	At Cost		At Retail	
Beginning inventory, 2/1/10		$ 83,400		$ 103,400
Purchases	$241,200		$294,300	
Less purchase returns	5,150	236,050	6,700	287,600
Totals		$319,450		391,000
Add mark-ups (net)				62,000
Totals				453,000
Deduct markdowns (net)				25,000
Sales price of goods available				428,000
Sales less sales returns				320,000
Ending inventory, 1/31/11 at retail				$ 108,000
Ending inventory at cost: Ratio of cost to retail =				
$319,450 / $453,000 = 70.52%				
$108,000 x 70.52% = $76,162		$ 76,162		

Pr. 8-128—Retail inventory method.

The records of Lin Stores included the following data:

Inventory, May 1, at retail, $14,500; at cost, $10,150
Purchases during May, at retail, $42,900; at cost, $31,550
Freight-in, $2,000; purchase discounts, $500
Additional mark-ups, $3,800; mark-up cancellations, $400; net markdowns, $1,300
Sales during May, $46,700

Instructions

Calculate the estimated inventory at May 31 under the conventional retail inventory method. (Carry the cost ratio to three decimal places.) Show your calculations in good form and label all amounts.

Solution 8-128

	Cost	Retail	Ratio
Inventory, May 1	$10,150	$14,500	
Purchases	31,550	42,900	
Freight-in	2,000		
Purchase discounts	(500)		
Net mark-ups	0	3,400	
	$43,200	60,800	.711
Net markdowns		(1,300)	
Goods available		59,500	
Sales		(46,700)	
Inventory, May 31		$12,800	
Estimated inventory, May 31 ($12,800 × .711)	$ 9,101		

Pr. 8-129—Conventional retail inventory method.

Nomad General Store uses the conventional retail inventory method. Information relating to the calculation of the inventory at December 31, 2010, follows:

	Cost	Retail
Inventory, January 1, 2010	$140,000	$220,000
Purchases	480,000	720,000
Freight-in	80,000	
Sales		750,000
Net mark-ups		160,000
Net markdowns		60,000

Instructions

Calculate the inventory at December 31, 2010, using the conventional retail inventory method. (Use two decimal places.)

Solution 8-129

Nomad General Store
December 31, 2010

	At Cost	At Retail	Ratio
Inventory, January 1, 2010	$140,000	$ 220,000	
Purchases	480,000	720,000	
Freight-in	80,000		
Net mark-ups	0	160,000	
	700,000	1,100,000	64%
Net markdowns		(60,000)	
Totals	$700,000	1,040,000	
Less sales		750,000	
Inventory, Dec. 31, 2010, at retail		$ 290,000	

Estimated inventory, Dec. 31 ($290,000 × .64) $185,600

Pr. 8-130 – Inventory errors

An audit of the inventory records of Mulder Inc. identified a number of errors. These errors are summarized in Exhibit A below:

EXHIBIT A

Year	Net Income Reported	Description of Error	
2006	$120,000	Overstatement of ending inventory	$11,000
2007	$95,000	Understatement of ending inventory	$1,500
2008	$99,000	Understatement of ending inventory	$18,000
2009	$105,000	Overstatement of ending inventory	$20,000
2010	$120,000	Overstatement of ending inventory	$5,200

Instructions

(a)

As financial accountant for Mulder, you have been asked to calculate the corrected net income amounts for each of the five years based on the audit findings.

(b)

Review your solution to part (a) and consider the self correcting effect of inventory errors. Why does total reported net income not equal total corrected income?

Solution 8-130

Part (a)

Year	Net Income As Reported	ADD: Beginning Inventory Over Statement	DEDUCT: Beginning Inventory Under Statement	DEDUCT: Ending Inventory Over Statement	ADD: Ending Inventory Under Statement	Net Income Corrected
2006	$120,000			($11,000)		$109,000
2007	$95,000	$11,000			$1,500	$107,500
2008	$99,000		($1,500)		$18,000	$115,500
2009	$105,000		($18,000)	($20,000)		$67,000
2010	$120,000	$20,000		($5,200)		$134,800
	$539,000					$533,800

Solution 8-130 (Continued)

Part (b)

While it is true that inventory errors are self correcting, the (self) correction occurs in the accounting period *following* the error. For Mulder, the over-statement of the 2010 ending inventory reduces corrected 2010 income by $5,200. If that amount were to be added back to total corrected net income, it would be equal to reported net income:

Total corrected net income:	$533,800		
Add:			
Self correction to take effect in 2011:	5,200		
Total	$539,000	=	equal to reported net income

LEGAL NOTICE

CHAPTER 9

INVESTMENTS

MULTIPLE CHOICE—Conceptual

Answer	No.	Description
c	1.	Debt securities.
d	2.	Application of the cost model
b	3.	Transaction costs under PE GAAP
a	4.	Holding gains under cost model
c	5.	Present value of a note.
c	6.	Implicit interest rates.
c	7.	Premiums/discounts on notes receivable.
a	8.	Holding gains under FV-NI model
d	9.	Holding gains under FV (OCI) model
a	10.	Classification as long term under FV (OCI) model
c	11.	Use of the cost method
b	12.	Impairment – incurred loss model
a	13.	Impairment – expected cash flow model
d	14.	Definition of comprehensive income.
c	15.	Classification of comprehensive income.
b	16.	Debt instruments
a	17.	Valuation of debt instruments
a	18.	Classification of investments
c	19.	Equity investments and the cost model
c	20.	Test of marketability.
d	21.	Nature of equity securities.
b	22.	Definition of readily marketable.
d	23.	Features of the FV-NI model
d	24.	Calculating the issue price of bonds.
d	25.	Components of comprehensive income
a	26.	Recording amortization of bond discount.
b	27.	Components of other comprehensive income
b	28.	Components of accumulated other comprehensive income
a	29.	The concept of “recycling”
c	30.	Indications for potential impairments
a	31.	Equity investments and significant influence
c	32.	Sale of bond investment prior to maturity.
b	33.	Conditions for using the equity method.
b	34.	Significant influence
a	35.	Classification as current
a	36.	Recording of dividends received under the equity method.
d	37.	Recognition of earnings of investee using the equity method.
d	38.	Effect of using the cost method in error.
d	39.	Actively traded shares
d	40.	Classification as current

MULTIPLE CHOICE—Conceptual (Continued)

Answer	No.	Description
d	41.	Disclosure requirements
b	42.	Disclosure requirements.
b	43.	Disclosures under IFRS and PE GAAP
a	44.	Reporting requirements for subsidiaries
a	45.	Transaction costs under IFRS and PE GAAP
d	46.	Treatment of interest and dividend income under IFRS and PE GAAP
a	47.	Implications of the concept of control
d	48.	Investing in subsidiaries
d	49.	Acquisition of controlling stake
b.	50.	Consolidation
d.	51.	Definition of financial assets
b	52.	Amortization of premium or discount
b	53.	Presence of control

MULTIPLE CHOICE—Computational

Answer	No.	Description
d	54.	Temporary investments in equity securities.
b	55.	Acquisition of long-term investment in bonds.
a	56.	Recording the purchase of bonds.
c	57.	Carrying value of long-term investment in bonds – cost model
d	58.	Carrying value of long-term investment in bonds – cost model
b	59.	Calculation of income from long-term investment in bonds.
a	60.	Calculation of income from long-term investment in bonds.
c	61.	Determine gain on sale of bond investment.
a	62.	Year end adjustments for FV-NI investment
d	63.	Accounting for share investments/equity method.
a	64.	Accounting for share investments/equity method.
c	65.	Accounting for share investments/equity method.
a	66.	Equity method of accounting.
d	67.	Cost model of accounting for share investment.
b	68.	Equity method of accounting for share investment.
a	69.	Balance of investment account using the equity method.
c	70.	Investment income recognized under the equity method.
a	71.	Balance of investment account using the equity method.
d	72.	Balance of investment account using the equity method.
c	73.	Investment income recognized under the equity method.
d	74.	Calculation of implicit interest rate.
c	75.	Calculation of interest for a note.
a	76.	Calculation of the present value of a note.
b	77.	Accounting for fair value adjustments.

*This topic is dealt with in an Appendix to the chapter.

MULTIPLE CHOICE—CPA Adapted

Answer	No.	Description
a	78.	Valuation of marketable equity securities.
a	79.	Valuation of marketable equity securities.
c	80.	Classification of an equity security.
c	81.	Transfer of securities from current to noncurrent.
b	82.	Carrying value of long-term investment in bonds.
b	83.	Investment income recognized under the equity method.
a	84.	Balance of investment account using the equity method.
d	85.	Sale of share investment.
b	86.	Calculate the acquisition price of a share investment.

EXERCISES

Item	Description
E9-87	Investments in debt securities (essay).
E9-88	True-False.
E9-89	Investment in debt securities at premium.
E9-90	Investment in bonds - amortized cost model.
E9-91	Investment in shares – equity method
E9-92	Cost and equity methods (essay).
E9-93	Cost and equity methods.
E9-94	Significant influence.
E9-95	Sale of equity investments – FV (OCI)

PROBLEMS

Item	Description
P9-96	Temporary investments FV (OCI)
P9-97	Note Receivable – amortized cost model
P9-98	Premium amortization schedule.
P9-99	Year-end adjustments for temporary investment
P9-100	Debt investment FV-NI
P9-101	Accounting for bonds – amortized cost model
P9-102	Temporary Investments
P9-103	Equity method
P9-104	Longterm investment – FV-NI
P9-105	Equity method - IFRS

MULTIPLE CHOICE—Conceptual

1. Which of the following is *not* a debt security?
   a. Convertible bonds
   b. Commercial paper
   c. Loans receivable
   d. All of these are debt securities.

2. When the cost model is applied to an investment in debt securities, such as bonds, it is referred to as
   a. the equity method.
   b. the fair value to net income model.
   c. the fair value to other comprehensive income model.
   d the amortized cost model.

3. Under PE GAAP, transaction costs are
   a. always expensed.
   b. capitalized when the investments are accounted for under the cost/amortized cost model.
   c. expensed when the investments are accounted for under the fair value through income model.
   d. None of these.

4. Under the cost/amortized cost model, holding gains are
   a. recognized in net income only when realized
   b. recognized in other comprehensive income
   c. recognized depending on management's intention
   d. None of these

5. The present value of a note will equal its face value when
   a. the face rate and the stated interest rate are the same.
   b. risk is low.
   c. the effective and stated interest rates are the same.
   d. the effective and the market interest rates are the same.

6. If a zero interest bearing note is received in exchange for cash, the implicit interest rate is
   a. calculated as the present value of the face rate.
   b. agreed between the two parties to the transaction.
   c. the rate that equates cash paid with the amounts receivable in the future.
   d. not determinable.

7. The difference between the face value and the present value of a note receivable, where the face value is higher at the time the note is issued, is recorded by the issuer as
   a. a debit to Premium on Note Receivable.
   b. a credit to Premium on Note Receivable.
   c. a credit to Discount on Note Receivable.
   d. a debit to Discount on Note Receivable.

8. Under the fair value through net income model, holding gains are

a. generally recognized in net income
b. recognized in other comprehensive income
c. recognized depending on management's intention
d. (a) and (c)

9. Under the fair value through other comprehensive income model, holding gains and losses
   a. are recognized in other comprehensive income
   b. are accumulated in other comprehensive income
   c. are recognized in net income
   d. (a) and (b)

10. Under the fair value through other comprehensive income model, investments are reported as long term assets
    a. Depending on marketability and management intent
    b. Depending on the value and risk of the investment
    c. Depending on the balance in the accumulated comprehensive income account
    d. None of these

11. A company that uses the cost method for an investment in a public company's actively traded shares
    a. Does not follow PE GAAP
    b. Does not follow international GAAP
    c. (a) and (b)
    d. None of these

12. The application of the incurred loss model in accounting for impairments
    a. Uses the historical rate of interest in the discounting process
    b. Uses the current market rate of interest in the discounting process
    c. Uses the investors internal rate of return in the discounting process
    d. None of these

13. The application of the expected cash flow model in accounting for impairments
    a. Generally uses the historical interest rate in the discounting process.
    b. Uses the historical rate of interest in the discounting process
    c. Uses the investors internal rate of return in the discounting process
    d. None of these

14. Comprehensive income is
    a. the change in net income for the complete entity.
    b. revenue and expense items that accounting standards exclude from net income.
    c. all past changes and credits excluded from net income.
    d. the change in equity during the period from transactions and events from non-owner sources.

15. Comprehensive income is included as part of
    a. retained earnings.
    b. net income.
    c. shareholders' equity.
    d. unearned revenue.

16. An investment in an entity's debt instruments makes that investor a(n)
    a. owner of the issuing entity
    b. creditor of the issuing entity
    c. parent company
    d. None of these

17. The price of a debt instrument is quoted as a percentage of
    a. its face value
    b. its fair market value
    c. its book value
    d. None of these

18. An investment that is intended to be held for three years should generally be classified as a(n)
    a. Long term asset
    b. Equity investment
    c. Temporary investment
    d. None of these

19. Equity investments that are accounted for under the cost model will result in
    a. the recognition of a gain or loss in net income at disposal
    b. the recognition of a gain or loss in other comprehensive income
    c. all of these
    d. the recognition of dividend income when the dividends are declared

20. The test of marketability must be met before securities owned can be properly classified as
    a. intangible assets.
    b. long-term investments.
    c. current assets.
    d. none of these.

21. Which of the following is an "equity security"?
    a. Treasury shares
    b. Term preferred shares
    c. Convertible bonds
    d. Warrants

22. When an investment is readily marketable, it means
    a. management intends to convert it to cash within a year or operating cycle, whichever is longer.
    b. it can be sold easily with minimum cost.
    c. it is an investment in shares rather than a debt security.
    d. it is a current asset.

23. The fair value through net income model requires that
    a. investments are measured at fair value
    b. transaction costs are expensed as incurred.
    c. transaction costs are generally capitalized
    d. (a) and (b)

24. Pippen Co. purchased ten-year, 10% bonds that pay interest semi-annually. The bonds are sold to yield 8%. One step in calculating the issue price of the bonds is to multiply the principal by the table value for
    a. 10 periods and 10% from the present value of 1 table.
    b. 10 periods and 8% from the present value of 1 table.
    c. 20 periods and 5% from the present value of 1 table.
    d. 20 periods and 4% from the present value of 1 table.

25. Comprehensive income includes
    a. Changes in equity related to non-owner sourced transactions.
    b. Changes in equity related to funds received from owners or shareholders.
    c. Other comprehensive income
    d. All of these

26. A bond is purchased at a discount and will be accounted for under the amortized cost model. The entry to record the amortization of the discount includes a
    a. debit to the investment account.
    b. debit to the discount account.
    c. debit to Interest Revenue.
    d. none of these.

27. Other comprehensive income does *not* include
    a. Comprehensive income
    b. net income
    c. Holding gains resulting from the application of the fair value through other comprehensive income model.
    d. (b) and (c)

28. Accumulated other comprehensive income includes
    a. the balance of all previous debits to other comprehensive income.
    b. the balance of all previous debits *and* credits to other comprehensive income.
    c. current year's net income
    d. (a) and (b)

29. The concept of recycling within the context of investments
    a. refers to the transfer of previously unrealized gains or losses to net income.
    b. refers to the switch of income between different investments categories.
    c. can be used in the fair value through other comprehensive income model.
    d. should *not* be used in the fair value through other comprehensive income model.

30. Which of the following situations might indicate the potential impairment of the underlying securities?
    a. The issuing entity is experiencing major financial difficulties
    b. The issuing entity is unable to pay its liabilities
    c. All of these
    d. The issuing entity is undergoing a major reorganization

31. The accounting for investments in another entity's equity instruments depends mainly on
    a. The level of influence the investor is *able* to exert
    b. The level of influence the investor *actually* exerts
    c. The quality of earnings of the investee
    d. Whether the investee pays dividends

32. Which of the following is *not* generally correct about recording a sale of a debt security before the maturity date?
    a. Accrued interest will be received by the seller even though it is not an interest payment date.
    b. An entry must be made to amortize a discount to the date of sale.
    c. The entry to amortize a premium to the date of sale includes a credit to Premium on Investments in Debt Securities.
    d. A gain or loss on the sale is not extraordinary.

33. When a public company holds between 20% and 50% of the outstanding common shares of an investee, which of the following statements applies?
    a. The investor should always use the equity method to account for its investment.
    b. The investor should use the equity method to account for its investment unless circumstances indicate that it is unable to exercise "significant influence" over the investee.
    c. The investor must use the cost method unless it can clearly demonstrate the ability to exercise "significant influence" over the investee.
    d. The investor should always use the cost method to account for its investment.

34. An investor who owns 15% of an entity's voting shares can
    a. Always be assumed to have little or no influence over the investee
    b. Potentially have influence over the investee if the shares are widely held
    c. Be assumed to account for the investment under the cost model.
    d. (a) and (c)

35. Investments should be reported as current if
    a. they mature within 12 months of the balance sheet date
    b. the investor is expected to exert significant influence over the investee in the current reporting period.
    c. the investment is expected to result in a current period loss
    d. none of these

36. Bitter Corporation accounts for its investment in the common shares of Young Company under the equity method. Bitter Corporation should ordinarily record a cash dividend received from Young as
   a. a reduction of the carrying value of the investment.
   b. additional paid-in capital.
   c. an addition to the carrying value of the investment.
   d. dividend income.

37. Under the equity method of accounting for investments, an investor recognizes its share of the earnings in the period in which the
   a. investor sells the investment.
   b. investee declares a dividend.
   c. investee pays a dividend.
   d. earnings are reported by the investee in its financial statements.

38. Dorr, Inc., owns 35% of Moik Corporation. During the calendar year 2011, Moik had net earnings of $300,000 and paid dividends of $30,000. Dorr mistakenly recorded these transactions using the cost method rather than the equity method of accounting. What effect would this have on the investment account, net income, and retained earnings, respectively?
   a. Understate, overstate, overstate
   b. Overstate, understate, understate
   c. Overstate, overstate, overstate
   d. Understate, understate, understate

39. Investments in companies with shares that are traded in an active market
   a. cannot be accounted for under the cost model
   b. can be accounted for under the fair value through net income model
   c. should generally be accounted for under the fair value through other comprehensive income model.
   d. (a) and (b)

40. Which of the following is *not* a condition for investments to be classified as current?
   a. It must be held primarily for trading purposes.
   b. It must be a cash equivalent.
   c. It must be expected to be sold or realized within 12 months from the balance sheet date.
   d. It must be accounted for under the cost model.

41. Which of the following best describes the disclosure requirements for investments? The disclosure must include
   a. Information about the investment's significance to the investor's financial position and performance.
   b. Information about the risks that the investor faces as a result of the investments
   c. Information about how these risks are managed.
   d. All of these

42. The disclosure requirements for private entities are usually less extensive as compared to those for public entities because
    a. investors in private entities are expected to have *less* information about the company.
    b. investors in private entities are expected to have *more* information about the company.
    c. investors in private entities tend to be *more* sophisticated.
    d. investors in private entities tend to be *less* sophisticated.

43. Which of the following is a reason for the differences in the disclosure requirements for investments in associates under IFRS and PE GAAP?
    a. Because PE GAAP requires that the associate must be a private entity
    b. Because PE GAAP allows the use of methods other than the equity method
    c. Because PE GAAP does not include an "associates" category
    d. None of these

44. The standards as they relate to the accounting for investments, differ under PE GAAP and IFRS. Which of the following best describes the differences relative to the reporting for investments in subsidiaries?
    a. IFRS requires consolidation whereas PE GAAP offers a choice of methods
    b. PE GAAP requires consolidation whereas IFRS offers a choice of methods
    c. Consolidation is specifically excluded as one of the choices under PE GAAP
    d. Consolidation is specifically excluded as one of the choices under IFRS

45. The standards as they relate to the accounting for investments, differ under PE GAAP and IFRS. Which of the following statement(s) best describe(s) the treatment of transaction costs?
    a. IFRS requires that transaction costs are capitalized except for those investments that are accounted under the fair value to net income model.
    b. PE GAAP requires that transaction costs are capitalized except for those investments that are accounted under the fair value to net income model.
    c. PE GAAP requires that transaction costs are expenses whenever cost-based measures are used.
    d. (a) and (c)

46. The standards as they relate to the accounting for investments, differ under PE GAAP and IFRS. Which of the following statement(s)best describe(s) the treatment of interest and dividend income?
    a. IFRS requires the use of the effective interest method when interest income is to be reported separately.
    b. IFRS requires certain dividends to be recognized in other comprehensive income
    c. PE GAAP allows the use of either the straight-line or effective interest method when applicable.
    d. All of these

47. When one corporation has control over another corporation, the investor corporation
    a. Is referred to as the parent
    b. Is referred to as the subsidiary
    c. Must have acquired at least 10% of the other company's voting shares
    d. (a) and (c)

48. An investor who has subsidiaries
    a. Is required to prepare consolidated financial statements under IFRS
    b. Has the option to prepare consolidated financial statements under PE GAAP
    c. None of these
    d. (a) and (b)

49. If the parent company owns 90% of the subsidiary company's outstanding shares, the company should generally account for the subsidiary's income under the
    a. Cost/amortized cost model
    b. Fair value to net income model
    c. The equity method
    d. The consolidation method

50. When the investor has control over the investee, this method is known as the:
    a. Cost method
    b. Consolidation method
    c. Market value method
    d. Equity method

51. Which of the following does *not* describe a financial asset?
    a. Cash
    b. A contractual right to receive cash
    c. An equity instrument of another entity
    d. None of these

52. The premium or discount on bonds accounted for under the cost/amortized cost model is
    a. Amortized over the expected holding period
    b. Amortized over the life of the bond
    c. Not amortized
    d. Is treated as a transaction cost

53. An investor who owns 11% of an entity's voting shares
    a. May have significant influence over the investee if the shares are *closely* held
    b. May have significant influence over the investee if the shares are widely held
    c. None of these
    d. Would likely choose the consolidation method

Multiple Choice Answers—Conceptual

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.
1.	c	12	b	23	d	34	b	45	a
2.	d	13	a	24	d	35	a	46	d
3.	b	14	d	25	d	36	a	47	a
4.	a	15	c	26	a	37	d	48	d
5.	c	16	b	27	b	38	d	49	d
6.	c	17	a	28	b	39	d	50	b
7.	c	18	a	29	a	40	d	51	d
8.	a	19	c	30	c	41	d	52	b
9.	d	20	c	31	a	42	b	53	b
10	a	21	d	32	c	43	b		
11	c	22	b	33	b	44	a		

Solutions to those Multiple Choice questions for which the answer is “none of these.”

51. Many different answers.

MULTIPLE CHOICE—Computational

54. On its December 31, 2011, balance sheet, Merck Co. reported its temporary investment in equity securities, under the fair value through net income model at $330,000. At December 31, 2012, the fair value of the securities was $350,000. What should Merck report on its 2012 income statement as a result of the increase in fair value of the investments in 2012?
    a. $0
    b. Loss on investments of $10,000
    c. Unrealized gain of $20,000
    d. Investment income of $20,000

55. On August 1, 2011, Cassidy Company acquired $60,000 face value 10% bonds of Hurley Corporation at 104 plus accrued interest. The bonds were dated May 1, 2011, and mature on April 30, 2016, with interest payable each October 31 and April 30. The bonds will be held to maturity. Assuming the cost model is used, what entry should Cassidy make to record the purchase of the bonds on August 1, 2011?

a.	Investment in Bonds	63,900	
	Cash		63,900
b.	Investment in Bonds	62,400	
	Interest Revenue	1,500	
	Cash		63,900
c.	Investment in Bonds	63,900	
	Interest Revenue		1,500
	Cash		62,400
d.	Investment in Bonds	60,000	
	Premium on Bonds	3,900	
	Cash		63,900

56. On August 1, 2011, Varney Co. acquired 40, $1,000, 9% bonds at 97 plus accrued interest. The bonds were dated May 1, 2011, and mature on April 30, 2017, with interest paid each October 31 and April 30. The bonds will be held to maturity. Under the cost model, the preferred entry to record the purchase of the bonds on August 1, 2011 is

a.	Investment in Bonds	38,800	
	Interest Revenue	900	
	Cash		39,700
b.	Investment in Bonds	39,700	
	Cash		39,700
c.	Investment in Bonds	38,800	
	Interest Receivable	900	
	Cash		39,700
d.	Investment in Bonds	40,000	
	Interest Revenue	900	
	Discount on Debt Securities		1,200
	Cash		39,700

57. On October 1, 2011, Neman Co. purchased to hold to maturity, 800, $1,000, 9% bonds for $792,000 which includes $12,000 accrued interest. The bonds, which mature on February 1, 2020, pay interest semiannually on February 1 and August 1. Neman uses the straight-line method of amortization. The bonds, which are accounted for under the cost model, should be reported in the December 31, 2011 balance sheet at a carrying value of
    a. $792,240.
    b. $780,000.
    c. $780,600.
    d. $792,000.

58. On November 1, 2011, Roper Company purchased 600 of the $1,000 face value, 9% bonds of Poon, Limited, for $632,000, which includes accrued interest of $9,000. The bonds, which mature on January 1, 2016, pay interest semiannually on March 1 and September 1. Assuming that Roper uses the straight-line method of amortization and that the bonds are accounted for under the cost method, the net carrying value of the bonds should be shown on Roper 's December 31, 2011, balance sheet at
    a. $632,000.
    b. $600,000.
    c. $623,000.
    d. $622,080.

59. On November 1, 2011, Isaak Co. purchased Lure, Ltd., 10-year, 9%, bonds with a face value of $90,000, for $81,000. An additional $2,700 was paid for the accrued interest. Interest is payable semiannually on January 1 and July 1. The bonds mature on July 1, 2018. Isaak uses the straight-line method of amortization. Ignoring income taxes, the amount reported in Isaak's 2011 income statement as a result of Isaak's investment in Lure was
    a. $1,200.
    b. $1,575.
    c. $1,500.
    d. $1,350.

60. On October 1, 2011, Ofram Co. purchased with the intent to hold to maturity, 500, $1,000, 9% bonds for $520,000. An additional $15,000 was paid for accrued interest. Interest is paid semiannually on December 1 and June 1 and the bonds mature on December 1, 2015. Ofram uses the cost model and straight-line amortization. Ignoring income taxes, the amount reported in Ofram's 2011 income statement from this investment should be
    a. $10,050.
    b. $11,250.
    c. $12,450.
    d. $13,650.

61. During 2009, Hauser Co. purchased 1,000, $1,000, 9% bonds. The carrying value of the bonds at December 31, 2011 was $980,000. The bonds mature on March 1, 2016, and pay interest on March 1 and September 1. Hauser sells 500 bonds on September 1, 2012, for $494,000, after the interest has been received. Hauser uses straight-line amortization and has accounted for the bonds under the cost model. The gain on the sale is
   a. $0.
   b. $5,600.
   c. $2,400.
   d. $4,000.

62. Russin, Inc. owns bonds that are accounted for under the fair value to net income model. The bonds have a carrying value of $124,365 on December 31, 2011. The fair value at that date is $123,000. The entry to record the year-end adjustment is

a. Loss on Investments	1,365	
Investments		1,365
b. no adjustment required.		
c. Unrealized Holding Loss on (OCI)	1,365	
Investments		1,365
d. Investments	1,365	
Unrealized Holding Gain on Available-for-Sale Investments (OCI)		1,365

Use the following information for questions 63 through 66.

The summarized balance sheets of Nolte Company and Boswell Company as of December 31, 2011 are as follows:

Nolte Company
Balance Sheet
December 31, 2011

Assets	$400,000
Liabilities	$ 50,000
Common shares	200,000
Retained earnings	150,000
Total equities	$400,000

Boswell Company
Balance Sheet
December 31, 2011

Assets	$300,000
Liabilities	$ 75,000
Common shares	185,000
Retained earnings	40,000
Total equities	$300,000

63. If Nolte Company acquired a 20% interest in Boswell Company on December 31, 2011 for $65,000 and the equity method of accounting for the investment was used, the amount of the debit to Investment in Boswell Company would have been
    a. $45,000.
    b. $37,000.
    c. $60,000.
    d. $65,000.

64. If Nolte Company acquired a 30% interest in Boswell Company on December 31, 2011 for $75,000 and the equity method of accounting for the investment were used, the amount of the debit to Investment in Boswell Company Stock would have been
    a. $75,000.
    b. $90,000.
    c. $60,000.
    d. $67,500.

65. If Nolte Company acquired a 20% interest in Boswell Company on December 31, 2011 for $45,000 and during 2012 Boswell Company had net income of $25,000 and paid a cash dividend of $10,000, applying the equity method would give a debit balance in the Investment in Boswell Company account at the end of 2012 of
    a. $37,000.
    b. $45,000.
    c. $48,000.
    d. $50,000.

66. If Nolte Company acquired a 30% interest in Boswell Company on December 31, 2011 for $67,500 and during 2012 Boswell Company had net income of $25,000 and paid a cash dividend of $10,000, applying the equity method would give a debit balance in the Investment in Boswell Company account at the end of 2012 of
    a. $72,000.
    b. $67,500.
    c. $75,000.
    d. $72,500.

Use the following information for questions 67 and 68.

Fossil Company purchased 200 of the 1,000 outstanding shares of Ericksen Company's common shares for $60,000 on January 2, 2011. During 2011, Ericksen Company declared dividends of $10,000 and reported earnings for the year of $40,000.

67. If Fossil Company uses the cost model of accounting for its investment in Ericksen Company, its Investment in Ericksen Company account on December 31, 2011 should be
    a. $58,000.
    b. $66,000.
    c. $68,000.
    d. $60,000.

68. If Fossil Company uses the equity method of accounting for its investment in Ericksen Company, its Investment in Ericksen Company account at December 31, 2011 should be
  a. $58,000.
  b. $66,000.
  c. $60,000.
  d. $68,000.

Use the following information for questions 69 and 70.

Caraway Corporation earns $120,000 and pays cash dividends of $40,000 during 2011. Macoon Corporation owns 3,000 of the 10,000 outstanding shares of Caraway and exercises significant influence.

69. What amount should Macoon show in the investment account at December 31, 2011 if the beginning of the year balance in the account was $160,000?
  a. $184,000.
  b. $196,000.
  c. $160,000.
  d. $240,000.

70. How much investment income should Macoon report in 2011?
  a. $40,000.
  b. $24,000.
  c. $36,000.
  d. $120,000.

71. Dielman Co. acquired a 60% interest in Simpson Corp. on December 31, 2011 for $315,000. During 2012, Simpson had net income of $200,000 and paid cash dividends of $50,000. Assuming Dielman used the equity method, at December 31, 2012, the balance in the investment account should be
  a. $405,000.
  b. $315,000.
  c. $435,000.
  d. $465,000.

Use the following information for questions 72 and 73.

Rodman Co. owns 3,000 of the 10,000 outstanding common shares of Gavin Corp. and exercises significant influence. During 2011, Gavin earns $60,000 and pays cash dividends of $20,000.

72. If the beginning balance in the investment account was $90,000, the balance at December 31, 2011 should be
  a. $90,000.
  b. $108,000.
  c. $120,000.
  d. $102,000.

73. Rodman should report investment revenue for 2011 of
    a. $6,000.
    b. $12,000.
    c. $18,000.
    d. $15,000.

74. Larsen Corp. issued a note with a face value of $10,000 and a zero interest rate with a two-year term, in return for $8,573. Determine the implicit interest rate for the note.
    a. 6%
    b. 7%
    c. 9%
    d. 8%

75. For a note receivable with a face rate of zero, an implicit rate of 8%, a term of 3 years, a present value of $14,000 and a face value of $17,636, the interest to record at the end of the first year is equal to
    a. $112.
    b. zero.
    c. $1,120.
    d. $1,411.

76. Arkade Corp issued a note with a face value of $20,000 and a 3-year term. The note pays interest based on a stated rate of 5% annually, when the market rate of interest is 10%. The present value of the note is
    a. $15,026.
    b. $20,000.
    c. $22,723.
    d. $18,000.

77. At December 31, 2011, Sedge Inc. has the following portfolio of common shares in which it does not have significant influence:

	Cost	Fair Value
Barrick Corp.	$100,000	$120,000
Chester Inc.	200,000	205,000
Dooley Ltd.	300,000	500,000
	$600,000	$825,000

Assuming Sedge uses the fair value through other comprehensive income model to account for this portfolio of investments, the entry to record the year-end adjustment is

a.	Investments	225,000	
	Holding Gain on Investment portfolio		225,000
b.	Investment in Barrick Corp	20,000	
	Investments in Chester Inc.	5,000	
	Investments in Dooley Ltd	200,000	
	Holding gain on Barrick Corp (OCI)		20,000
	Holding gain on Chester Inc (OCI)		5,000
	Holding gain on Dooley Ltd (OCI)		200,000
c.	Investment in Barrick Corp	20,000	
	Investments in Chester Inc.	5,000	
	Investments in Dooley Ltd	200,000	
	Holding gain on Barrick Corp		20,000
	Holding gain on Chester Inc		5,000
	Holding gain on Dooley Ltd		200,000
d.	Investments	225,000	
	Holding Gain on Investment portfolio (OCI)		225,000

Multiple Choice Answers—Computational

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.
54.	d	58.	d	62.	a	66.	a	70.	c	74.	d
55.	b	59.	b	63.	d	67.	d	71.	a	75.	c
56.	a	60.	a	64.	a	68.	b	72.	d	76.	a
57.	c	61.	c	65.	c	69.	a	73.	c	77.	b

MULTIPLE CHOICE—CPA Adapted

78. Kuhn Corp. began operations in 2011. An analysis of Kuhn's equity securities portfolio acquired in 2011 shows the following totals at December 31, 2011. Kuhn accounts for these investments under the fair value through net income model

Aggregate cost	$114,000
Aggregate market value	96,000

What amount should Kuhn report in its 2011 income statement for loss on investment?
a. $18,000.
b. $15,000.
c. $8,000.
d. $10,000.

79. At December 31, 2011, Escot Corp. has the following equity securities (no significant influence) that were purchased earlier this year, its first year of operation:

		Cost	Market
Security	A	$80,000	$ 83,000
	B	112,000	124,000
Totals		$192,000	$ 207,000

If the investments are correctly accounted for under the fair value through net income model the aggregate book value of the investment accounts should
a. Be increased by $15,000
b. Be decreased by $15,000
c. Be decreased by $32,000
d. Remain unchanged

80. In January 2011, Colt Co. had purchased an investment for $100,000. By December 31 2011 the market value of that investment had increased by $10,000. Assuming this gain was NOT included in the company's 2011 net income, which accounting model did Colt use to account for this investment?
a. The cost model
b. The fair value through net income model
c. The fair value through OCI model
d. None of these

81. Gerard Corporation had purchased an investment in 2011 (an equity investment without significant control). The purchase price of $94,000 included transaction costs of $1,000. Assuming the transaction costs were capitalized and Gerard uses the appropriate IFRS method, which model did Gerard NOT use to account for this investment?
a. The amortized cost model
b. The fair value through OCI model
c. The fair value through net income model
d. None of these

82. On October 1, 2011, Moreau Co. purchased 500 of the $1,000 face value, eight percent bonds of Lear, Ltd., for $585,000, including accrued interest of $10,000. The bonds, which mature on January 1, 2018, pay interest semiannually on January 1 and July 1. Moreau used the straight-line method of amortization and appropriately recorded the bonds as long-term. On Moreau's December 31, 2012 balance sheet, the carrying value of the bonds is
a. $575,000.
b. $560,000.
c. $568,000.
d. $570,000.

Use the following information for questions 83 through 85.

Altadore Ltd. acquired 30% of Dorset Corp.'s common shares on January 1, 2011 for $240,000. During 2011, Dorset earned $100,000 and paid dividends of $60,000. Altadore's 30% interest in Dorset gives Altadore the ability to exercise significant influence over Dorset 's operating and financial policies. During 2012, Dorset earned $120,000 and paid dividends of $40,000 on April 1 and $40,000 on October 1. On July 1, 2012, Altadore sold half of its shares in Dorset for $158,000 cash.

83. Before income taxes, what amount should Altadore include in its 2011 income statement as a result of the investment?
a. $100,000.
b. $30,000.
c. $60,000.
d. $18,000.

84. The carrying amount of this investment in Altadore's December 31, 2011 balance sheet should be
a. $252,000.
b. $240,000.
c. $270,000.
d. $275,000.

85. What should be the gain on sale of this investment in Altadore's 2012 income statement?
a. $38,000.
b. $35,000.
c. $23,000.
d. $29,000.

86. On January 1, 2011, Argon Co. purchased 25% of Peroga Corp.'s common shares; no goodwill resulted from the purchase. Argon appropriately carries this investment at equity and the balance in Argon's investment account was $360,000 at December 31, 2011. Peroga reported net income of $225,000 for the year ended December 31, 2011, and paid dividends totaling $90,000 during 2011. How much did Argon pay for its 25% interest in Peroga?
a. $382,500.
b. $326,250.
c. $393,750.
d. $438,750.

Multiple Choice Answers—CPA Adapted

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.
78.	a	80.	c	82.	b	84.	a	86.	b
79.	a	81.	c	83.	b	85.	d		

DERIVATIONS — Computational

No.	Answer	Derivation
54.	d	2012: $350,000 - $330,000 = $20,000 recognized as investment income.
55.	b	Dr. Investment in Bonds: $60,000 × 1.04 = $62,400 Dr. Interest Revenue: $60,000 × .05 × 3/6 = $1,500 Cr. Cash: $62,400 + $1,500 = $63,900.
56.	a	Dr. Investment in Bonds: 40 × $1,000 × .97 = $38,800 Dr. Interest Revenue: $40,000 × .045 × 3/6 = $900 Cr. Cash: $38,800 + $900 = $39,700.
57.	c	$780,000 + ($20,000 × 3/100) = $780,600.
58.	d	$632,000 – $9,000 = $623,000 $623,000 – ($23,000 × 2/50) = $622,080.
59.	b	($90,000 × .045) + ($9,000 × 2/80) – $2,700 = $1,575.
60.	a	($500,000 × .09 × 3/12) – ($20,000 × 3/50) = $10,050.
61.	c	Discount amortization: $20,000 × 8/50 = $3,200 ($980,000 + $3,200) ÷ 2 = $491,600; $491,600 – $494,000 = $2,400 gain.
62.	a	$124,365 – $123,000 = $1,365 unrealized holding loss.
63.	d	$65,000, acquisition cost.
64.	a	$75,000, acquisition cost.
65.	c	$45,000 + ($25,000 x .2) – ($10,000 x .2) = $48,000.
66.	a	$67,500 + ($25,000 × .3) – ($10,000 × .3) = $72,000.
67.	d	$60,000, acquisition cost.
68.	b	$60,000 + ($40,000 × .2) – ($10,000 × .2) = $66,000.
69.	a	$160,000 + ($120,000 × .3) – ($40,000 × .3) = $184,000.
70.	c	$120,000 × .3 = $36,000.
71.	a	$315,000 + ($200,000 × .6) – ($50,000 × .6) = $405,000.
72.	d	$90,000 + ($60,000 × .3) – ($20,000 × .3) = $102,000.
73.	c	$60,000 × .3 = $18,000.

DERIVATIONS — Computational (Continued)

No.	Answer	Derivation
74.	d	PV = $8,573, FV = $10,000, *n* = 2, solve for *i*.
75.	c	$14,000 × .08 = $1,120.
76.	a	FV = $20,000, *n* = 3, *i* = 10%, solve for PV.
77.	b	$120,000 – $100,000 = $20,000 OCI gain Barrick. $205,000 – $200,000 = $5,000 OCI gain Chester. $500,000 - $300,000 = $200,000 OCI gain Dooley.

DERIVATIONS — CPA Adapted

No.	Answer	Derivation
78.	a	$96,000 - $114,000 = $18,000 loss.
79.	a	$207,000 - $192,000 = $15,000.
80.	c	Conceptual.
81.	c	Conceptual.
82.	b	$585,000 – $10,000 = $575,000 $\$575{,}000 - \left(\$75{,}000 \times \frac{15}{75}\right) = \$560{,}000.$
83.	b	$100,000 × 30% = $30,000.
84.	a	$240,000 + $30,000 – ($60,000 × 30%) = $252,000.
85.	d	$252,000 – ($40,000 × 30%) + ($120,000 × 50% × 30%) = $258,000. $158,000 – ($258,000 ÷ 2) = $29,000.
86.	b	$360,000 – ($225,000 × 25%) + ($90,000 × 25%) = $326,250.

EXERCISES

Ex. 9-87- Investments in debt securities

Presented below are unrelated cases involving investments in debt securities.

Case 1:
A company owns another firm's debt securities in the form of bonds. The bonds were acquired at a discount and are accounted for under the amortized cost model.
Case 2:
An investment in notes receivable that had been held for several years is being sold. The investment was accounted for under the amortized cost model.
Case 3:
A portfolio of debt investments has been determined to be impaired.

Instructions
Indicate the accounting required and/or available for each case separately.

Solution 9-87
For case 1, the bonds would have been recognized at their fair value plus transaction costs. The discount would be amortized to net income over the life of the bond.

For case 2, the accrued interest and discount or premium would have to be updated up to the date of disposal. The resulting gain or loss (difference between book value and sales proceeds) would be recognized in net income and the investment be removed from the investor's books.

For case 3, once the investment has been determined to be impaired, three different models are (depending on whether PE GAAP or IFRS are followed) available to recognize the loss: The incurred loss model, the expected cash flow model, and the full fair value model.

Ex. 9-88 - True-false questions

Mark T or F in the left margin opposite the question number.

When one entity (investor) acquires the shares of another entity (investee) and the investment results in significant influence:
___ 1. The investor may use the equity method to account for the investment if certain conditions are met and PE GAAP is followed.
___ 2. The investment would generally require MORE extensive disclosures under IFRS.
___ 3. The investor may use the cost method to account for the investment if certain conditions are met and IFRS is followed.

When an investor follows IFRS in accounting for its investments:
___4. Transaction costs must be capitalized except when the investment is accounted for under the fair value to net income model.
___ 5. Gains and losses are always recognized in net income.
___ 6. Investments in subsidiaries must be accounted for under the equity method.
___ 7. Reclassifications between measurement models are allowed in rare circumstances.

Solution 9-88
1. T
2. T
3. F
4. T
5. F
6. F
7. T

Ex. 9-89—Investment in debt securities at premium.

On April 1, 2011, Mollar Co. purchased $120,000 of six percent bonds for $124,725 plus accrued interest as a held-to-maturity investment. Interest is paid on July 1 and January 1 and the bonds mature on July 1, 2016. Mollar uses the amortized cost model to account for this investment.

Instructions
(a) Prepare the journal entry on April 1, 2011.

(b) The bonds are sold on November 1, 2012 at 103 plus accrued interest. Amortization was recorded when interest was received by the straight-line method (by months and round to the nearest dollar). Prepare all entries required to properly record the sale.

Solution 9-89

(a)	Investment in Bonds	124,725	
	Interest Revenue ($120,000 × .06 × 1/4)	1,800	
	Cash		126,525
(b)	Interest Revenue ($4,725 × 4 ÷ 63)	300	
	Investment in Bonds		300
	Cash ($120,000 × .06 × 1/3)	2,400	
	Interest Revenue		2,400
	Cash	123,600	
	Gain on Sale of Securities		300
	Investment in Bonds		123,300
	$124,725 – [($4,725 ÷ 63) × 19]		

Ex. 9-90—Investment in debt securities at a premium.

On January 1, 2011, Gables Co. purchased $100,000 of eight percent bonds for $108,530. The bonds were purchased to yield six percent. Interest is paid on July 1 and January 1 and the bonds mature on January 1, 2016. Gables Co. uses the effective interest method to amortize the premium and applies the amortized cost model.

Instructions
(1) Prepare the journal entry on January 1, 2011.
(2) Prepare the journal entries for the receipt of interest and amortization of the premium for the remainder of 2011.
(3) What is the carrying value of the investment at the end of 2012?

Solution 9-90

(1)	Investment in Bonds	108,530	
	Cash		108,530
(2)	July 1, 2011		
	Cash	4,000	
	Interest Revenue		3,256
	Investment in Bonds		744
	$108,530 × .06 × .5 = $3,256		
	December 31, 2011		
	Interest Receivable	4,000	
	Interest Revenue		3,234
	Investment in Bonds		766
	($108,530 – $744) × .06 × .5 = $3,234		

Solution 9-90 (Continued)

(3) (\$108,530 – \$744 – \$766) × .06 × .5 = \$3,211; \$4,000 – \$3,211 = \$789.
(\$108,530 – \$744 – \$766 – \$789) × .06 × .5 = \$3,187; \$4,000 – \$3,187 = \$813.
Carrying value at the end of 2012:
(\$108,530 – \$744 – \$766 – \$789 – \$813) = \$105,418.

Ex. 9-91—Investment in equity securities.

Schmidt Corp. acquired a 30% interest in Roscoe Co. on January 1, 2011, for \$500,000. At that time, Roscoe had 1 million of its no par common shares issued and outstanding. During 2011, Roscoe paid cash dividends of \$220,000 and thereafter declared and issued a five percent common stock dividend when the market value was \$2 per share. Roscoe 's net income for 2011 was \$480,000. Schmidt is using the equity method to account for this investment. What should be the balance in Schmidt's investment account at the end of 2011?

Solution 9-91

Cost	\$500,000
Share of net income (.3 × \$480,000)	144,000
Share of dividends (.3 × \$220,000)	(66,000)
Balance in investment account	\$578,000

Ex. 9-92—Cost and equity methods. (Essay)

Compare the cost and equity methods of accounting for investments in stocks subsequent to acquisition (when permitted by PE GAAP).

Solution 9-92

Under the cost method, investments are originally recorded at cost and remain at cost unless the investor receives a dividend larger than its proportion of earnings since the acquisition. Dividends are reported as revenue. Under the equity method, investments are originally recorded at cost. Subsequently, the investment account is adjusted for the investor's share of the investee's net income or loss and this amount is recognized in the income of the investor. Dividends received from the investee are reductions in the investment account.

Ex. 9-93—Cost and equity methods.

Fill in the dollar changes caused in the Investment account and Dividend Revenue or Investment Revenue account by each of the following transactions, assuming Norfolk Company uses (a) the fair value method and (b) the equity method for accounting for its investments in Jameson Company.

	(a) Fair Value Method		(b) Equity Method	
Transaction	Investment Account	Dividend Revenue	Investment Account	Investment Revenue
1. At the beginning of Year 1, Norfolk bought 30% of Jameson's common shares at its book value. Total book value of all Jameson's common shares was $900,000 on this date.				
2. During Year 1, Jameson reported $50,000 of net income and paid $25,000 of dividends.				
3. During Year 2, Jameson reported $20,000 of net income and paid $25,000 of dividends.				
4. During Year 3, Jameson reported a net loss of $12,000 and paid $5,000 of dividends.				
5. Indicate the Year 3 ending balance in the Investment account, and cumulative totals for Years 1, 2, and 3 for dividend revenue and investment revenue.				

Solution 9-93

	(a) Fair Value Method		(b) Equity Method	
Transaction	Investment Account	Dividend Revenue	Investment Account	Investment Revenue
1.	270,000		270,000	
2.			15,000	15,000
		7,500	(7,500)	
3.			6,000	6,000
		7,500	(7,500)	
4.			(3,600)	(3,600)
		1,500	(1,500)	
5.	270,000	16,500	270,900	17,400

Ex. 9-94—Significant influence.

Describe how to determine if an investment results in significant influence.

Solution 9-94

If the ownership is less than 20%, there is a presumption that there is not significant influence. However, if there is evidence indicating that such influence exists, such as the investor having seats on the board of directors, then the investment should be accounted for as one with significant influence. If the ownership is 20% or greater, then the presumption is that there is significant influence. If the facts of the situation indicate that there is not significant influence, such as the existence of a larger shareholder and the investor having no seats on the board of directors, then the investment should be accounted for as one without significant influence.

Ex. 9-95 - Sale of equity investments - FV (OCI)

Jessup Corp., a company that follows international GAAP, holds 10,000 preferred shares from Gielow Corp. The investment is *not* considered significant and was accounted for under the fair value to other comprehensive income model. The shares are sold on August 1 for $235,200 and Jessup's accountant has brought the investment account up-to-date. After these adjustments were posted, the balance in the account "Holding gain on Gielow Corp (OCI)" had a balance of $12,625.

Instructions
Prepare the entries to record the sale.

Solution 9-95

Cash	235,200	
Investment in Gielow Corp		235,200
Holding gain on Gielow Corp (OCI)	12,625	
Gain on sale of Gielow Corp		12,625

PROBLEMS

Pr. 9-96—Temporary investments FV-NI model

During the course of your examination of the financial statements of Taradale Corporation for the year ended December 31, 2011, you found a new account, "Investments." Your examination revealed that during 2011, Taradale began a program of investments, and all investment-related transactions were entered in this account. Your analysis of this account for 2011 follows:

Taradale Corporation
Analysis of Investments
Year Ended December 31,2011

Date—2011			Debit	Credit
		(a)		
		Ropert Company Common Shares		
Feb.	14	Purchased 3,000 shares @ $55 per share.	$165,000	
July	26	Received 300 of Ropert Company common shares as a stock dividend. (Memorandum entry in general ledger.)		
Sept.	28	Sold the 300 common shares of Ropert Company received July 26 @ $70 per share.		$21,000
		(b)		
			Debit	Credit
		Luke Ltd., Common Shares		
Apr.	30	Purchased 5,000 shares @ $40 per share.	$200,000	
Oct.	28	Received dividend of $1.20 per share.		$6,000

Additional information:

1. The market value for each security as of the 2011 date of each transaction follow:

Security	Feb. 14	Apr. 30	July 26	Sept. 28	Dec. 31
Ropert Co.	$55		$62	$70	$72
Luke Ltd.		$40			32
Taradale Corp.	25	28	30	33	35

2. All of the investments of Taradale are nominal in respect to percentage of ownership (five percent or less).
3. Each investment is considered by Taradale's management to be temporary.

4. The company has adopted PE GAAP and intended to use the FV NI method to account for these investments.

5. It follows a policy to separately report dividend income.

Instructions

(1) Prepare any necessary correcting journal entries related to investments (a) and (b).
(2) Prepare the entry, if necessary, to record the proper valuation of these investments as of December 31, 2011.

Solution 9-96

(1) (a) Ropert —

	original purchase	3,000 shares
	stock dividend	300 shares
	total holding	3,300 shares

Total cost of $165,000 ÷ Total shares of 3,300 = $50 cost per share

Sold 300 shares

Correct entry:

Cash (300 × $70)	21,000	
Temporary investments		15,000
Gain on sale of temporary investments		6,000

Entry made:

Cash	21,000	
Temporary investments		21,000

Correction:

Temporary investments - Ropert	6,000	
Gain on sale of temporary investments		6,000

(b) Luke—should record cash dividend as dividend income.

Correct entry:

Cash	6,000	
Dividend income		6,000

Entry made:

Cash	6,000	
Temporary investments - Luke		6,000

Correction:

Temporary investments - Luke	6,000	
Dividend income		6,000

Solution 9-96 (Continued)

(2) Valuation at End of Year:

	Quantity	Cost	Market Value	Increase (Decrease)
Ropert	3,000 shares	$150,000	$216,000	$66,000
Luke	5,000 shares	200,000	160,000	(40,000)
		$350,000	$376,000	$26,000

Year-end Adjustment:

Temporary investments - Ropert	66,000	
Gain on Rupert investment (FV-NI)		66,000
Loss on Luke investment (FV-NI)	40,000	
Temporary investments - Luke		40,000

Pr. 9-97—Note Receivable – Amortized cost model.

Pollock Inc. issued a note with a face value of $100,000 with a three-year term and paying annual interest of $3,000. The current market interest rate is 6%.

Instructions
Prepare the discount amortization schedule for Pollock Inc.

Solution 9-97

Face value of note		$100,000
Present value of the principal:		
$100,000 (PVF*$_{3,6\%}$) =	$83,962	
Present value of the interest:		
$3,000 (PVF*OA-$_{3,6\%}$) =	8,019	
Present value of the note		91,981
Difference		$ 8,019

Pollock Inc.
Discount Amortization Schedule
3% Note Discounted at 6%

Date of Issue	Cash Received	Interest	Discount Amortization	Carrying Value
				$91,981
End of Year 1	$3,000	$ 5,519	$2,519	94,500
End of Year 2	3,000	5,670	2,670	97,170
End of Year 3	3,000	5,830	2,830	100,000
	$9,000	$17,019	$8,019	

Pr. 9-98—Premium amortization schedule.

Olaf Inc. issued a note with a face value of $100,000 with a three-year term and paying annual interest of $7,000. The current market interest rate is 4%. Olaf applies the amortized cost model to this investment.

Instructions
Prepare the premium amortization schedule for Olaf Inc.

Solution 9-98

Face value of note	$100,000
Present value of the principal:	
$100,000(PVF*$_{3,4\%}$) =	$88,900
Present value of the interest:	
$7,000(PVF*OA$_{3,4\%}$) =	19,426
Present value of the note	108,326
Difference	$ 8,326

Olaf Inc.
Premium Amortization Schedule
7% Note Discounted at 4%

Date of Issue	Cash Received	Interest	Premium Amortization	Carrying Value
				$108,326
End of Year 1	$ 7,000	$ 4,333	$(2,667)	105,659
End of Year 2	7,000	4,226	(2,774)	102,885
End of Year 3	7,000	4,115	(2,885)	100,000
	$21,000	$12,674	$(8,326)	

Pr. 9-99—Year-end adjustments for temporary investments.

Sirkov Corp. has the following portfolio of common shares (without significant influence) as at December 31, 2011.

Investment	Cost	Fair value
Alba Inc.	$240,000	$285,000
Lock Ltd.	45,000	310,000
Tessara Corp.	60,000	110,000
Total	$345,000	$705,000

Instructions
Provide the entry to record the year-end adjustment for these investments, assuming Sirkov uses one control account and has adopted the FV-NI model.

Solution 9-99

Temporary investments	360,000	
Gain on temporary investments (FV-NI)		360,000

Pr. 9-100 - Debt investments - FV-NI

On January 1, 2011, Houseman Company acquired $100,000 face value 8% bonds of Lamont Corporation to yield 6%. The bonds were dated January 1, 2011, and mature on December 31, 2015, with interest payable each January 1. Houseman intends to hold the bonds to maturity.

Instructions
Assuming the FV NI model is applied, prepare the following entries in the books of Houseman:
(a) Acquisition of bonds on January 1, 2011
(b) The year-end adjusting entry at December 31, 2011
(c) The receipt of the first interest payment on January 1, 2012

Solution 9-100

<u>(a) Acquisition of bonds on January 1, 2011</u>

PV of principal: $100,000 (PVF*5,6%) = $100,000 x 0.74726 =	$74,726
PV of interest: (PVF*OA 5,6%) = $8,000 x 4.21236 =	<u>$33,699</u>
Present value of the bond	$108,425

Investment in Lamont Corp Bonds	108,425	
Cash		108,425

<u>(b) The year-end adjusting entry at December 31,2011</u>

Interest receivable	8,000	
Investment in Lamont Corp Bonds		1,495
Interest income		6,505

$100,000 x 8% = $8,000
$108,425 x 6% = $6,505
$8,000 - $6,505 = $1,495

<u>(c) Receipt of first interest payment on Jan-1-2012</u>

Cash	8,000	
Interest receivable		8,000

Pr. 9-101—Accounting for bonds – amortized cost model

Laflame Inc. purchased $200,000 of 10-year bonds with a stated rate of 9% that pay interest annually on their issue date of January 1, 2011. Laflame records the bonds according to the amortized cost model. The current market rate was 10% and as a result Aardvark paid $187,711 for the bonds. On December 31, 2011, the bonds have a market value of $185,000.

Instructions
a. Record the receipt of interest for the year and amortization for the year.
b. Record any year-end adjustment.

Solution 9-101

a.	Effective interest—year 1 = $187,711 × .10 =	$18,771
	Actual interest	18,000
	Discount amortization	$ 771

	Debit	Credit
Cash	18,000	
Amortization of Discount	771	
Interest Income		18,771

b.	Carrying value of bonds = $187,711 + $771 =	$188,482
	Market value	185,000
	Unrealized loss	$ 3,482

	Debit	Credit
Unrealized Loss on bonds (FV-NI)	3,482	
Investment in bonds		3,482

Pr: 9-102 Temporary investments – FV NI

Huber Company has the following securities in its portfolio of temporary investments on December 31, 2011:

	Cost	Market
5,000 shares of Lest Corp., Common	$160,000	$139,000
10,000 shares of Reap, Common	182,000	185,000
	$342,000	$324,000

All of the securities had been purchased in 2011. In 2012, Huber completed the following securities transaction:

April 1 Bought 600 shares of Wass, Common @ $50 plus fees of $550.

The Huber Company portfolio of trading equity securities appeared as follows on December 31, 2012:

	Cost	Market
5,000 shares of Lest Corp. Common	$160,000	$156,000
10,000 shares of Reap, Common	182,000	198,500
600 shares of Wass, Common	30,550	25,500
	$372,550	$380,000

Instructions
Assuming Huber uses the FV-NI method, prepare the general journal entries for Huber Company for:
(a) the 2011 year-end adjusting entry.
(b) the purchase of the Wass' shares.
(c) the 2012 year-end adjusting entry.

Solution 9-102

		Dr.	Cr.
(a)	Dec-31-2011		
	Loss on temporary investment (FV-NI)	18,000	
	Temporary investments		18,000
	($342,000 – $324,000)		
(b)	Apr-01-2012		
	Temporary investments	30,550	
	Cash [(600 × $50) + $550]		30,550
(c)	Dec-31-2012		
	Temporary investments	25,450	
	Gain on temporary investments (FV-NI)		25,450

Pr. 9-103 – Equity method
On January 1, 2010, Halkirk Company bought 30,000 shares of the available 100,000 voting common shares of Wong Corporation a publicly traded firm. This acquisition provided Halkirk with significant influence. Halkirk paid $700,000 cash for the investment. At the time of the acquisition, Wong had assets of $2,500,000 and liabilities of $1,200,000. Asset values reflected fair market value except for capital assets that had a net book value of $500,000 and a fair market value of $730,000. These assets had a remaining useful life of five years. For 2010 Wong reported net income of $400,000 and paid cash dividends of $100,000.
On May 16, 2011, Halkirk sold 15,000 of its shares in Wong for 425,000. Halkirk has no immediate plans to sell the remaining investment in Wong Corporation.

Stock price information for Wong Corporation is below:
1.1.2010 - $23
31.12.2010 - $25
1.1.2011 - $26

Instructions

Assuming Halkirk is using private entity GAAP,
A) Did the initial investment include a payment for goodwill? Provide support for your answer.
B) At the end of 2010 what would appear on the income statement and balance sheet of Halkirk? Show supporting calculations.
C) Provide the entr(ies) to account for Halkirk's sale of the shares in May 2011. How should Halkirk account for its remaining investment in Wong?

Solution 9-103

A)

Purchase price (30%)		$700,000
Market value of identifiable assets*	$2,730,000	
Less: liabilities	(1,200,000)	
Total market value of net assets acquired	1,530,000	
Portion purchased (30%) (.3 x $1,530,000)		(459,000)
Goodwill		$241,000

*$2,500,000 + ($730,000 - $500,000)

B)

Investment income, on income statement

Share of net income ($400,000 x .3)		$120,000
Less: Amortization of fair value increment		
($730,000 - $500,000)/ 5	$ 46,000	
Investor portion	0.3	(13,800)
		$106,200

Investment account, on balance sheet

Cost	$700,000
Plus: investment income	106,200
Less: dividends received ($100,000 x .3)	(30,000)
	$776,200

C)

Cash	425,000	
Investment in Wong		388,100
Gain on sale of investment		36,900

To record the sale of the shares
$776,200 x 50% = $388,100

After that sale, Halkirk will no longer have significant influence over Wong. As a result, the use of the equity will no longer be appropriate. Under private entity GAAP, Halkirk can choose the cost or fair value to net income (FV-NI) for its remaining investment in Wong.

Pr. 9-104 – Longterm investment – FV-NI method

Checkov Corporation is considering a significant long-term investment in Pratt Ltd, a young and very promising company. It decides to make a smaller investment first, and if it turns successful, it intends to make an additional investment to reach significant influence. Pratt has 200,000 shares authorized, 110,000 issued and 90,000 shares outstanding.

In order to make the investment, on January 1, 2011, Pratt issues Checkov 10,000 shares to Checkov for $400,000 in cash.

Additional information:

(a) On November 1, 2011, Pratt declares a cash dividend of $180,000.
(b) Pratt's net income for 2011 is $225,000; Its stock price on December 31, 2011 is $38.
(c) On November 1, 2012, Pratt announces a dividend of $270,000 to be paid on January 2, 2013.
(d) Pratt's net income for 2012 is $360,000. Its stock price on December 31, 2012 is $44.
(e) On March 15, 2013, Checkov is approached by an investment fund which offers to buy Pratt's shares for $55 per share, a 25% premium over the current stock price of $44. Checkov accepts the offer and sells the shares on that day.

Instructions

Assuming Checkov uses the Fair Value to Net Income method (FV-NI) to account for this investment:
1. Prepare the journal entries in Checkov's books for the year ending December 31, 2011.
2. Prepare the journal entries in Checkov's books for the year ending December 2012.
3. Prepare the journal entries in Checkov's books to account for the sale of the Pratt shares on March 15, 2013.

Solution 9-104:

1. 2011 Entries:
Investment in Pratt 400,000
Cash 400,000
To record the initial investment on January 1, 2011.

Cash 18,000
Dividend revenue 18,000
To record Checkov's share of the dividend on November 1, 2011.
$180,000 x 10,000/100,000 = $18,000.

Holding loss on investment (FV-NI) 20,000
Investment in Pratt 20,000
To record holding loss on December 31, 2011 ($38 - $40) x 10,000 = $20,000.

Solution 9-104 (Continued)

2. 2012 Entries:
Dividend receivable 27,000
Dividend revenue...27,000
To record Checkov's share of the dividend on November 1, 2012.
$270,000 x 10,000/100,000 = $27,000.

Investment in Pratt 60,000
Holding gain on investment (FV-NI) 60,000
To record holding gain on December 31, 2012.
($44 - $38) x 10,000 = $60,000

3. 2013 Entries:
Cash 550,000
Investment in Pratt 440,000
Gain on sale of investment...................................110,000
To record gain on sale of Pratt shares on March 15, 2013.
$55 x 10,000 = $550,000
($55 - $44) x 10,000 = $110,000

Pr. 9-105 - Equity method – IFRS

Salinger Corporation decided to purchase 35% of the outstanding shares of Fester Ltd. Salinger's CFO conducted an extensive evaluation of the financial statements of Fester and reported to the board of directors his findings in the following memo:

Dear Board of Director's members,
Following your request, I conducted a detailed analysis of Fester Ltd. I found out that the liabilities in its books as of 31.12.10 in the amount of $20M fairly represent their economic values. As for the assets, their book value is $45M. The company owns an office building in downtown Toronto where its headquarters are located. The net book value of this building including the land is $10M. They purchased the land for $6M some 20 years ago and then constructed the building. I consulted with real estate experts and currently the fair value of the land is $9M and the fair value of the building is $8M. The remaining useful life of the building in Fester's books is 20 years and I find this estimate realistic.
The firm has developed a patent. According to my analysis, the fair value of the patent is $12M. Given future advances in technology, I expect the value of the patent to decline monotonically and become worthless 6 years from now. The patent was developed by the company and all the related costs were recorded as Research and development expenses.
Sincerely,
Jake Connor, CA

The board of directors of Salinger Corporation adopted the report by Mr. Connor and on 1.1.2011 purchased 35% of the shares of Fester based on its fair value according to the analysis of Mr. Connor. After the acquisition of the shares, Salinger was able to exercise significant influence over Fester.
In 2011 Fester reported a net income of $10M and distributed 40% of it as cash dividend.
In 2012 earnings of Fester doubled compared with 2011. Fester distributed 60% of its income as cash dividend. On 31.12.2012 Salinger sold its investment in Fester Ltd for $20M.

Instructions
Assuming Salinger accounts for this investment using the method acceptable under IFRS
(a) Record the initial purchase by Salinger Corp.
(b) Record the entries related to the investment in Fester Ltd for 2011.
(c) Record the entries related to the investment in Fester Ltd for 2012.

Solution 9-105

(a) Calculation of amount paid

Net book value of Fester (45 – 20)	25M
Fair Value of patent	12M
Excess value of land (9 – 6)	3M
Excess value of building (8 – (10 – 6))	4M
Fair value of Fester	44M
Shares held	35%
Amount paid	15.4M

(b) Journal entries for 2011

Investment in Fester...	15.4M	
Cash..		15.4M
To record initial investment		

Calculation of income to be recorded by Salinger:

Fester's net income	10M
Salinger's holdings	35%
Salinger's share in net income	3.5M
Amortization of patent (12/6) x 35%	(0.7M)
Excess depreciation of the building (4M x 35%)/20	(0.07M)
Salinger's adjusted share in barker's net income	2.73M

Investment in Fester...	2.73M	
Investment income....................................		2.73M
Cash............................	1.4M	
Investment in Fester.....................................		1.4M
To record dividend distribution (10M x 40% x 35%)		

(c) Journal entries for 2012

For recording its share in Fester's net income the only adjustment to the calculation of 2011 is that income now is 20M and Salinger's share is $7M an increase of $3.5M compared with last year so investment income amount increased to 6.23M (2.73 + 3.5)

Investment in Fester......................	6.23M	
Investment income...............................		6.23M
Cash......................................	4.2M	
Investment in Fester.......................... ..		4.2M
To record dividend distribution (10M x 2 x 60% x 35%)		

By the end of 2012 the value of the investment in Salinger's books is as follow:

Initial investment	15.4
Investment income 2011	2.73
Dividend 2011	(1.4)
Investment income 2012	6.23
Dividend 2012	(4.2)

Solution 9-105 (Continued)

Investment in Fester 31.12.2012	18.76M
Investment selling price	20.00M
Gain on sale of investment	1.24M

Cash..	20M	
Investment in Fester...............................		18.76M
Gain on sale of investment.......................		1.24M

LEGAL NOTICE

CHAPTER 10

PROPERTY, PLANT, AND EQUIPMENT: ACCOUNTING MODEL BASICS

MULTIPLE CHOICE—Conceptual

Answer	No.	Description
d	1.	Definition of plant assets.
b	2.	Characteristics of property, plant, and equipment assets.
d	3.	Characteristics of property, plant, and equipment assets.
c	4.	Valuation of property, plant, and equipment assets.
a	5.	Additions to land costs.
b	6.	Definition of land costs.
d	7.	Treatment of land improvements.
d	8.	Determine cost of land used as a parking lot.
c	9.	Determine cost of delivery truck.
a	10.	Determine cost of machinery.
b	11.	Classification of small tools and containers.
d	*12.	Capitalization of borrowing costs.
d	*13.	Capitalization of borrowing costs.
b	14.	Treatment of restoration costs.
c	15.	Features of the cost model.
d	16.	Features of the revaluation model.
b	*17.	Capitalization of borrowing costs.
a	18.	Features of the revaluation model.
d	*19.	Capitalized borrowing costs.
d	20.	Plant asset acquired by issuance of stock.
d	21.	Valuation of nonmonetary exchanges.
a	22.	Gain recognition on a nonmonetary exchange.
c	23.	Gain recognition on a nonmonetary exchange.
b	24.	Accounting for donated assets.
b	25.	Valuation of donated assets.
d	26.	Identify conditions for capital expenditures.
c	27.	Capital expenditure.
d	28.	Identification of a capital expenditure.
a	29.	Identification of a capital expenditure.

*This topic is dealt with in an Appendix to the chapter.

MULTIPLE CHOICE—Computational

Answer	No.	Description
c	30.	Calculate cost of land acquired.
b	31.	Determine cost of land.
d	32.	Determine cost of building.
d	33.	Calculate cost of land and building.
b	*34.	Calculate average accumulated expenditures.
a	*35.	Calculate amount of borrowing costs to be capitalized.
d	*36.	Calculate weighted-average accumulated expenditures.
b	*37.	Calculate weighted-average accumulated expenditures.
d	*38.	Calculate weighted-average accumulated expenditures.
d	*39.	Calculate actual interest cost incurred during year.
c	*40.	Calculate borrowing costs to be capitalized.
b	41.	Application of the fair value model.
a	42.	Application of the fair value model.
c	43.	Calculate cost of truck purchased.
a	44.	Calculate cost of machine purchased.
d	45.	Allocation of cost of a lump sum purchase.
b	46.	Calculate cost of machine purchased.
d	47.	Acquisition of equipment by exchange of shares held as an investment.
b	48.	Exchange of similar assets.
b	49.	Exchange of similar assets/gain.
b	50.	Application of the revaluation model.
d	51.	Application of the revaluation model.
a	52.	Application of the revaluation model.
b	53.	Components of PP&E assets.
c	54.	Components of PP&E assets.
d	55.	Components of PP&E assets.
c	56.	Application of the cost model.
b	57.	Capitalization of exploration costs and discovery values.

MULTIPLE CHOICE—CPA Adapted

Answer	No.	Description
c	58.	Determine cost of land.
b	59.	Classification of sale of building.
b	*60.	Determine borrowing costs to be capitalized.
a	61.	Valuation of a nonmonetary exchange.
a	62.	Exchange of similar assets/loss.
d	63.	Accounting for donated assets.
d	64.	Costs subsequent to acquisition.
a	65.	Valuation of replacement equipment.

EXERCISES

Item	Description
E10-66	Plant asset accounting.
E10-67	Capitalization of borrowing costs.
E10-68	Capitalization of interest.
E10-69	Application of the revaluation model.
E10-70	Asset exchange with commercial substance.
E10-71	Donated assets.
E10-72	Measurement models.
E10-73	Application of the fair value model.
E10-74	Asset Acquisition
E10-75	Expenditure
E10-76	Non interest bearing note
E10-77	Non monetary transaction
E10-78	Asset Exchange

PROBLEMS

Item	Description
P10779	Deferred payments.
P10-80	Fair value model
P10-81	Capitalization of borrowing costs.
P10-82	Capitalization of borrowing costs.
P10-83	Nonmonetary exchange.
P10-84	Revaluation model.
P10-85	Nonmonetary exchange.
P10-86	Nonmonetary exchange.
P10-87	Nonmonetary exchange.

MULTIPLE CHOICE—Conceptual

1. Property, plant, and equipment assets may properly include
   a. deposits on machinery not yet received.
   b. idle equipment awaiting sale.
   c. land held for possible use as a future plant site.
   d. none of these.

2. Which of the following is *not* a major characteristic of a property, plant, and equipment asset?
   a. Possesses physical substance
   b. Acquired for resale
   c. Acquired for use
   d. Yields services over a number of years

3. Which of these is *not* a major characteristic of a property, plant, and equipment asset?
   a. Possesses physical substance
   b. Acquired for use in operations
   c. Yields services over a number of years
   d. All of these are major characteristics of a property, plant, and equipment asset.

4. Property, plant, and equipment assets purchased on long-term credit contracts should be accounted for at
   a. the total value of the future payments.
   b. the future amount of the future payments.
   c. the present value of the future payments.
   d. none of these.

5. Costa Company purchased a large area of land with the intention to transform it into a banana plantation. Before the new seedlings can be planted, the site, which is prone to flooding, must be drained. The cost of the draining should be
   a. Capitalized as part of the cost of the land.
   b. Expensed only after the first crop of bananas has been harvested.
   c. Expensed immediately
   d. Reported as loss from discontinued operations

6. Land is generally included in property, plant and equipment except when
   a. It is not yet ready for use
   b. It is held for resale by land developers
   c. It includes a building that must be demolished
   d. All of the above

7. The costs of land improvements with limited lives are
   a. Added to the land account
   b. Recorded in a separate account
   c. Amortized over their useful lives.
   d. (b) and (c) only

8. If a corporation purchases a lot and building and subsequently tears down the building and uses the property as a parking lot, the proper accounting treatment of the cost of the building would depend on
   a. the significance of the cost allocated to the building in relation to the combined cost of the lot and building.
   b. the length of time for which the building was held prior to its demolition.
   c. the contemplated future use of the parking lot.
   d. the intention of management for the property when the building was acquired.

9. Kirk Co. exchanged merchandise that cost $19,000 and normally sold for $27,000 for a new delivery truck with a list price of $31,000. The delivery truck should be recorded on Kirk's books at
   a. $19,000
   b. $27,000
   c. $31,000
   d. $12,000

10. The debit for a sales tax properly levied and paid on the purchase of machinery preferably would be a charge to
    a. the machinery account.
    b. a separate deferred charge account.
    c. miscellaneous tax expense (which includes all taxes other than those on income).
    d. Accumulated Depreciation—Machinery.

11. Small tools and containers used repeatedly for more than a year are classified on the balance sheet as
    a. current assets.
    b. fixed assets.
    c. deferred charges.
    d. investments.

*12. Borrowing costs incurred for the acquisition of assets may be capitalized if certain conditions are met. Which of the following issues is *irrelevant* in making that determination?
    a. The capitalization period
    b. The avoidable borrowing costs
    c. Whether the asset is are already being used
    d. The depreciation period

*13. The capitalization of borrowing costs for the purchase of assets
    a. Can have a significant impact on a company's earnings
    b. Must be disclosed in the notes to the financial statements
    c. Is allowed under both private entities GAAP and international GAAP.
    d. All of the above

14. Under Private Entity GAAP, the cost for environmental clean-up costs at the end of an asset's useful life are
    a. Expensed as incurred
    b. Recognized only if they represent a legal obligation.
    c. Are capitalized once they have become apparent.
    d. None of the above

15. The cost model of accounting for PP&E assets
    a. Should be applied to investment property only
    b. Should be applied to other PP&E assets only
    c. Can be applied to all classes of PP&E including investment property.
    d. Is not appropriate under current Canadian GAAP

16. The revaluation model of accounting for PP&E assets
    a. May be applied to all classes of PP&E including investment property.
    b. Uses a revaluation surplus account to hold net increases in the asset's fair value.
    c. Should not be applied to investment property.
    d. (b) and (c) only

*17. Construction of a qualifying asset is started on April 1 and finished on December 1. The fraction used to multiply an expenditure made on April 1 to find weighted-average accumulated expenditures is
    a. 8/8.
    b. 8/12.
    c. 9/12.
    d. 11/12.

18. The fair value model of accounting for PP&E assets
    a. Should be applied to investment property only.
    b. Recognizes changes in the asset's fair value in other comprehensive income.
    c. Once chosen for one investment property does *not* have to be applied to all investment property.
    d. (a) and (c) only

*19. Borrowing cost that are capitalized should
    a. be written off over the remaining term of the debt.
    b. be accumulated in a separate deferred charge account and written off equally over a 40-year period.
    c. not be written off until the related asset is fully amortized or disposed of.
    d. none of these.

20. When a plant asset is acquired by the issuance of a public company's common shares, the cost of the plant asset is properly measured by the
    a. no par value of the shares.
    b. stated value of the shares.
    c. book value of the shares.
    d. market value of the shares.

21. When a closely held corporation issues preferred shares for land, the land should be recorded at the
    a. total no par value of the shares issued.
    b. total book value of the shares issued.
    c. total liquidating value of the shares issued.
    d. fair market value of the land.

22. Accounting recognition should be given to some or all of the gain realized on a nonmonetary exchange of plant assets *except* where the assets exchanged are
    a. similar and additional cash (less than 10%) is paid.
    b. similar and additional cash (greater than 10%) is received.
    c. dissimilar and additional cash (less than 10%) is paid.
    d. dissimilar and additional cash (greater than 10%) is received.

23. For a nonmonetary exchange of plant assets, accounting recognition should *not* be given to
    a. a loss when the assets exchanged are similar.
    b. a gain when the assets exchanged are dissimilar.
    c. part of a gain when the assets exchanged are similar and cash is paid.
    d. part of a gain when the assets exchanged are similar and cash is received.

24. When an enterprise is the recipient of a donated asset, the account credited may be a
    a. paid-in capital account.
    b. revenue account.
    c. deferred revenue account.
    d. all of these.

25. A plant site donated by a township to a manufacturer that plans to open a new factory should be recorded on the manufacturer's books at
    a. the nominal cost of taking title to it.
    b. its market value.
    c. one dollar (since the site cost nothing but should be included in the balance sheet).
    d. the value assigned to it by the company's directors.

26. In order for a cost to be capitalized (capital expenditure), the following must be present:
    a. The useful life of an asset must be increased.
    b. The quantity of assets must be increased.
    c. The quality of assets must be increased.
    d. Any one of these.

27. A major overhaul made to a machine increased its fair market value and its production capacity by 25% without extending the machine's useful life. The cost of the improvement should be
    a. expensed.
    b. debited to accumulated depreciation.
    c. capitalized in the machine account.
    d. allocated between accumulated depreciation and the machine account.

28. Which of the following is a capital expenditure?
    a. Payment of an account payable
    b. Retirement of bonds payable
    c. Payment of federal income taxes
    d. None of these

29. Which of the following is *not* a capital expenditure?
    a. Repairs that maintain an asset in operating condition
    b. Inspections
    c. Major overhauls
    d. Replacements

Multiple Choice Answers—Conceptual

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.
1.	d	6.	b	11.	b	16.	d	21.	d	26.	d
2.	b	7.	d	*12.	d	*17.	b	22.	a	27.	c
3.	d	8.	d	*13.	d	18.	a	23.	c	28.	d
4.	c	9.	c	14.	b	*19.	d	24.	b	29.	a
5.	a	10.	a	15.	c	20.	d	25.	b		

Solutions to those Multiple Choice questions for which the answer is "none of these."

1. Long-lived tangible assets used in the enterprise's operations.
19. Capitalized interest is amortized over the related asset's useful life.
28. Capital expenditures include additions, betterments, improvements, and extraordinary repairs.

MULTIPLE CHOICE—Computational

30. On December 1, Lambert Corporation exchanged 2,000 shares of its no par value common shares for a parcel of land to be held for a future plant site. The book value of the shares is currently $45 per share, and their market value is $55 per share. Lambert received $15,000 for selling scrap when an existing building on the property was removed from the site. Based on these facts, the land should be capitalized at
    a. $120,000
    b. $75,000
    c. $110,000
    d. $95,000

Use the following information for questions 31 and 32.

Parry Co. purchased land as a factory site for $500,000. Parry paid $20,000 to tear down two buildings on the land. Salvage was sold for $2,700. Legal fees of $1,740 were paid for title investigation and making the purchase. Architect's fees were $20,600. Title insurance cost $1,200, and liability insurance during construction cost $1,300. Excavation cost $5,220. The contractor was paid $1,200,000. An assessment made by the city for pavement was $3,200. Interest costs during construction were $85,000.

31. The cost of the land that should be recorded by Parry Co. is
    a. $520,240.
    b. $523,440.
    c. $524,940.
    d. $528,140.

32. The cost of the building that should be recorded by Parry Co. is
    a. $1,306,900.
    b. $1,307,420.
    c. $1,311,600.
    d. $1,312,120.

33. On February 1, 2010, Sarazin Corporation purchased a parcel of land as a factory site for $300,000. An old building on the property was demolished, and construction began on a new building which was completed on November 1, 2010. Costs incurred during this period are listed below:

Demolition of old building	$ 25,000
Architect's fees	35,000
Legal fees for title investigation and purchase contract	5,000
Construction costs	990,000

(Salvaged materials resulting from demolition were sold for $10,000.)

Sarazin should record the cost of the land and new building, respectively as
    a. $330,000 and $1,015,000.
    b. $315,000 and $1,030,000.
    c. $315,000 and $1,025,000.
    d. $320,000 and $1,025,000.

*34. On May 1, 2010, Lloyd Company began construction of a building. Expenditures of $75,000 were incurred monthly for five months beginning on May 1. The building was completed and ready for occupancy on September 1, 2010. For the purpose of determining the amount of interest cost to be capitalized, the average accumulated expenditures on the building during 2010 were
a. $60,000
b. $62,500
c. $75,000
d. $290,000

*35. During 2010, Weber Co. incurred average accumulated expenditures of $500,000 during construction of assets that qualified for capitalization of interest. The only debt outstanding during 2010 was a $600,000, 8%, five-year note payable dated January 1, 2008. What is the amount of interest that should be capitalized by Weber during 2010?
a. $40,000
b. $0
c. $20,000
d. $30,000

*36. On March 1, Delta Co. began construction of a small building. Payments of $150,000 were made monthly for three months beginning March 1. The building was completed and ready for occupancy on June 1. In determining the amount of interest cost to be capitalized, the weighted-average accumulated expenditures are
a. $0
b. $450,000
c. $150,000
d. $75,000

*37. On March 1, Mega Co. began construction of a small building. Payments of $50,000 were made monthly for four months beginning March 1. The building was completed and ready for occupancy on June 1. In determining the amount of interest cost to be capitalized, the weighted-average accumulated expenditures are
a. $50,000
b. $25,000
c. $150,000
d. $140,000

Use the following information for questions 38 through 40.

On March 1, 2010, Beck Company purchased land for an office site by paying $270,000 cash. Beck began construction on the office building on March 1. The following expenditures were incurred for construction:

Date	Expenditures
March 1, 2010	$450,000
April 1, 2010	252,000
May 1, 2010	450,000
June 1, 2010	720,000

The office was completed and ready for occupancy on July 1. To help pay for construction, $360,000 was borrowed on March 1, 2010 on a nine percent, three-year note payable. Other than the construction note, the only debt outstanding during 2010 was a $150,000, 10%, six-year note payable dated January 1, 2010.

*38. The weighted-average accumulated expenditures on the construction project during 2010 were
- a. $258,000.
- b. $1,467,000.
- c. $156,000.
- d. $348,000.

*39. The actual interest cost incurred during 2010 was
- a. $45,000.
- b. $50,400.
- c. $25,200.
- d. $42,000.

*40. Assume the weighted-average accumulated expenditures for the construction project are $435,000. The amount of interest cost to be capitalized during 2010 is
- a. $39,150.
- b. $41,400.
- c. $39,900.
- d. $50,400.

41. A company owns assets that qualify as investment property and applies the fair value model for all such property. Assuming the assets are expected to be used for 10 years and have a year-1 book value of $100,000, depreciation expense for that year is:
- a. $10,000
- b. nil
- c. $15,000
- d. $9,000

42. Jakob Corporation uses the fair value model of accounting for its investment property. The fair values of its property were $124,000 and $129,000 at December 2011 and and December 2012 respectively. At December 2012 Jakob should
a. Recognize a gain of $5,000 in income
b. Report a gain of $5,000 in other comprehensive income
c. Defer the gain until realized
d. none of the above

43. Lamont Company buys a lift truck with a list price of $20,000. The dealer grants a 15% reduction in list price and an additional two percent cash discount on the net price if payment is made in 30 days. Sales taxes amount to $250 and the company paid an extra $200 to have a special horn installed. What should be the recorded cost of the truck?
a. $16,660.
b. $17,080.
c. $17,110.
d. $16,910.

44. On August 1, 2010, Danube Corporation purchased a new machine on a deferred payment basis. A down payment of $2,000 was made and four monthly instalments of $3,000 each are to be made beginning on September 1, 2010. The cash equivalent price of the machine was $12,000. Danube incurred and paid installation costs amounting to $1,000. The amount to be capitalized as the cost of the machine is
a. $13,000
b. $3,000
c. $12,000
d. $14,000

45. On April 1, Lagos Corporation purchased for $765,000 a tract of land on which was located a warehouse and office building. The following data were collected concerning the property:

	Current Assessed Valuation	Vendor's Original Cost
Land	$300,000	$250,000
Warehouse	200,000	150,000
Office building	400,000	300,000
	$900,000	$700,000

What are the appropriate amounts that Lagos should record for the land, warehouse, and office building, respectively?
a. Land, $250,000; warehouse, $150,000; office building, $300,000.
b. Land, $300,000; warehouse, $200,000; office building, $400,000.
c. Land, $273,214; warehouse, $163,929; office building, $327,857.
d. Land, $255,000; warehouse, $170,000; office building, $340,000.

46. On August 1, 2010, Volmar Corporation purchased a new machine on a deferred payment basis. A down payment of $4,000 was made and four annual instalments of $6,000 each are to be made beginning on September 1, 2010. The cash equivalent price of the machine was $25,000. Due to an employee strike, Volmar could not install the machine immediately, and thus incurred $300 of storage costs. Costs of installation (excluding the storage costs) amounted to $800. The amount to be capitalized as the cost of the machine is
    a. $25,000.
    b. $25,800.
    c. $26,100.
    d. $28,000.

47. Bliss Company exchanged 500 common shares of Davos Company, which Bliss was holding as an investment, for equipment from East Company. The Davos Company common shares, which had been purchased by Bliss for $50 per share, had a quoted market value of $58 per share at the date of exchange. The equipment had a recorded amount on East's books of $26,500. What journal entry should Bliss make to record this exchange?

a.	Equipment	25,000	
	Investment in Davos Co. Common Shares................		25,000
b.	Equipment	26,500	
	Investment in Davos Co. Common Shares................		25,000
	Gain on Disposal of Investment		1,500
c.	Equipment	26,500	
	Loss on Disposal of Investment	2,500	
	Investment in Davos Co. Common Shares................		29,000
d.	Equipment	29,000	
	Investment in Davis Co. Common Shares.................		25,000
	Gain on Disposal of Investment		4,000

48. On January 2, 2010, Mack Delivery Company traded in an old delivery truck for a newer model. Data relative to the old and new trucks follow:

<u>Old Truck</u>	
Original cost	$18,000
Accumulated Depreciation as of January 2, 2010	12,000
Average published retail value	6,000
<u>New Truck</u>	
List price	$30,000
Cash price without trade-in	27,000
Cash paid with trade-in	22,000

What should be the cost of the new truck for financial accounting purposes?
    a. $22,000.
    b. $27,000.
    c. $28,000.
    d. $30,000.

49. On December 1, 2010, Lear Company acquired a new delivery truck in exchange for an old delivery truck that it had acquired in 2007. The old truck was purchased for $20,000 and had a book value of $7,600. On the date of the exchange, the old truck had a market value of $8,000. In addition, Lear paid $26,000 cash for the new truck, which had a list price of $36,000. At what amount should Lear record the new truck for financial accounting purposes?
 a. $26,000.
 b. $33,600.
 c. $34,000.
 d. $36,000.

Use the following information for questions 50 - 52.

Meissner Inc. owns assets to which it applies the revaluation model. The following additional information is available:

- Accumulated Depreciation at December 31, 2011 (prior to any fair value adjustments) was $24,000.
- Between 2010 and December 31, 2011, the property's fair value had increased by $49,000.
- The December 31, 2011 balance in the revaluation surplus account (prior to any fair value adjustments) was $1,000.

50. The *adjusted* 2011 year-end balance in Meissner's accumulated depreciation account will be
 a. $24,000
 b. nil
 c. $23,000
 d. $25,000

51. The *adjusted* 2011 year-end balance in Meissner's revaluation surplus account will be
 a. nil
 b. $49,000
 c. $48,000
 d. $50,000

52. Assume the same facts as indicated above, except that, between 2010 and December 31, 2011, the property's fair value had *decreased* by $10,000. As a result, Meissner's 2011 income statement will include a
 a. $9,000 loss
 b. $9,000 gain (other comprehensive income)
 c. $10,000 loss
 d. $1,000 loss

Use the following information for questions 53 - 55.

Volarex Inc. acquires a new machine. It is comprised of 2 different components (A and B) that are expected to be overhauled at different intervals.
The acquisition costs of the machine are as follows:
Component A: $198,000
Component B: $240,000
Total $438,000
Component A is expected to have a useful life of 5 years and a residual value of $20,000 before the first major overhaul is required. Component B is expected to have a useful life of 7 years and a residual value of $15,000 before its first overhaul.

53. Assuming straight-line depreciation, what will be the net book value of component A after 5 years?
a. $19,000
b. $20,000
c. $55,600
d. nil

54. At the beginning of year 6, component A undergoes a major overhaul at a cost of 100,000. The work is expected to extend its life by 3 years with a residual value of zero. Volarex uses the straight-line method to depreciate this asset. What will be the net book value of component A one year after the overhaul?
a. $66,667
b. $40,000
c. $80,000
d. $120,000

55. Assuming, the double declining balance is used, what will be the net book value of component B at the end of year 1?
a. $205,714
b. $34,286
c. $80,000
d. $171,429

56. Abcor Corporation uses the cost model to account for its PP&E assets. The assets were acquired on January 1, 2010. The following additional information is available:
Acquisition costs: $87,500
2010 Depreciation: $8,750
2011 Depreciation: $8,750

Assuming Abcor did not experience any impairment losses, the 2011 net carrying value of the assets is
a. $87,500
b. $78,750
c. $70,000
d. $68,000

57. In 2004, Miles Company purchased a tract of land as a possible future plant site. In January, 2010, valuable sulphur deposits were discovered on adjoining property and Minton Company immediately began explorations on its property. In December, 2010, after incurring $500,000 in exploration costs that were accumulated in an expense account, Miles discovered sulphur deposits appraised at $2.5 million more than the value of the land. To record the discovery of the deposits, Miles should
    a. make no entry.
    b. debit $500,000 to an asset account.
    c. debit $2,500,000 to an asset account.
    d. debit $3,000,000 to an asset account.

Multiple Choice Answers—Computational

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.
30.	c	*34.	b	*38.	d	42.	a	46.	b	50.	b	54.	c
31.	b	*35.	a	*39.	d	43.	c	47.	d	51.	d	55.	d
32.	d	*36.	d	*40.	c	44.	a	48.	b	52.	a	56.	c
33.	d	*37.	b	41.	b	45.	d	49.	b	53.	b	57.	b

MULTIPLE CHOICE—CPA Adapted

58. On December 1, 2010, Moik Co. purchased a tract of land as a factory site for $500,000. The old building on the property was razed, and salvaged materials resulting from demolition were sold. Additional costs incurred and salvage proceeds realized during December 2010 were as follows:

Cost to raze old building	$25,000
Legal fees for purchase contract and to record ownership	5,000
Property purchase tax	8,000
Proceeds from sale of salvaged materials	4,000

In Moik's December 31, 2010 balance sheet, what amount should be reported as land?
a. $513,000.
b. $521,000.
c. $534,000.
d. $538,000.

59. Land was purchased to be used as the site for the construction of a plant. A building on the property was sold and removed by the buyer so that construction on the plant could begin. The proceeds from the sale of the building should be
a. classified as other income.
b. deducted from the cost of the land.
c. netted against the costs to clear the land and expensed as incurred.
d. netted against the costs to clear the land and amortized over the life of the plant.

*60. A company is constructing an asset for its own use. Construction began in 2010. The asset is being financed entirely with a specific new borrowing. Construction expenditures were made in 2010 and 2011 at the end of each quarter. The total amount of interest cost capitalized in 2011 should be determined by applying the interest rate on the specific new borrowing to the
a. total accumulated expenditures for the asset in 2011 and 2011.
b. average accumulated expenditures for the asset in 2010 and 2011.
c. average expenditures for the asset in 2011.
d. total expenditures for the asset in 2011.

61. Jasper Football Co. had a player contract with Larsen that is recorded in its books at $600,000 on July 1, 2010. Tex Football Co. had a player contract with Muller that is recorded in its books at $750,000 on July 1, 2010. On this date, Jasper traded Larsen to Tex for Muller and paid a cash difference of $75,000. The fair value of the Muller contract was $900,000 on the exchange date. After the exchange, the Muller contract should be recorded in Jasper's books at
a. $675,000.
b. $750,000.
c. $825,000.
d. $900,000.

62. Laroche Co. exchanged similar nonmonetary assets with Karr Co. No cash was exchanged. The carrying amount of the asset surrendered by Laroche exceeded both the fair value of the asset received and Karr's carrying amount of that asset. Laroche should recognize the difference between the carrying amount of the asset it surrendered and
    a. the fair value of the asset it received as a loss.
    b. the fair value of the asset it received as a gain.
    c. Karr's carrying amount of the asset it received as a loss.
    d. Karr's carrying amount of the asset it received as a gain.

63. Modesto City owned an idle parcel of real estate consisting of land and a factory building. Modesto gave title to this realty to Mission Co. as an incentive for Mission to establish manufacturing operations in the city. Mission paid nothing for this realty, which had a fair market value of $250,000 at the date of the grant. Mission should record this nonmonetary transaction as a
    a. memo entry only.
    b. credit to Contribution Revenue for $250,000.
    c. credit to extraordinary income for $250,000.
    d. credit to Donated Capital for $250,000.

64. On September 10, 2010, Linx Co. incurred the following costs for one of its printing presses:

Purchase of stapling attachment	$84,000
Installation of attachment	10,000
Replacement parts for renovation of press	36,000
Labour and overhead in connection with renovation of press	14,000

Neither the attachment nor the renovation increased the estimated useful life of the press. However, the renovation resulted in significantly increased productivity. What amount of the costs should be capitalized?
    a. $0.
    b. $108,000.
    c. $130,000.
    d. $144,000.

65. On January 2, 2010, Bork Corp. replaced its boiler with a more efficient one. The following information was available on that date:

Purchase price of new boiler	$90,000
Carrying amount of old boiler	5,000
Fair value of old boiler	3,000
Installation cost of new boiler	8,000

The old boiler was sold for $3,000. What amount should Ross capitalize as the cost of the new boiler?
    a. $98,000.
    b. $92,000.
    c. $95,000.
    d. $97,000.

Multiple Choice Answers—CPA Adapted

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.
58.	c	*60.	b	62.	a	64.	d
59.	b	61.	a	63.	d	65.	a

DERIVATIONS — Computational

No.	Answer	Derivation
30.	c	\$2,000 × \$55 = \$110,000.
31.	b	\$500,000 + \$20,000 – \$2,700 + \$1,740 + \$1,200 + \$3,200 = \$523,440.
32.	d	\$20,600 + \$1,300 + \$5,220 + \$1,200,000 + \$85,000 = \$1,312,120.
33.	d	Land: \$300,000 + \$25,000 + \$5,000 – \$10,000 = \$320,000. Building: \$35,000 + \$990,000 = \$1,025,000.
*34.	b	(\$75,000 × 4/12) + (\$75,000 × 3/12) + (\$75,000 × 2/12) + (\$75,000 × 1/12) = \$50,000.
*35.	a	\$500,000 × .08 = \$40,000.
*36.	d	\$150,000 × (3/12 + 2/12 + 1/12) = \$75,000.
*37.	b	\$50,000 × (3/12 + 2/12 + 1/12) = \$25,000.
*38.	d	(\$450,000 × 4/12) + (\$252,000 × 3/12) + (\$450,000 × 2/12) + (\$720,000 × 1/12) = \$348,000.
*39.	d	(\$360,000 × 9% × 10/12) + (\$150,000 × 10%) = \$42,000.
*40.	c	(\$360,000 × .09) + (\$75,000 × .10) = \$39,900.
41.	b	Conceptual
42.	a	\$129,000 - \$124,000 = \$5,000
43.	c	(\$20,000 × .85 × .98) + \$250 + \$200 = \$17,110.
44.	a	\$12,000 + \$1,000 = \$13,000.
45.	d	Land: 3/9 × \$765,000 = \$255,000. Warehouse: 2/9 × \$765,000 = \$170,000. Office Building: 4/9 × \$765,000 = \$340,000.
46.	b	\$25,000 + \$800 = \$25,800.
47.	d	\$29,000 – \$25,000 = \$4,000 (gain).
48.	b	Fair market value of new truck = \$27,000. Loss: (\$27,000 – \$22,000) – \$6,000 = \$1,000. New Machine: \$6,000 + \$22,000 – \$1,000 = \$27,000.

DERIVATIONS — Computational (Continued)

No.	Answer	Derivation
49.	b	$7,600 + $26,000 = $33,600.
50.	b	$24,000 - $24,000 = 0
51.	d	$1,000 + $49,000 = $50,000 .
52.	a	$10,000 - $1,000 = $9,000
53.	b	Residual value.
54.	c	$20,000 + $100,000 = $120,000 $120,000 - ($120,000/3) = $80,000
55.	d	$240,000 - [$240,000 x (2 x 1/7)] = $171,429
56.	c	$87,500 - $8,750 - $8,750 = $70,000
57.	b	Discovery value is generally not recognized.

DERIVATIONS — CPA Adapted

No.	Answer	Derivation
58.	c	$500,000 + $25,000 + $5,000 + $8,000 – $4,000 = $534,000.
59.	b	Conceptual.
*60.	b	Conceptual.
61.	a	($900,000 – $75,000) – $600,000 = $225,000 (deferred gain) $900,000 – $225,000 = $675,000 (Basis).
62.	a	Conceptual.
63.	d	Conceptual.
64.	d	$84,000 + $10,000 + $36,000 + $14,000 = $144,000.
65.	a	$90,000 + $8,000 = $98,000.

EXERCISES

Ex. 10-66—Plant asset accounting.

During 2010 and 2011, Elcoro Corporation experienced several transactions involving plant assets. A number of errors were made in recording some of these transactions. For each item listed below, indicate the effect of the error (if any) in the blanks provided by using the following codes:

O = Overstate; U = Understate; NE = No Effect

If no error was made, write NE in each of the four columns.

	2010		2011	
Transaction	Net Book Value of Plant Assets at Dec/31/2010	2010 Net Income	Net Book Value of Plant Assets at Dec/31/2011	2011 Net Income
1. The cost of installing a new computer system in 2010 was not recorded in 2010. It was charged to expense in 2011.	_____	_____	_____	_____
2. In 2011, clerical workers were trained to use the new computer system at a cost of $15,000, which was erroneously capitalized. The cost is to be written off over the expected life of the new computer system.	_____	_____	_____	_____
3. A major overhaul of factory machinery in 2010, which extended its useful life by five years, was charged to accumulated depreciation in 2010.	_____	_____	_____	_____
4. Interest cost qualifying for capitalization in 2010 was charged to interest expense in 2010.	_____	_____	_____	_____
5. In 2010 land was bought for an employee parking lot. The $2,000 title search fee was charged to expense in 2010.	_____	_____	_____	_____
6. The cost of moving several manufacturing facilities from metropolitan locations to suburban areas in 2010 was capitalized. The cost was written off over a 10-year period beginning in 2010.	_____	_____	_____	_____

Solution 10-66

	Net Book Value of Plant Assets at Dec/31/2010	2010 Net Income	Net Book Value of Plant Assets at Dec/31/2011	2011 Net Income
1.	U	O	U	U
2.	NE	NE	O	O
3.	NE	NE	NE	NE
4.	U	U	U	O
5.	U	U	U	NE
6.	NE	NE	NE	NE

*** Ex. 10-67** - Capitalization of Borrowing Costs

In February 2011, Quorum Co. began the construction of a 10 story building. The construction is expected to be completed by January 2012.
During 2011, the following payments were made:
April 1: $1,000,000
June 1: $1,500,000
Aug 1: $900,000
Oct 1: $950,000
No asset specific debt was incurred.

During 2011, Quorum's general debt consisted of the following:
A $2 Mill. 5%. 2-year note
A $1.2 Mill. 4.5% 2-year note
A $0.75 Mill. 3% 5-year note

Instructions

(a) Calculate the weighted average accumulated expenditures for the year ended December 31, 2012.
(b) Calculate the weighted average capitalization rate on Quorum's general-purpose debt for the year ended December 31, 2012.
(c) Calculate the avoidable borrowing costs
(d) Calculate the amount of Quorum's borrowing costs that should be capitalized.

Solution 10-67

(a) weighted average accumulated expenditures for the year ended December 31, 2012.

Date	Amount	Capitalization Period	Weighted Average Accumulated Expenditures
Apr-1	1,000,000	9/12	750,000
Jun-1	1,500,000	7/12	875,000
Aug-1	900,000	5/12	375,000
Oct-1	950,000	3/12	237,500
Total	4,350,000		2,237,500

(b) weighted average capitalization rate on Quorum's general-purpose debt for the year ended December 31, 2012.

Description	Principal	Borrowing Costs
$2 Mill. 5%. 2-year note	2,000,000	100,000
$1.2 Mill. 4.5% 2-year note	1,200,000	54,000
$0.75 Mill. 3% 5-year note	750,000	22,500
Total	3,950,000	176,500

Weighted average rate = $176,500 / $3,950,000 = 4.47%

(c) Avoidable borrowing costs
($2,237,500 - $0) x 4.47% = $100,016

(d) Borrowing costs to be capitalized
$0 + $100,016 = $100,016

***Ex. 10-68**—Capitalization of interest.

On March 1, Marlin Co. began construction of a small building. The following expenditures were incurred for construction:

March 1	$ 75,000	June 1	$300,000
April 1	84,000	July 1	100,000
May 1	180,000		

The building was completed and occupied on July 1. To help pay for construction, $60,000 was borrowed on March 1 on a 10%, three-year note payable. The only other debt outstanding during the year was a $500,000, 8% note issued two years ago.

Instructions

(a) Calculate the weighted-average accumulated expenditures.
(b) Calculate avoidable interest.

Solution 10-68

(a)

Date	Expenditures	Capitalization Period	Weighted-Average Accum. Expend.
March 1	$ 75,000	4/12	$ 25,000
April 1	84,000	3/12	21,000
May 1	180,000	2/12	30,000
June 1	300,000	1/12	25,000
July 1	100,000	0	0
			$101,000

(b)

Weighted-Average Accum. Expend.	Rate	Avoidable Interest
$ 60,000	.10	$6,000
41,000	.08	3,280
$101,000		$9,280

Ex. 10-69 – Application of the revaluation model

Calexa Motels Inc. owns a motel that it had purchased on January 1, 2010 for $3 Mill. The cost applicable to the basic structure of the motel is $1.5 Mill and is accounted for in a separate account, classified as "Structures". The company is using the revaluation model to account for its structures and revalues them annually. Calexa takes straight-line depreciation over the asset's 15-year useful life with no residual value.
The asset's fair values were as follows:
Dec-31-2010: Equal to its book value.
Dec-31-2011: $1,450,000.

Instructions

Assuming Calexa uses the accumulated depreciation account in its revaluation, prepare all required journal entries for 2010 and 2011.

Solution 10-69

Journal Entries - 2010:
January 1:

Structures	1,500,000	
Cash		1,500,000

To account for acquisition

December 31

Depreciation expense	100,000	
Accumulated depreciation - Structures		100,000

To record 2010 depreciation
($1,500,000 - 0)/15 = $100,000

Journal Entries - 2011:
December 31:

Depreciation expense	100,000	
Accumulated depreciation - Structures		100,000

To record 2011 depreciation (prior to revaluation)
($1,500,000 - 0)/15 = $100,000

December 31:

Accumulated depreciation - Structures	200,000	
Structures		200,000

To eliminate accumulated depreciation (as part of the revaluation process)
($100,000 x 2 = $200,000)

December 31:

Structures	150,000	
Revaluation Surplus (OCI)		150,000

To adjust the Structures account to fair value
$1,450,000 - ($1,500,000 - $200,000) = $150,000

Ex. 10-70 - Asset Exchange WITH commercial substance:

In 2011, McLane Company exchanged equipment for two delivery trucks. The equipment had been purchased for $110,000 ten years ago and has since been fully depreciated. While the equipment was recently appraised at $19,000, a reliable valuation for the trucks was not available.

Instructions

Prepare the required entr(ies) to record the exchange.

Solution 10-70

Trucks	19,000	
Accumulated depreciation - Equipment	110,000	
Equipment		110,000
Gain on disposal of equipment		19,000

Ex. 10-71—Donated assets.

Morgan Company has recently decided to accept a proposal from the City of Toronto that publicly owned property with a large warehouse located on it will be donated to Morgan if Morgan will build a branch plant in Toronto. The appraised value of the property is $330,000 and of the warehouse is $825,000.

Instructions

Prepare the entry by Morgan for the receipt of the properties.

Solution 10-71

Building (Warehouse)	825,000	
Land	330,000	
Deferred Revenue		825,000
Donated Capital		330,000

Ex. 10-72 - Measurement Models

Instructions

Identify and briefly describe the three main models to accounting for PP&E assets.

Solution 10-72

The following three models are available and may be used subject to the asset type and whether IFRS or private entity GAAP is used:

1. The cost model

This model can be used for all types of PP&E assets. The assets are depreciated and adjusted for impairment as necessary.

2. The revaluation model

This model can be used for all types of PP&E assets except for investment property. Net increases in fair value are accumulated in a separate account, revaluation surplus, and are not reported in income.

3. The fair value model

This model can only be used for investment property. Assets are not depreciated and all changes in fair value are recognized in net income.

Ex. 10-73 Application of the fair value model

On January 20, 2011, Okanagan Corp. purchased a luxury apartment complex in British Columbia for $10 Mill In addition to the purchase price, Okanagan paid:

Transfer fees $150,000
Legal fees $20,000

To make the complex more attractive to tenants, management decided to remodel the building's foyer at a cost of $350,000.
Wages paid to maintenance staff during each of the three years:
2011: $103,000
2012: $107,000
2013: $110,000
Fair value information:
Dec-31-2011: $9.1 Mill
Dec-31-2012: $10.9 Mill
Dec-31-2013: $11.7 Mill
Other information:
The complex qualifies as investment property.
Okanagan applies the fair value method to all its investment property.

Instructions

Prepare all required journal entries for 2011, 2012 and 2013.

Solution 10-73

Journal Entries - 2011

Investment Property - Apartment Complex	10,170,000	
Cash		10,170,000

To account for acquisition on January 20.
($10,000,000 + $150,000 + $20,000 = $10,170,000)

Wages expense	103,000	
Cash		103,000

To account for wages paid during 2011

Loss in value of investment property	1,070,000	
Investment property - Apartment Complex		1,070,000

To adjust the value of the investment property to fair value at Dec-31-2011
($10,170,000 - $9,100,000 = $1,070,000)

Journal Entries - 2012

Wages expense	107,000	
Cash		107,000

To account for wages paid during 2012

Investment property - Apartment Complex	1,800,000	
Gain in value of investment property		1,800,000

To adjust the value of the investment property to fair value at Dec-31-2012
($10,900,000 - $9,100,000 = $1,800,000)

Journal Entries - 2013

Wages expense	110,000	
Cash		110,000

To account for wages paid during 2013

Investment property - Apartment Complex	800,000	
Gain in value of investment property		800,000

To adjust the value of the investment property to fair value at Dec-31-2013
($11,700,000 - $10,900,000 = $800,000)

Ex. 10-74 – Acquisition Cost
Llepert Corporation purchased property at a cost of $ 54,000 in 2010. Closing costs were $2,800. Land preparation cost of $24,400 was incurred. What amount should be recorded as the cost of the property in 2010?

Solution 10-74

$54,000 + $2,800 + $24,400 = $ 81,200

Ex. 10-75 – Expenditures

Grammate Ltd. is in its third expansion phase. Due to the expansion they incurred the following costs during the fiscal period when they constructed a new factory in its Trinidad Location. What cost should be included in the cost of the new factory?

Direct Labour	70,000
Loan Interest to finance expansion	3,000
Architectural drawings	15,000
Purchase of company car for the new plant manager	44,000
Direct material for factory	81,000
Allocation of overhead based on labour hours worked on Factory	58,000
Imputed interest on lost opportunity costs	9,000

Solution 10-75

Direct Labour	$ 70,000
Loan interest to finance expansion	3,000
Drawings for Factory	15,000
Material purchased for Factory	81,000
Allocation of overhead based on labour hours worked on Factory	58,000
Total	$227,000

Ex. 10-76 – Non-interest bearing note

Topaz Auto purchased several trucks by issuing a $40,000, 4 year, non interest bearing note to Torrent Auto. The market interest rate for this transaction is 8%. Prepare the Journal entry to record the purchase of these trucks.

Solution 10-76

Truck ($40,000 x .0.73503)	$ 29,401	
Notes Payable		$ 29,401

Ex. 10-77 Non- monetary transaction
Matziwin Auto, after several years traded one of its used trailers (cost $40,000, accumulated depreciation $36,000) for another used trailer worth $6,400. Matziwin also pays $600 in the transaction. Prepare the journal entry to record the exchange assuming the transaction lacks commercial substance.

Solution 10-77

Trailer (new)	$ 4,600	
Accumulated Depreciation	36,000	
Trailer (old)		$40,000
Cash		600

NB. This transaction is non monetary because the amount of cash is not significant. Since transaction lacks commercial substance, no gain is recognized.

Ex. 10-78 Asset Exchange

Jameson Inc. traded its fleet of rental cars for a new fleet. Two thirds of the old fleet's original cost of $375,000 had been depreciated. The new fleet is valued at $500,000 and Jameson was required to make a cash payment of $400,000.

Instructions

Prepare the required entr(ies) to record the exchange.

Solution 10-78

Fleet (new)	500,000	
Accumulated depreciation	250,000	
Loss on disposal of fleet	25,000	
Fleet (old)		375,000
Cash		400,000

PROBLEMS

Pr. 10-79 Deferred Payments

Macoon Corporation is a Toronto-based manufacturer of automobile parts. In early January 2011 the company acquired land and a building to be used as the company's new head office. Macoon issued a $2 Mill, five-year non-interest bearing note to the seller. Payment is to be made in five equal installments of $400,000 at the end of each year. As a result of a depressed real estate market, the fair value of the building cannot be readily determined. However, it has been ascertained that, given Macoon's credit rating and market conditions, an interest rate of 9% would properly reflect the substance and credit risk of the negotiated payment schedule.

Other information:

- One third of the total value of the acquisition is attributable to the land.
- The building is expected to have a useful life of 25 years.
- Throughout the year, the company incurred maintenance costs in the amount of $87,000.
- A parking lot was built at a cost of $100,000. The work was completed on July 1 and is expected to have a useful life of 10 years.
- The company uses straight-line depreciation for all its PP&E assets.

Instructions

Prepare all journal entries that are required to record the above events and transactions.

Solution 10-79

Land	518,620	
Building	1,037,240	
Note Payable		1,555,860

To record the acquisition of land and building
$400,000 x 3.88965 = $1,555,860
Land: $1,555,860 x 1/3 = $518,620
Building: $1,555,860 x 2/3 = $1,037,240

Maintenance expense	87,000	
Cash		87,000

To record maintenance costs.

Land improvements - parking lot	100,000	
Cash		100,000

Depreciation expense	46,490	
Accumulated depreciation - building		41,490
Accumulated depreciation - land improvements		5,000

To record annual depreciation
Building: $1,037,240 / 25 = $41,490
Land improvements: ($100,000 / 10) x 6/12 = $5,000

Pr. 10-80 - Fair Value model

In February 2011, Thompson Corp. purchased a vineyard in southern Ontario for $7.5 Mill. This includes legal fees of $18,000 and property taxes of $40,000 (of that amount, $30,000 are in arrears). Based on appraisals, the property's year-end fair values were $8.2 Mill. and $8 Mill for 2011 and 2012 respectively.

Other information:
- The vineyard qualifies as investment property.
- Thompson applies the fair value method to all its investment property.

Instructions
Prepare all required journal entries for 2011 and 2012.

Solution 10-80

<u>Journal Entries - 2011</u>

Investment Property - vineyard	7,490,000	
Cash		7,490,000

To account for acquisition in February 2011.
$7,500,000 - ($40,000 - $30,000) = $7,490,000

Investment property - Apartment Complex	710,000	
Gain in value of investment property		710,000

To adjust the value of the investment property to fair value at Dec-31-2011
($8,200,000 - $7,490,000 = $710,000)

<u>Journal Entries - 2012</u>

Loss in value of investment property	200,000	
Investment property - Vineyard		200,000

To adjust the value of the investment property to fair value at Dec-31-2012
($8,200,000 - $8,000,000 = $200,000)

***Pr. 10-81**—Capitalization of borrowing costs.

During 2010, Checker Building Company constructed various assets at a total cost of $4.2 million. The weighted-average accumulated expenditures on assets qualifying for capitalization of interest during 2010 were $2.8 million. The company had the following debt outstanding at December 31, 2010:

1.	8%, five-year note to finance construction of various assets, dated January 1, 2010, with interest payable annually on January 1	$1,800,000
2.	10%, ten-year bonds issued at par on December 31, 2004, with interest payable annually on December 31	2,000,000
3.	7%, three-year note payable, dated January 1, 2009, with interest payable annually on January 1	1,000,000

Instructions
Calculate the amounts of each of the following (show calculations).
1. Avoidable interest.
2. Total interest to be capitalized during 2010.

Solution 10-81

1.

Weighted-Average Accumulated Expenditures	Applicable Interest Rate	Avoidable Interest	
$1,800,000	.08	$144,000	
1,000,000	.09*	90,000	
$2,800,000		$234,000	= Avoidable Interest

*Calculation of weighted-average interest rate:

	Principal	Interest
10% ten-year bonds	$2,000,000	$200,000
7% three-year note	1,000,000	70,000
	$3,000,000	$270,000

Weighted-average interest rate = $270,000 ÷ $3,000,000 = 9%.

2. Actual interest cost during 2010:

Construction note, $1,800,000 × .08	$144,000
10% ten-year bonds, $2,000,000 × .10	200,000
7% three-year note, $1,000,000 × .07	70,000
	$414,000

The interest cost to be capitalized is $234,000 (the lesser of the $234,000 avoidable interest and the $414,000 actual interest).

***Pr. 10-82**—Capitalization of borrowing costs.

Early in 2010, Obarth Corporation engaged Morse Ltd. to design and construct a complete modernization of Obarth's manufacturing facility. Construction was begun on June 1, 2010 and was completed on December 31, 2010. Obarth made the following payments to Morse Ltd. during 2010:

Date	Payment
June 1, 2010	$3,300,000
August 31, 2010	4,800,000
December 31, 2010	4,000,000

In order to help finance the construction, Obarth issued the following during 2010:

1. $2,000,000 of ten-year, 9% bonds payable, issued at par on May 31, 2010, with interest payable annually on May 31.
2. 1,000,000 no-par common shares, issued at $10 per share on October 1, 2010.

In addition to the 9% bonds payable, the only debt outstanding during 2010 was a $700,000, 12% note payable dated January 1, 2006 and due January 1, 2016, with interest payable annually on January 1.

Instructions

Calculate the amounts of each of the following (show calculations):
1. Weighted-average accumulated expenditures qualifying for capitalization of interest cost.
2. Avoidable interest incurred during 2010.
3. Total amount of interest cost to be capitalized during 2010.

Solution 10-82

1.

Date	Capitalization Expenditures	Period	Weighted-Average Accumulated Expenditures
June 1	$3,300,000	7/12	$1,925,000
August 31	4,800,000	4/12	1,600,000
December 31	4,000,000	0	0
			$3,525,000

2.

Weighted-Average Accumulated Expenditures	Appropriate Interest Rate	Avoidable Interest
$2,000,000	.09	$180,000
1,525,000	.12	183,000
$3,525,000		$363,000

Solution 10-82 (Continued)

3. Actual interest incurred during 2010:

9% bonds payable, $2,000,000 × .09 × 7/12	$105,000
12% note payable, $700,000 × .12	84,000
	$189,000

The interest cost to be capitalized is $189,000 (the lesser of the $363,000 avoidable interest and the $189,000 actual interest cost).

Pr. 10-83—Nonmonetary exchanges.

Schelling Corporation follows a policy of a 10% depreciation charge per year on all machinery and a 5% depreciation charge per year on buildings.

The following transactions occurred in 2010:

March 31, 2010— Negotiations which began in 2009 were completed and a warehouse purchased Jan/1/2001 (Depreciation has been properly charged through December 31, 2009) at a cost of $1.7 million with a fair market value of $1 million was exchanged for a second warehouse which also had a fair market value of $1 million. Both parcels of land on which the warehouses were located were equal in value, and had a fair value equal to book value.

June 30, 2010— Machinery with a cost o/f $120,000 and accumulated depreciation through January 1 of $90,000 was exchanged with $75,000 cash for a parcel of land with a fair market value of $115,000.

Instructions
Prepare all appropriate journal entries for Schelling Corporation for the above dates.

Solution 10-83

Mar/31/2010	Depreciation Expense	21,250	
	Accumulated Depreciation—Warehouse		21,250
	($1,700,000 × 5% × 1/4)		
	Warehouse	913,750	
	Accumulated Depreciation—Warehouse	786,250	
	Warehouse		1,700,000
	($1,700,000 × 5% × 9 1/4 = $786,250)		
Jun/30/2010	Depreciation Expense	6,000	
	Accumulated Depreciation—Machinery		6,000
	($120,000 × 10% × 1/2)		
	Land	115,000	
	Accumulated Depreciation—Machinery	96,000	
	Gain on Exchange		16,000
	Machinery		120,000
	Cash		75,000
	[$40,000 – ($120,000 – $96,000)] = $16,000		

Pr. 10-84 - Revaluation model

Marlowe Inc. owns equipment that it had purchased on January 1, 2011 for $4 Mill.
The following additional information is available:
Dec-31-2011 - Book value (after recording 2011 depreciation): $3,600,000
Dec-31-2011 - Fair value: $4,100,000
The company uses the revaluation model to account for its property, plant and equipment.

Instructions
Assuming the entry for the current year's depreciation has *already* been recorded, prepare the entr(ies) to adjust the asset's carrying amount to fair value.

Solution 10-84

Accumulated depreciation - Equipment	400,000	
Equipment		400,000
To eliminate accumulated depreciation ($4,000,000 / 10 = $400,000)		
Equipment	100,000	
Revaluation Surplus (OCI)		100,000
To adjust the equipment account to fair value $4,100,000 - ($3,600,000 + $400,000) = $100,000		

Pr. 10-85—Nonmonetary exchange.

Beringer Co. has a computer that cost $106,000 on March 20, 2006. This old computer had an estimated life of ten years and a residual value of $6,000. On December 23, 2010, the old computer is exchanged for a similar computer with a market value of $58,000. Beringer also received $6,000 cash. Assume that the last fiscal period ended on December 31, 2009, and that straight-line depreciation is used.

Instructions

(a) Show the calculation of the amount of gain or loss to be recognized by Beringer Co. from the exchange. (Round to the nearest dollar.)

(b) Prepare all entries that are necessary on December 23, 2010.

Solution 10-85

(a)	Cost	$106,000
	Accumulated Depreciation (4 3/4 × $10,000)	(47,500)
	Book value	58,500
	Fair value ($58,000 + $6,000)	64,000
	Gain	$5,500

Cash received does not exceed 10% of $64,000; therefore, none of the gain is recognized.

(b)	Accumulated Depreciation	47,500	
	Computer	52,500	
	Cash	6,000	
	Computer		106,000

Pr. 10-86—Nonmonetary exchange.

Gargoyle Co. exchanged Building 24 which has an appraised value of $1,700,000, a cost of $2,800,000 and accumulated depreciation of $1,300,000 for Building M belonging to Ross Co. Building M has an appraised value of $1,620,000, a cost of $3,100,000, and accumulated Depreciation of $1,750,000. The correct amount of cash was also paid. Assume depreciation has already been updated.

Instructions

Prepare the entries on both companies' books assuming the buildings are similar assets. Show a check of the amount recorded for Building M on Gargoyle's books. (Round to the nearest dollar.)

Solution 10-86

Gargoyle Co.:

Cost	$2,800,000
Accumulated Depreciation	1,300,000
Book value	1,500,000
Fair value	1,700,000
Gain	$ 200,000

No gain is recognized because the cash received is less than 10%.

Accumulated Depreciation	1,300,000	
Building M	1,420,000	
Cash	80,000	
Building 24		2,800,000

(1,700,000 – 1,620,000 = 80,000 cash *received*)

Ross Co.:

Cost	$3,100,000
Accumulated Depreciation	1,750,000
Book value	1,350,000
Fair value	1,620,000
Gain	$ 270,000

Accumulated Depreciation	1,750,000	
Building 24	1,430,000	
Building M		3,100,000
Cash		80,000

(1,700,000 – 1,620,000 = 80,000 cash paid)

Pr. 10-87—Nonmonetary exchange.

Pan Company exchanged machinery with an appraised value of $1,170,000, a recorded cost of $1,800,000 and Accumulated Depreciation of $900,000 with Nile Corporation for machinery Nile owns. The machinery has an appraised value of $1,140,000, a recorded cost of $2,160,000, and Accumulated Depreciation of $1,188,000. Nile also gave Pan $30,000 in the exchange. Assume Depreciation has already been updated.

Instructions

(a) Prepare the entries on both companies' books assuming that it is considered an exchange of dissimilar assets. (Round all calculations to the nearest dollar.)

(b) Prepare the entries on both companies' books assuming that it is considered an exchange of similar assets. (Round all calculations to the nearest dollar.)

Solution 10-87

(a) Dissimilar Assets

Pan

Machinery	1,140,000		Cost	$1,800,000
Cash	30,000		A/D	900,000
Accum. Depreciation—			BV	900,000
Machinery	900,000		FV	1,170,000
Gain on Exchange of			Gain	$ 270,000
Plant Assets		270,000		
Machinery		1,800,000		

Nile

Machinery	1,170,000		Cost	$2,160,000
Accum. Depreciation—			A/D	1,188,000
Machinery	1,188,000		BV	972,000
Gain on Exchange of			FV	1,140,000
Plant Assets		168,000	Gain	$ 168,000
Machinery		2,160,000		
Cash		30,000		

(b) Similar Assets

Pan

Machinery	870,000	
Cash	30,000	
Accumulated Depreciation—Machinery	900,000	
Machinery		1,800,000

Nile

Machinery	1,002,000	
Accumulated Depreciation—Machinery	1,188,000	
Machinery		2,160,000
Cash		30,000

LEGAL NOTICE

CHAPTER 11

DEPRECIATION, IMPAIRMENT, AND DISPOSITION

MULTIPLE CHOICE—Conceptual

Answer	No.	Description
d	1.	Knowledge of depreciation accounting.
b	2.	Conceptual rationale for depreciation accounting.
c	3.	Depreciation and retaining funds.
c	4.	Definition of cash generating unit (CGU)
a	5.	Activity method of Depreciation.
a	6.	Units-of-production method of depreciation.
d	7.	Units-of-production method of depreciation.
d	8.	Knowledge of double declining-balance method.
c	9.	Estimating an asset's useful life.
c	10.	Graphic depiction of straight-line and declining-balance methods.
b	11.	Disadvantage of using straight-line method.
d	12.	PP&E disclosures.
b	13.	Rational entity model.
d	14.	Cost recovery model.
c	15.	Change in estimated life of depreciable asset.
c	16.	Change in depreciation rate.
d	17.	Held for sale assets.
d	18.	Disclosure of depreciation policy.
d	19.	Depreciation and liquidating dividends.
a	20.	Classification of depletion expense.
d	21.	Units-of-production depletion expense.
c	22.	Private entity GAAP – impairment.
d	23.	Asset turnover ratio.
d	24.	Determine loss on sale of depreciable asset.
d	25.	Indicators of asset impairment.
c	*26.	Objectives of CCA method.
d	*27.	Factors to consider in CCA tax depreciation.
c	*28.	Effect of accelerated depreciation on the income statement.
d	29.	Depreciation cessation.
b	30.	IFRS impairment
a	31.	Time based depreciation
b	32.	Depreciation continuation.
a	33.	Productive output method of depreciation

*This topic is dealt with in an Appendix to the chapter.

MULTIPLE CHOICE—Computational

Answer	No.	Description
b	34.	Calculate depreciation using double declining-balance.
c	35.	Calculate depreciation using double declining-balance.
b	36.	Calculate depreciation using double declining-balance.
b	37.	Calculate depreciation using double declining-balance.
b	38.	Depreciation on asset held for sale.
b	39.	Double declining-balance method.
d	40.	Double declining-balance method.
d	41.	Calculate depreciation using straight-line method.
a	42.	Calculate depreciation using double declining-balance.
d	43.	Determine acquisition cost from straight-line depreciation.
a	44.	Determine acquisition cost from activity method.
b	45.	Calculate activity ratio.
d	46.	Determine depreciation expense from change in Accumulated Depreciation account.
b	47.	Determine depreciation expense from change in Accumulated Depreciation account.
d	48.	Componentization of assets
d	49.	Calculate return on assets.
b	50.	Change in estimated life of equipment.
a	51.	Determine depreciation expense after major overhaul.
c	52.	Calculate recoverable amount.
d	53.	Calculate impairment loss.
d	54.	Fair value adjustment on equipment held for sale.
a	55.	Calculate depreciation expense.
c	56.	Calculate units-of-production depletion expense.
a	57.	Calculate impairment under private entity GAAP.
b	58.	Calculate gain for held for sale assets.
b	59.	Calculate gain under involuntary conversion.
d	60.	Calculate depletion expense.
b	61.	Calculate loss on sale of machine.
b	62.	Calculate gain on sale of equipment.
c	*63.	Calculate CCA for the year.
a	64.	Calculate loss on disposal

MULTIPLE CHOICE—CPA Adapted

Answer	No.	Description
b	65.	Calculate depreciation using 150% declining-balance.
b	66.	Double declining-balance method.
c	67.	Determine accumulated depreciation balance using declining-balance.
d	68.	Calculate depreciation expense using declining-balance.
d	69.	Effect of residual value on accumulated depreciation.
b	70.	Effect of including residual value in depreciation base.

MULTIPLE CHOICE—CPA Adapted (Continued)

Answer	No.	Description
c	71.	Effect of decreasing charge methods on sale of asset.
c	72.	Units-of-production depletion expense.
c	73.	Calculate depletion expense for the year.

EXERCISES

Item	Description
E11-74	Definitions.
E11-75	Componentization and Depreciation of PP&E assets
E11-76	True or False.
E11-77	Calculate depreciation.
E11-78	Calculate depreciation.
E11-79	Asset depreciation and disposition.
E11-80	Rational entity impairment model.
E11-81	Asset impairment.

PROBLEMS

Item	Description
P11-82	Fair value impairment.
P11-83	Depreciation methods.
P11-84	Asset overhaul

MULTIPLE CHOICE—Conceptual

1. The following is true of depreciation accounting.
   a. It is not a matter of valuation.
   b. It is part of the matching of revenues and expenses.
   c. It retains funds by reducing income taxes and dividends.
   d. All of these.

2. Which of the following principles best describes the conceptual rationale for the methods of matching depreciation expense with revenues?
   a. Associating cause and effect
   b. Systematic and rational allocation
   c. Immediate recognition
   d. Partial recognition

3. Depreciation accounting
   a. provides funds.
   b. funds replacements.
   c. retains funds.
   d. all of these.

4. Which of the following best describes the concept of cash-generating units (CGU)?
   a. Their cash flows are independent from those of other CGU's.
   b. The individual assets that are included in the CGU do not generate cash flows on their own.
   c. (a) and (b)
   d. Their cash flows are not independent from those of other CGU's

5. The activity method of depreciation
   a. is a variable charge approach.
   b. assumes that depreciation is a function of the passage of time.
   c. conceptually associates cost in terms of input measures.
   d. all of these.

6. For income statement purposes, depreciation is a variable expense if the depreciation method used is
   a. units-of-production.
   b. straight-line.
   c. increasing charge.
   d. declining-balance.

7. If an industrial firm uses the units-of-production method for calculating depreciation on its only plant asset, factory machinery, the credit to accumulated depreciation from period to period during the life of the firm will
   a. be constant.
   b. vary with unit sales.
   c. vary with sales revenue.
   d. vary with production.

8. Use of the double declining-balance method
   a. results in a decreasing charge to depreciation expense.
   b. means residual value is not deducted in calculating the depreciation base.
   c. means the book value should not be reduced below residual value.
   d. all of these.

9. An asset's useful life
   a. remains unchanged once it has been determined.
   b. is the same as its physical life.
   c. is affected by physical and economic factors.
   d. all of these.

10. A graph is set up with "yearly depreciation expense" on the vertical axis and "time" on the horizontal axis. Assuming linear relationships, how would the graphs for straight-line and declining-balance depreciation, respectively, be drawn?
    a. Vertically and sloping down to the right
    b. Vertically and sloping up to the right
    c. Horizontally and sloping down to the right
    d. Horizontally and sloping up to the right

11. A principal objection to the straight-line method of depreciation is that it
    a. provides for the declining productivity of an aging asset.
    b. ignores variations in the rate of asset use.
    c. tends to result in a constant rate of return on a diminishing investment base.
    d. gives smaller periodic write-offs than decreasing charge methods.

12. Disclosures relating to PP&E assets
    a. Are identical under IFRS and private entity GAAP.
    b. Are less extensive under IFRS
    c. Are more extensive under private entity GAAP
    d. Are less extensive under private entity GAAP

13. Which of the following does *not* describe the rational entity model?
    a. It allows the reversal of previously recognized impairment losses
    b. It is the method used in private entity GAAP
    c. It uses discounted cash flows in its determination of impairment
    d. (a) and (c)

14. Which of the following does *not* describe the cost recovery model?
    a. It uses undiscounted cash flows in its determination of impairment
    b. It is the method used in IFRS
    c. It allows the reversal of previously recognized impairment losses
    d. (b) and (c)

15. Hopper Company acquired machinery on January 1, 2005 which it amortized under the straight-line method with an estimated life of fifteen years and no residual value. On January 1, 2010, Hopper estimated that the remaining life of this machinery was six years with no residual value. How should this change be accounted for by Hopper?
    a. As a prior period adjustment
    b. As the cumulative effect of a change in accounting principle in 2010
    c. By setting future annual depreciation equal to one-sixth of the book value on January 1, 2010
    d. By continuing to amortize the machinery over the original fifteen year life

16. Changes in the depreciation rate are accounted for
    a. As a catch-up adjustment to prior periods
    b. As an adjustment to the current period only
    c. As an adjustment to current and future periods
    d. None of the above

17. Long-lived assets that are held for sale
    a. Are not depreciated.
    b. Are reported separately
    c. Must be re-measured at each balance sheet date
    d. All of the above

18. A general description of the depreciation methods applicable to major classes of depreciable assets
    a. is not a current practice in financial reporting.
    b. is not essential to a fair presentation of financial position.
    c. is needed in financial reporting when company policy differs from income tax policy.
    d. should be included in corporate financial statements or notes thereto.

19. Dividends representing a return of capital to shareholders are not uncommon among companies which
    a. use accelerated depreciation methods.
    b. use straight-line depreciation methods.
    c. recognize both functional and physical factors in depreciation.
    d. none of these.

20. Depletion expense
    a. is usually part of cost of goods sold.
    b. includes tangible equipment costs in the depletion base.
    c. excludes intangible development costs from the depletion base.
    d. excludes restoration costs from the depletion base.

21. The most common method of recording depletion for accounting purposes is the
    a. percentage depletion method.
    b. decreasing charge method.
    c. straight-line method.
    d. units-of-production method.

22. Private entity GAAP requires that assets must be assessed for indications of impairment
   a. At the end of each reporting period.
   b. At the end of every quarter.
   c. When events and circumstances indicate that asset's carrying amount may not be recoverable.
   d. Whenever the method of depreciation has changed

23. The asset turnover ratio is calculated by dividing
   a. net income by ending total assets.
   b. net income by average total assets.
   c. net sales by ending total assets.
   d. net sales by average total assets.

24. The sale of a depreciable asset resulting in a loss indicates that the proceeds from the sale were
   a. less than current market value.
   b. greater than cost.
   c. greater than book value.
   d. less than book value.

25. Which of the following is most likely an indicator for possible asset impairment?
   a. Evidence of obsolescence
   b. A significant decrease of the asset's market value
   c. External and internal factors
   d. All of the above

*26. A major objective of capital cost allowance for tax depreciation is to
   a. reduce the amount of depreciation deduction on business firms' tax returns.
   b. assure that the amount of depreciation for tax and book purposes will be the same.
   c. help companies achieve a faster write-off of their capital assets.
   d. require companies to use the actual economic lives of assets in calculating tax depreciation.

*27. Under capital cost allowance, which one of the following is *not* considered in determining depreciation for tax purposes?
   a. Cost of the asset
   b. Class of the asset
   c. Half-year convention
   d. Residual value

*28. If income tax effects are ignored, accelerated depreciation methods
   a. provide funds for the earlier replacement of fixed assets.
   b. increase funds provided by operations.
   c. tend to offset the effect of steadily increasing repair and maintenance costs on the income statement.
   d. tend to decrease the fixed asset turnover ratio.

29. Depreciation should be discontinued when
    a. The asset has been derecognized
    b. The asset is classified as held for sale
    c. The asset has been taken out of service
    d. (a) and (b)
30. International standards require that assets must be assessed for indications of impairment
    a. At the end of every quarter.
    b. At the end of each reporting period.
    c. Only when events and circumstances indicate that asset's carrying amount may not be recoverable.
    d. Whenever the method of depreciation has changed

31. Which of the following is not a time based depreciation method?
    a. Productive output method
    b. Straight line method
    c. Double declining method
    d. Sum of the years digit

32. Depreciation commences or continues when
    a. The asset has been paid for.
    b. The asset is available for use.
    c. The asset's fair value can be recovered
    d. None of the above

33. When the productive output method of depreciation is used, which of the following best describes depreciation expense?
    a. Depreciation expense will vary directly with output
    b. Depreciation rate per unit will vary directly with output
    c. Depreciation rate per unit will vary directly with sales
    d. Depreciation expense will vary directly with sales

Multiple Choice Answers—Conceptual

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.
1.	d	6.	a	11.	b	16.	c	21.	d	*26.	c	31.	a
2.	b	7.	d	12.	d	17.	d	22.	c	*27.	d	32.	b
3.	c	8.	d	13.	b	18.	d	23.	d	*28.	c	33.	a
4.	c	9.	c	14.	d	19.	d	24.	d	29.	d		
5.	a	10.	c	15.	c	20.	a	25.	d	30.	b		

MULTIPLE CHOICE—Computational

34. On July 1, 2010, Jenkins Corporation purchased factory equipment for $300,000. Residual value was estimated to be $8,000. The equipment will be amortized over ten years using the double declining-balance method. Counting the year of acquisition as one-half year, Blenko should record depreciation expense for 2011 on this equipment of
    a. $60,000.
    b. $54,000.
    c. $52,560.
    d. $48,000.

35. Marlowe Corporation purchased factory equipment that was installed and put into service January 2, 2010, at a total cost of $110,000. Residual value was estimated at $6,000. The equipment is being amortized over four years using the double declining-balance method. For the year 2011, Marsh should record depreciation expense on this equipment of
    a. $21,000.
    b. $55,000.
    c. $27,500.
    d. $48,000.

36. On April 13, 2010, Kiefer Co. purchased machinery for $240,000. Residual value was estimated to be $10,000. The machinery will be amortized over ten years using the double declining-balance method. If depreciation is calculated on the basis of the nearest full month, Foley should record depreciation expense for 2011 on this machinery of
    a. $41,600.
    b. $40,800.
    c. $41,100.
    d. $41,866.

37. Moldowa Co. purchased machinery that was installed and ready for use on January 3, 2010, at a total cost of $115,000. Residual value was estimated at $15,000. The machinery will be amortized over five years using the double declining-balance method. For the year 2011, Vincent should record depreciation expense on this machinery of
    a. $24,000.
    b. $27,600.
    c. $30,000.
    d. $46,000.

38. Kierov Inc. purchased a building for $800,000 on January 1, 2000. At the time of acquisition, the building had an estimated residual value of $300,000 and an estimated useful life of twenty years. The company has recorded monthly depreciation using the straight-line method. On January 1, 2010, it is decided to put the building up for sale at the price of $1,200,000. At December 31, 2010, the building is still for sale. The correct depreciation to record for 2010 is
    a. $25,000.
    b. nil.
    c. $40,000.
    d. $60,000.

39. A plant asset has a cost of $48,000 and a residual value of $12,000. The asset has a three-year life. If depreciation in the second year amounted to $4,000, which depreciation method was used?
    a. Straight-line
    b. Double declining-balance
    c. Activity method
    d. Cannot tell from information given

40. On January 1, 2010, Mirage Company purchased a new machine for $1,400,000. The new machine has an estimated useful life of nine years and the residual value was estimated to be $50,000. Depreciation was calculated on the double declining-balance method. What amount should be shown in Storey's balance sheet at December 31, 2011, net of accumulated depreciation, for this machine?
    a. $1,100,000
    b. $890,000
    c. $855,556
    d. $846,914

41. On January 1, 2003, Selkirk Company purchased equipment at a cost of $80,000. The equipment was estimated to have a residual value of $8,000 and it is being amortized over eight years under the straight-line method. What should be the charge for depreciation of this equipment for the year ended December 31, 2010?
    a. $2,000
    b. $2,222
    c. $4,000
    d. $9,000

42. On September 19, 2010, Nara Co. purchased machinery for $285,000. Residual value was estimated to be $15,000. The machinery will be amortized over eight years using the double declining-balance method. If depreciation is calculated on the basis of the nearest full month, Trane should record depreciation expense for 2011 on this machinery of
    a. $66,797.
    b. $65,313.
    c. $53,125.
    d. $52,500.

43. On January 3, 2010, Pankor Co. purchased machinery. The machinery has an estimated useful life of nine years and an estimated residual value of $45,000. The depreciation applicable to this machinery was $77,000 for 2012, calculated by the straight-line method. The acquisition cost of the machinery was
    a. $693,000.
    b. $685,000.
    c. $738,000.
    d. $710,000.

44. On January 2, 2010, Pepper Company acquired equipment to be used in its manufacturing operations. The equipment has an estimated useful life of ten years, an estimated residual value of $22,000, and was estimated to be used 42,000 hours. The depreciation applicable to this equipment was $104,000 for 2012, calculated under the activities method after the machine was used for 5,000 hours. What was the acquisition cost of the equipment?
    a. $872,400
    b. $895,600
    c. $873,600
    d. $815,000

45. In 2010 K-Pac Company had net revenues, average total assets and net income of $90,000, $12,000 and $50,000 respectively. K-Pac's activity ratio for 2010 was
    a. 4.2
    b. 7.5
    c. 3.8
    d. 7

46. On January 1, 2010, the Accumulated depreciation—Machinery account of a particular company showed a balance of $760,000 At the end of 2010, after the adjusting entries were posted, it showed a balance of $820,000. During 2010, one of the machines which cost $240,000 was sold for $118,000 cash. This resulted in a loss of $7,000. Assuming that no other assets were disposed of during the year, how much was depreciation expense for 2010?
    a. $180,000
    b. $189,000
    c. $182,000
    d. $175,000

47. During 2010, Sayer Co. sold equipment that had cost $206,000 for $127,600. This resulted in a gain of $9,600. The balance in Accumulated depreciation—Equipment was $660,000 on January 1, 2010, and $630,000 on December 31. No other equipment was disposed of during 2010. Depreciation expense for 2010 was
    a. $20,000
    b. $58,000
    c. $59,600
    d. $101,000

48. Consider an asset that was separated into its main components (A, B and C). The $1,200,000 purchase price was allocated to these components in equal proportions. The useful lifes are 12, 4, and 7 years for components A, B and C respectively. Neither of the components (except for component C for which a $18,000 value is anticipated) is expected to have a residual value. Assuming straight-line depreciation, total annual depreciation expense relating to these assets is
    a. $125,120
    b. $190,476
    c. $100,000
    d. $187,905

49. In 2010 Banko Corporation's financial statements included the following information:
Net income: $19,000
Sales: $98,000
Total assets - beginning of the year: $85,000
Total assets - end of the year: $112,000
Inventory: $70,000
Banko's return on assets (ROA) for 2010 was
a. 17.2%
b. 21.0%
c. 0.99
d. 19.3%

50. Portland Corporation purchased a machine on July 1, 2007, for $250,000. The machine was estimated to have a useful life of 10 years with an estimated residual value of $14,000. During 2010, it became apparent that the machine would become uneconomical after December 31, 2014, and that the machine would have no scrap value. Accumulated depreciation on this machine as of December 31, 2009, was $59,000. What should be the charge for depreciation in 2010 under current GAAP?
a. $35,400
b. $38,200
c. $41,000
d. $47,750

51. Garrison Company purchased a tooling machine on January 3, 2003 for $600,000. The machine was being amortized on the straight-line method over an estimated useful life of ten years, with no residual value. At the beginning of 2010, the company paid $150,000 to overhaul the machine. As a result of this improvement, the company estimated that the useful life of the machine would be extended an additional five years (15 years total). What should be the depreciation expense recorded for the machine in 2010?
a. $41,250
b. $50,000
c. $60,000
d. $66,000

52. Perkola, a public Corporation, owns the following equipment:
Carrying amount: $80,000
Value in use: $68,000
Fair value less selling costs: $72,000
The recoverable amount to be used in the determination of impairment is
a. $80,000
b. $68,000
c. $72,000
d. None of the above

53. Magenta Company, a public corporation owns equipment for which the following year-end information is available:
Carrying amount: $59,000
Recoverable amount: $52,000
Which of the following best describes the proper accounting treatment for Magenta's equipment?
a. It is *not* impaired and a loss should not be recognized
b. It *is* impaired, a loss must be recognized, but may be reversed in future periods.
c. It is impaired and a loss must be recognized
d. (b) and (c)

54. Goldman Corp. has a piece of equipment held for sale with a carrying value of $100,000. Previously it had been written down from a carrying value of $180,000 when the decision to sell had been made. At December 31, 2010, it is estimated that the fair value less disposition costs is $140,000. Goldman should recognize as at December 31, 2010 a recovery (gain) of
a, $47,000
b. $30,000
c. $27,500
d. nil.

55. Consider an asset for which the following information is available:

Carrying value at Dec-31-2010 prior to depreciation:	$9,000
Calculated depreciation for 2010:	$2,400
Original cost:	$24,000
Residual value:	$8,500
Remaining useful life:	3 years

Depreciation expense for 2010 is
a. $500
b. $2,400
c. $3,000
d. $3,100

56. In January, 2010, Korro Corporation purchased a mineral mine for $5.1 million with removable ore estimated by geological surveys at 2 million tons. The property has an estimated value of $300,000 after the ore has been extracted. The company incurred $1.5 million of development costs preparing the mine for production. During 2010, 500,000 tons were removed and 400,000 tons were sold. What is the amount of depletion that Pratt should *expense* for 2010?
a. $960,000
b. $1,200,000
c. $1,260,000
d. $1,680,000

57. Consider an impairment loss at a company that uses private entity GAAP. The required year-end journal entry includes
    a. A Debit to loss on impairment and a Credit to Accumulated impairment losses.
    b. A Debit to other comprehensive income and a Credit to Accumulated impairment losses.
    c. A Debit to loss on impairment and a Credit to the affected asset.
    d. A Debit to other comprehensive income and a Credit to the affected asset.

58. Consider an asset that is classified as held for sale for which the following information is available:
    Accumulated Depreciation (at March 1, 2010): 24,300
    Asset: $50,000
    If the asset was sold on April 1, 2011 for $27,600, there would be
    a. A loss of $1,900
    b. A gain of $1,900
    c. A loss from discontinued operations
    d. An extraordinary loss

59. Consider a company's asset that was expropriated by government authorities. The following additional information is available:
    Net-book value at the time of expropriation: $1,200,000
    Cash received: $3,000,000
    Under current Canadian GAAP, this situation would be reflected in the company's financial statements as follows:
    a. As an extraordinary gain of $1.8 Mill.
    b. As a $1.8 Mill. gain from expropriation of assets
    c. As a $1.8 Mill. gain from discontinued operations.
    d. As a $1.8 Mill. gain that would be included in other comprehensive income.

60. In 2010, CopperCo Corporation purchased a mine for $200 million ($30 million were applicable to the land). An independent evaluation estimated the mine's reserves at 7.5 million tons.
    In 2010, CopperCo extracted 0.9 million tons.
    The company's depletion expense for 2010 is:
    a. $24 Mill.
    b. $0.2 Mill.
    c. $18 Mill.
    d. $20.4 Mill.

61. Moritz Company purchased a new machine on May 1, 2001 for $132,000. At the time of acquisition, the machine was estimated to have a useful life of ten years and an estimated residual value of $6,000. The company has recorded monthly depreciation using the straight-line method. On March 1, 2010, the machine was sold for $18,000. What should be the loss recognized from the sale of the machine?
    a. $0
    b. $2,700
    c. $6,000
    d. $8,700

62. On January 1, 2002, Buccaro Corporation purchased for $76,000, equipment having a useful life of ten years and an estimated residual value of $4,000. Flynn has recorded monthly depreciation of the equipment on the straight-line method. On December 31, 2010, the equipment was sold for $14,000. As a result of this sale, Flynn should recognize a gain of
a. $0.
b. $2,800.
c. $6,800.
d. $14,000.

*63. On January 1, 2010, Olds Company purchased a machine costing $250,000. The machine is an asset class for tax purposes with a CCA rate of 30%. It has an estimated $40,000 residual value at the end of its economic life. Assuming the company uses the capital cost allowance method, the amount of CCA deduction for tax purposes for the year 2010 is
a. $40,000.
b. $75,000
c. $37,500.
d. $35,000.

64. On June 1, 2009 Morgan manufacturer acquired a machine for $100,000 with an estimated useful life of 5 years and an estimated residual value of $10,000. The company uses the double declining method of depreciation and takes a full year's depreciation in the year of acquisition and none in the year of disposition. If the machine was disposed of for $16,000 on May 1, 2011, what amount should the loss to be recognized on disposal be?
a. $20,000
b. $26,400
c. $13,800
d. $24,000

Multiple Choice Answers—Computational

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.
34.	b	39.	b	44.	a	49.	d	54.	d	59.	b	64.	a
35.	c	40.	d	45.	b	50.	b	55.	a	60.	d		
36.	b	41.	d	46.	d	51.	a	56.	c	61.	b		
37.	b	42.	a	47.	b	52.	c	57.	a	62.	b		
38.	b	43.	c	48.	d	53.	d	58.	b	63.	c		

MULTIPLE CHOICE—CPA Adapted

65. Maltese Co. purchased a machine on July 1, 2010, for $750,000. The machine has an estimated useful life of five years and a residual value of $100,000. The machine is being amortized from the date of acquisition by the double declining-balance method. For the year ended December 31, 2010, Maltese should record depreciation expense on this machine of
    a. $100,000.
    b. $150,000.
    c. $300,000.
    d. $250,000.

66. A machine with an eight-year estimated useful life and an estimated ten percent residual value was acquired on January 1, 2008. The depreciation expense for 2010 using the double declining-balance method would be original cost multiplied by
    a. 90% × 25% × 25%.
    b. 75% × 75% × 25%.
    c. 90% × 75% × 25%.
    d. 25% × 25%.

67. On April 1, 2008, Caleko Co. purchased new machinery for $400,000. The machinery has an estimated useful life of five years, a residual value of $20,000, and depreciation is calculated by the declining-balance method. The accumulated depreciation on this machinery at March 31, 2010, should be
    a. $102,500.
    b. $131,200.
    c. $141,600.
    d. $182,400.

68. Chavin Co. takes a full year's depreciation expense in the year of an asset's acquisition and no depreciation expense in the year of disposition. Data relating to one of Chavin's tangible capital assets at December 31,2009 are as follows:

Acquisition year	2007
Cost	$280,000
Residual value	40,000
Accumulated depreciation	219,520
Estimated useful life	5 years

Using the same depreciation method as used in 2007, 2008, and 2009, how much Depreciation expense should Irvin record in 2010 for this asset?
    a. $48,000
    b. $56,000
    c. $32,000
    d. $20,480

69. An item of property, plant, and equipment has an estimated 15% residual value. At the end of its estimated useful life, the accumulated depreciation would equal the original cost of the asset under which of the following depreciation methods?

	Straight-line	Productive Output
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

70. Net income is understated if, in the first year, estimated residual value is excluded from the depreciation calculation when using the

	Straight-line Method	Production or Use Method
a.	Yes	No
b.	Yes	Yes
c.	No	No
d.	No	Yes

71. A plant asset with a five-year estimated useful life and no residual value is sold at the end of the second year of its useful life. How would using the declining-balance method of depreciation instead of the straight-line method of depreciation affect a gain or loss on the sale of the plant asset?

	Gain	Loss
a.	Decrease	Decrease
b.	Decrease	Increase
c.	Increase	Decrease
d.	Increase	Increase

72. Palmere Company acquired a tract of land containing an extractable natural resource. Lane is required by the purchase contract to restore the land to a condition suitable for recreational use after it has extracted the natural resource. Geological surveys estimate that the recoverable reserves will be 6.2 million tons, and that the land will have a value of $1.2 million after restoration. Relevant cost information follows:

Land	$8,000,000
Estimated restoration costs	2,100,000

If Palmere maintains no inventories of extracted material, what should be the charge to depletion expense per ton of extracted material?

a. $1.32
b. $1.00
c. $1.44
d. $1.63

73. In January 2010, Taroque Mining Corporation purchased a mineral mine for $4.2 million with removable ore estimated by geological surveys at 3 million tons. The property has an estimated value of $400,000 after the ore has been extracted. Taroque incurred $1,150,000 of development costs preparing the property for the extraction of ore. During 2010, 340,000 tons were removed and 300,000 tons were sold. For the year ended December 31, 2010, Taroque should include what amount of depletion in its cost of goods sold?
a. $430,667
b. $380,000
c. $495,000
d. $561,000

Multiple Choice Answers—CPA Adapted

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.
65.	b	67.	c	69.	d	71.	c	73.	c
66.	b	68.	d	70.	b	72.	c		

DERIVATIONS — Computational

No.	Answer	Derivation
34	b	[$300,000 – ($300,000 × 0.1)] × 0.2 = $54,000.
35.	c	[$110,000 × (1 – 0.5)] × 0.5 = $27,500.
36.	b	[$240,000 – ($240,000 × 0.2 × 0.75)] × 0.2 = $40,800.
37.	b	[$115,000 – ($115,000 × 0.4)] × 0.4 = $27,600.
38	b	nil (no depreciation on property held for sale)
39.	b	$48,000 × 2/3 = $32,000; ($48,000 - $32,000) × 2/3 = $10,667 but need $4,000 to arrive at residual value of $12,000.
40.	d	$1,400,000 × 2/9 = $311,111; ($1,400,000 - $311,111) × 2/9 = $241,975 $1,400,000 – ($311,111 + $241,975) = $846,914.
41.	d	($80,000 – $8,000) × 1/8 = $9,000.
42.	a	($285,000 × 2/8 × 3/12) = $17,813; ($285,000 - $17,813) × 2/8 = $66,797.
43.	c	AC = ($77,000 × 9) + $45,000 = $738,000
44.	a	AC = ($84,000 ÷ $4,800 × $40,000) + $18,000 = $718,000.
45.	b	$90,000/$12,000 = 7.5
46.	d	($820,000 – $760,000) + [$240,000 – ($118,000 + $7,000)] = $175,000.
47.	b	$630,000 – {$660,000 – [$206,000 – ($127,600 – $9,600)]} = $58,000.
48.	d	$1,200,000/3 = $400,000 (400,000/12) + (400,000/4) + (400,000-18,000)/7 = $187,905
49.	d	$19,000/[(85,000 + 112,000)/2] = 19.3%
50.	b	($250,000 – $59,000) ÷ 5 = $38,200.
51.	a	[($600,000 ÷ 10) × 7] – $150,000 = $270,000 new (AD) $600,000 – $270,000 = $330,000; $330,000 ÷ 8 = $41,250 per year.
52.	c	.
53.	d	

DERIVATIONS — Computational (Continued)

No.	Answer	Derivation
54.	d	
55.	a	\$9,000 - \$8,500 = \$500
56.	c	[(\$5,100,000 – \$300,000 + \$1,500,000) ÷ 2,000,000] × 400,000 = \$1,260,000.
57.	a	
58.	b	\$27,600 – (\$50,000 - \$24,300) = \$1,900
59.	b	\$3,000,000 - \$1,200,000 = \$1,800,000
60.	d	[(\$200 - \$30) ÷ 7.5] x 0.9 = \$20.4
61.	b	(\$132,000 – \$6,000) ÷ (10 × 12) = \$1,050 per month \$18,000 – [\$132,000 – (\$1,050 × 106 mo.)] = –2,700.
62.	b	(\$76,000 – \$4,000) ÷ (10 × 12) = \$600/mo.; \$14,000 – [\$76,000 – (\$600 × 108)] = \$2,800.
*63.	c	\$250,000 × 30% × .5 = \$37,.500
64.	a	\$100,000 x2/5= 40,000 \$40,000+ \$24,000=\$64,000 The carrying value is \$100,000-\$64,000= \$36,000 The loss on disposal is \$36,000-\$16,000=\$20,000

DERIVATIONS — CPA Adapted

No.	Answer	Derivation
65.	b	750,000 x 0.4 x 0.5 = 150,000
66.	b	Conceptual.
67.	c	(400,000 x 1/5 x 9/12) = 60,000 (400,000 - 60,000) x 1/5 = 68,000 (400,000 - 60,000 - 68,000) x 1/5 x 3/12 = 13,600 $60,000 + $68,000 + $13,600 = $141,600
68.	d	$280,000 × .6 × .6 × .6 = $60,480. $60,480 – $40,000 = $20,480.
69.	d	Conceptual.
70.	b	Conceptual.
71.	c	Conceptual.
72.	c	(8,000,000 + 2,100,000 - 1,200,000) / 6,200,000 = $1.44
73.	c	[($4,200,000 – $400,000 + $1,150,000) ÷ 3,000,000] × 300,000 = $495,000.

EXERCISES

Ex. 11-74—Definitions.

Provide clear, concise answers for the following.

1. Define depreciation.

2. Define depreciation accounting.

3. Does depreciation accounting provide funds? If not, what does provide funds? What does depreciation accounting do related to funds?

Solution 11-74

1. Depreciation is the decline in service potentials or in future benefits of a plant asset due to physical or economic factors.

2. Depreciation accounting is the systematic and rational allocation of the cost of plant assets to the periods benefited from the use of the assets.

3. Depreciation accounting does not provide funds. Revenues provide funds. Depreciation accounting retains funds by reducing income taxes and dividends.

Ex. 11-75 - Componentization and Depreciation of PP&E assets.

You are the accountant for a manufacturing company. You have just been advised of the acquisition of a new machine. You have received a memo which only gives you the following information:

Grinding Equipment
Model: XZ-1-1000
Cost: $1,250,000

Instructions
To be able to account for this asset, state and briefly describe what additional information you require.

Solution 11-75
The information should include details on the machines:
- Components
- Depreciable amount
- Depreciation period
- Usage pattern

The machine may include different parts that may have different usage and maintenance patterns. If so, and if these parts are significant, they should be accounted for separately, so these patterns can be captured in the depreciation process. The depreciable amount will likely not be identical to the given cost of $1,250,000 and will have to be adjusted for residual value(s) if any. The depreciation period will be affected by the date that the machine is installed and ready for use. Finally, the usage pattern will drive the decision of depreciation method (straight-line, decreasing charge, activity based)

Ex. 11-76—True or False.

Place T or F in front of each of the following statements.

1. The choice of depreciation method is specified in GAAP and does not require the use of professional judgment.

2. Depreciation is the process of allocating the cost of assets in a manner that is consistent with the desired effect on income.

3. Changes in the depreciation rate due to changes in the estimate of the asset's useful life are accounted for in the current and future periods.

4. Gains and losses from the disposal of property, plant and equipment are always reported as part of other comprehensive income.

5. The term "recoverable amount" with respect to a capital asset's impairment has the *same* definition under private entity GAAP and IFRS.

6. Once a loss has been recognized, IFRS prohibits the subsequent reversal of that loss.

7. Only assets with cash flows that are independent from those of other assets are included in a cash-generating unit (CGU).

8. The asset's residual value is deducted in the calculation of depreciation expense under the straight-line method.

9. An asset that has been depreciated to its residual value can continue to be depreciated until it has reached a net book value of zero.

Solution 11-76

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.
1.	F	3.	T	5.	F	7.	T	9.	F
2.	F	4.	F	6.	F	8.	T		

Ex. 11-77—Calculate depreciation.

A machine which cost $400,000 is acquired on October 1, 2010. Its estimated residual value is $40,000 and its expected life is eight years. The company has a calendar year end. The asset is a Class 8 asset with a maximum CCA rate of 20%.

Instructions
Calculate depreciation expense for 2010 and 2011 by each of the following methods, showing the figures used.
(a) Double declining-balance
(b) Capital cost allowance

Solution 11-77

(a) 2010: 25% × $400,000 × 3/12 = $25,000

2011: 25% × $375,000 = $93,750

(b) 2010: 20% × $400,000 × 1/2 = $40,000

2011: 20% × $360,000 = $72,000

Ex. 11-78—Calculate depreciation.

A machine cost $500,000 on April 1, 2010. Its estimated residual value is $50,000 and its expected life is eight years. The asset is a Class 8 asset with a maximum CCA rate of 20%.

Instructions
Calculate the depreciation expense (to the nearest dollar) by each of the following methods, showing the figures used.

(a) Straight-line for 2010

(b) Double declining-balance for 2011

(c) Capital cost allowance for 2011

Solution 11-78

(a) 1/8 × $450,000 × 9/12 = $42,188

(b) 2010: 25% × $500,000 × 9/12 = $93,750
2011: 25% × $406,250 = $101,562

(c) 2010: 20% × $500,000 × 1/2 = $50,000
2011: 20% × $450,000 = $90,000

Ex. 11-79—Asset depreciation and disposition.

Answer each of the following questions.

1. A plant asset purchased for $180,000 has an estimated life of ten years and a residual value of $14,000. Depreciation for the *second year of use*, determined by the declining-balance method at twice the straight-line rate is $_____________.

2. A plant asset purchased for $30,000 at the beginning of the year has an estimated life of five years and a residual value of $3,000. It is expected to be driven 210,000 kilometres. Depreciation for the *second year,* determined by the activities method is $______________. The asset was driven 45,000 kilometres.

3. A plant asset with a cost of $43,000 and accumulated depreciation of $12,000, is given together with cash of $16,000 in exchange for a similar asset worth $44,000. The gain or loss recognized on the disposal (indicate by "G" or "L" is $______________.

4. A plant asset with a cost of $72,000, estimated life of five years, and residual value of $12,000, is amortized by the straight-line method. This asset is sold for $50,000 at the end of the *second year of use*. The gain or loss on the disposal (indicate by "G" or "L") is $___________.

Solution 11-79

1. $28,800
2. $5,786
3. $3,000 L
4. $2,000 G

Ex. 11-80 - Rational Entity Impairment Model

Jessup Corporation's balance sheet includes the following asset:

Equipment	$95,000
Less: Accumulated depreciation:	(25,000)
Carrying amount	$70,000

After performing its annual review for impairment, Jessup obtains the following data:

Asset value in use:	$58,000
Fair value less selling costs:	$62,000

Instructions

Assuming Jessup uses the rational entity impairment model,
1. Calculate the recoverable amount.
2. Calculate the impairment loss.
3. Prepare the entry to record the impairment loss

Solution 11-80

1. Recoverable amount

The recoverable amount is the higher of the asset's value in use of $58,000 and its fair value less selling costs of $62,000. Thus, the recoverable amount is $62,000.

2. Impairment loss:

Carrying amount	$70,000
Recoverable amount	$62,000
Impairment loss	$8,000

3. Journal entry:

Loss on impairment	8,000	
Accumulated impairment loss		8,000

Ex. 11-81 - Impairment

Assume the same information as in Ex. 11-80 above, except for the following:

Jessup's review for impairment indicates the following:

Asset value in use:	$64,000
Fair value less selling costs:	$73,000

Instructions

1. Calculate the recoverable amount
2. Calculate the impairment loss.

Solution 11-81

1. Recoverable amount

The recoverable amount is the higher of the asset's value in use of $64,000 and its fair value less selling costs of $73,000. Thus, the recoverable amount is $73,000.

2. Impairment loss:

Carrying amount	$70,000
Recoverable amount	$73,000
Impairment loss	n/a

Because the recoverable amount is higher that the asset's carrying amount, an impairment loss has not occurred.

PROBLEMS

Pr. 11-82 - Cost Recovery Impairment Model

Resora Corporation is a manufacturer of automobile parts. Its capital assets include specialized equipment that is being used in the finishing stage of its manufacturing process.

The equipment was purchased in 2010 and is depreciated using the activity method. By December 2011, the net book value was $430,000. That same year Resora became aware of new technology that would make the equipment obsolete within the next 5 years. An appraisal puts the equipment's future undiscounted net cash flows and fair value at $390,000 and $300,000 respectively. While considering its options for the eventual replacement, Resora will continue using the equipment, but will change the method of depreciation to straight-line.

Instructions

Assuming Resora is a private Canadian company,

(a) Prepare the journal entry, if any, to record the impairment loss at December 31, 2011.

(b) Prepare the journal entries to record 2012 and 2013 depreciation.

Solution 11-82

(a)

Loss on impairment	130,000	
Accumulated impairment losses..................................		130,000

(Carrying value $430,000 - Fair value $300,000 = $130,000 impairment loss)

(b)

2012 Depreciation:

Depreciation expense..	60,000	
Accumulated depreciation-equipment		60,000

($300,000 / 5 years = $60,000)

2013 Depreciation:

Depreciation expense..	60,000	
Accumulated depreciation-equipment		60,000

($300,000 / 5 years = $60,000)

Pr. 11-83—Depreciation methods.

On July 2, 2010, Vermont Company purchased for $720,000 snow-making equipment having an estimated useful life of six years with an estimated residual value of $30,000. Depreciation is taken for the portion of the year the asset is used. The asset is a Class 8 asset with a maximum CCA rate of 20%.

Instructions

(a) Complete the form below by determining the depreciation expense and year-end book values for 2010 and 2011 using the
1. capital cost allowance method.
2. double declining-balance method.

Capital Cost Allowance Method	2010	2011
Equipment	$720,000	$720,000
Less: Accumulated depreciation	______	_______
Year-End Book Value	______	_______
Depreciation Expense for the Year	______	_______
Double Declining-Balance Method		
Equipment	$720,000	$720,000
Less: Accumulated depreciation	______	_______
Year-End Book Value	______	_______
Depreciation Expense for the Year	______	_______

Assume the company had used straight-line depreciation during 2010 and 2011. During 2012, the company determined that the equipment would be useful to the company for only one more year beyond 2012. Residual value is estimated at $40,000. Calculate the amount of depreciation expense for the 2012 income statement.

Solution 11-83

(a)

Capital Cost Allowance Method	2010	2011
Accumulated depreciation	$ 72,000	$201,600
Book Value	648,000	518,400
Depreciation Expense	72,000	129,600
Double Declining-Balance Method		
Accumulated depreciation	$120,000	$320,000
Book Value	600,000	400,000
Depreciation Expense	120,000	200,000

(b)

Cost	$720,000
Depreciation	(172,500)
Residual	(40,000)
	$507,500 × 1/2 = $253,750, 2012 Depreciation

Pr. 11-84 - Expenditures for asset overhaul

Schmidt Corporation is an international provider of freight services that follows international GAAP. Its fleet of vehicles includes a truck that is carried in its books as "VC1-016". It was acquired two years ago at a cost of $150,000 and has since been depreciated on a straight-line basis. By December 31, 2010 it had a net book value of $97,000

As part of its commitment to safety and as required by its insurer, the company has a policy to overhaul its trucks after every 50,000 km's. The associated costs of the overhauls are tracked in separate accounts.
At December 31, 2010 the balances for VC1-016 are as follows:

<u>Overhauls # 1 - 5:</u>	
Accumulated Depreciation:	$0
<u>Overhaul # 6:</u>	
Cost :	$20,000
Less:	
Accumulated Depreciation:	($16,400)
Net book value	$3,600

On January 1, 2011, after the driver had reported problems with the truck's engine, a decision was made to do an early overhaul (i.e. 9,000 km prior to the next scheduled overhaul). The overhaul was completed on January 7, 2011 at a cost of $28,000.

Because of a slowdown in the economy, the truck only operated for 21,000 km for the remainder of 2011.

Instructions
Prepare the appropriate journal entries for 2011 relating to the truck's overhaul.

Solution 11-84

Truck overhaul (VC1-016 #7)	28,000	
Cash		28,000

To account for costs of January 2011 overhaul.

Accumulated Depreciation (VC1-016 #6)	16,400	
Loss on Overhaul	3,600	
Truck overhaul (VC1-016 #6)		20,000

To remove costs relating to previous overhaul and recognize loss.

Depreciation expense - Overhauls	11,760	
Accumulated Depreciation (VC1-016 #7)		11,760

To recognize 2011 depreciation expense for current overhaul.
$28,000 / 50,000 km x 21,000 km = $11,760

LEGAL NOTICE

CHAPTER 12

GOODWILL AND OTHER INTANGIBLE ASSETS

MULTIPLE CHOICE—Conceptual

Answer	No.	Description
b	1.	Identification of intangible assets.
d	2.	Impairment test.
c	3.	Amortization of intangible assets.
b	4.	Amortization methods for intangible assets.
d	5.	Accounting for a change in amortization rate.
d	6.	Patent amortization.
c	7.	Patent amortization.
d	8.	Legal fees associated with trademark infringement.
a	9.	Accounting for internally developed trademark.
d	10.	Accounting for leasehold improvements.
c	11.	Accounting for limited life franchises or licenses.
a	12.	Goodwill impairment – Private Entity GAAP.
c	13.	Goodwill impairment – IFRS.
c	14.	Reversal of goodwill impairment.
a	15.	Recording goodwill.
b	16.	Post-acquisition accounting for intangibles – Private Entity GAAP.
b	17.	Definition of negative goodwill.
d	18.	Post acquisition treatment of goodwill.
a	19.	Treatment of a goodwill impairment.
c	20.	Post-acquisition accounting for intangibles – IFRS.
d	21.	Characteristics of intangibles assets.
d	22.	Recognition of internally developed intangibles.
b	23.	Amortization of laboratory building used in R & D.
a	24.	Capitalization of certain R & D costs.
b	25.	Accounting for computer software costs.
d	*26.	Methods of measuring goodwill.
a	27.	Goodwill
c	28.	Capitalization of pre-opening costs.
a	29.	Amortization Method
b	30.	Goodwill Impairment
c	31.	Goodwill Impairment

MULTIPLE CHOICE—Computational

Answer	No.	Description
a	32.	Calculate total intangible assets.
b	33.	Determine amount of worthless patent to be written off.

MULTIPLE CHOICE—Computational (cont.)

Answer	No.	Description
d	34.	Calculate trademark amortization.
a	35.	Calculate goodwill.
b	36.	Calculate goodwill.
d	37.	Calculate goodwill.
c	38.	Exchange of similar intangible assets.
d	39.	Proper accounting when fair value of net assets acquired exceeds cost.
c	40.	Calculate R & D expense.
b	41.	Calculate R & D expense.
a	42.	Calculate R & D expense.
c	*43.	Calculate goodwill by capitalizing excess earnings.
c	*44.	Calculate goodwill by capitalizing excess earnings.
b	*45.	Calculate goodwill by capitalizing excess earnings.
c	*46.	Calculate goodwill by capitalizing excess earnings. (Interest tables needed.)
d	47.	Amortization of computer software costs.

* This topic is dealt with in an Appendix to the chapter.

MULTIPLE CHOICE—CPA Adapted

Answer	No.	Description
c	48.	Determine capitalized patent costs.
b	49.	Valuation of patent exchanged for an investment in shares.
c	50.	Valuation of patent exchanged for common shares.
b	51.	Valuation and amortization of a trademark.
b	52.	Amortization of a patent.
a	53.	Amortization of a trademark.
c	54.	Capitalization of legal fees.
d	55.	Capitalization of goodwill.
b	56.	Calculate R & D expense.

EXERCISES

Item	Description
E12-57	Definitions.
E12-58	Terminology.
E12-59	Intangible assets theory
E12-60	Alternative treatments of goodwill after recognition.
E12-61	Criteria for development cost capitalization.
E12-62	Carrying value of patent.
E12-63	Acquisition of tangible and intangible assets.
*E12-64	Calculation of goodwill. (Interest tables needed.)
*E12-65	Goodwill calculation.
*E12-66	Goodwill.
*E12-67	Calculation of goodwill.

PROBLEMS

Item	Description
P12-68	Intangible assets.
P12-69	Journal entries for impairment of intangible assets

MULTIPLE CHOICE—Conceptual

1. Which of the following is *not* an intangible asset?
   a. Trade name
   b. Long-term investment in bonds
   c. Franchise
   d. Organization costs

2. Which of the following is the impairment test for indefinite-life intangibles?
   a. Recoverability test and then fair value test
   b. Fair value test and then recoverability test
   c Recoverability test
   d. Fair value test

3. Which of the following intangible assets should *not* be amortized?
   a. Copyrights
   b. Organization costs with limited life
   c. Goodwill
   d. All of these intangible assets should be amortized.

4. Which of the following methods of amortization is normally used for intangible assets?
   a. Capital cost allowance
   b. Straight-line
   c. Activity method
   d. Double declining-balance

5. A change in the amortization rate for an intangible asset should be accounted for as a
   a. change in accounting principle.
   b. change in reporting entity.
   c. correction of an error.
   d. change in accounting estimate.

6. The cost of purchasing patent rights for a product that might otherwise have seriously competed with one of the purchaser's patented products should be
   a. charged off in the current period.
   b. amortized over the legal life of the purchased patent.
   c. added to factory overhead and allocated to production of the purchaser's product.
   d. amortized over the remaining estimated life of the original patent covering the product whose market would have been impaired by competition from the newly patented product.

7. Santo Corporation was granted a patent on a product on January 1, 2010. To protect its patent, the corporation purchased on January 1, 2009 a patent on a competing product which was originally issued on January 10, 2005. Because of its unique plan, Santo Corporation does not feel the competing patent can be used in producing a product. The cost of the competing patent should be
   a. amortized over a maximum period of 20 years.
   b. amortized over a maximum period of 16 years.
   c. amortized over a maximum period of 11 years.
   d. expensed in 2009.

8. Wriglee, Ltd. went to court this year and successfully defended the brand name of its product, "Sweet Gum," from infringement by a competitor. The cost of this defence should be charged to
   a. patents and amortized over the legal life of the patent.
   b. legal fees and amortized over five years or less.
   c. expenses of the period.
   d. trademarks and amortized over the same period of time as the "Sweet Gum" trademark.

9. If a trademark is developed by the enterprise itself, the costs should be
   a. capitalized if future benefits are reasonably assured.
   b. capitalized.
   c. expensed.
   d. expensed if future benefits are reasonably assured.

10. Costs of leasehold improvements may be accounted for as
    1. property, plant, and equipment.
    2. intangible assets.
    3. other assets.

   a. 1
   b. 2
   c. 3
   d. 1 or 2

11. A franchise or licence with a limited life is
   a. expensed.
   b. not amortized.
   c. amortized over the lesser of its legal or useful life.
   d. amortized over its legal life.

12. Which of the following statements *best* describes when goodwill should be tested for impairment under Private Entity GAAP?
    a. Goodwill should be tested for impairment when events or changes in circumstances indicate that impairment may have occurred.
    b. Goodwill should be tested annually for impairment regardless of the circumstances.
    c. Goodwill should be tested for impairment annually *and* whenever events or changes in circumstance indicate that impairment may have occurred.
    d. Goodwill should only be tested for impairment when the company follows a policy to amortize its goodwill.

13. Which of the following statements *best* describes when goodwill should be tested for impairment under IFRS?
    a. Goodwill should be tested for impairment when events or changes in circumstance indicate that impairment may have occurred.
    b. Goodwill should be tested annually for impairment regardless of the circumstances.
    c. Goodwill should be tested for impairment annually *and* whenever events or changes in circumstance indicate that impairment may have occurred.
    d. Goodwill should only be tested for impairment when the company follows a policy to amortize its goodwill.

14. Which of the following statements *best* describes when previously recognized goodwill impairment may be reversed?
    a. Reversals are permitted under both Private Entity GAAP and IFRS.
    b. Reversals are permitted under Private Entity GAAP but are *not* allowed under IFRS
    c. Reversals are *not* permitted under either standard.
    d. None of these

15. The intangible asset goodwill may be
    a. capitalized only when purchased.
    b. capitalized either when purchased or created internally.
    c. capitalized only when created internally.
    d. written off directly to retained earnings.

16. Which of the following statements *best* describes the accounting for intangible assets *after* acquisition under Private Entity GAAP?
    a. They may be accounted for under the cost model *or* the revaluation model.
    b. They should be accounted for under the cost model.
    c. They should be accounted for under the revaluation model.
    d. None of these.

17. Negative goodwill arises when
    a. the book value of identifiable net assets acquired exceeds the purchase price.
    b. the fair value of identifiable net assets acquired exceeds the purchase price.
    c. the fair value of identifiable net assets acquired is less than the purchase price.
    d. the fair value of identifiable net assets acquired exceeds the book value.

18. Purchased goodwill should be
    a. written off as soon as possible against retained earnings.
    b. written off as soon as possible as an extraordinary item.
    c. written off by systematic charges as a regular operating expense over the period benefited, but not more than 40 years.
    d. not written off but rather reduced only if impairment occurs.

19. Goodwill was purchased when a business was acquired. When an impairment to the goodwill is determined, the credit is usually made to
    a. the Goodwill account.
    b. an Accumulated Amortization account.
    c. a Deferred Credit account.
    d. a shareholders' equity account.

20. Which of the following statements *best* describes the accounting for intangible assets *after* acquisition under IFRS?
    a. They may be accounted for under the cost model *or* the revaluation model.
    b. They should be accounted for under the cost model.
    c. They should be accounted for under the revaluation model if an active market exists for the asset.
    d. None of these

21. Which of the following is *not* a characteristic of intangible assets?
    Intangible assets must be
    a. Individually identifiable
    b. Non-monetary in nature
    c. Non-physical in nature
    d. Identifiable as part of the business as a whole

22. When determining whether an internally developed intangible asset should be recognized, the process of generating the intangible is usually broken down into the following parts:
    a. The research and financing element.
    b. The acquisition and disposal stages.
    c. The exploitation and disposal stages.
    d. The research and development phase.

23. If a company constructs a laboratory building to be used as a research and development facility, the cost of the laboratory building is matched against earnings as
    a. research and development expense in the period(s) of construction.
    b. amortization deducted as part of research and development costs.
    c. amortization or immediate write-off, depending on company policy.
    d. an expense at such time as productive research and development has been obtained from the facility.

24. Which of the following research and development related costs should be capitalized and amortized over current and future periods?
    a. Research and development general laboratory building which can be put to alternative uses in the future
    b. Inventory used for a specific research project
    c. Administrative salaries allocated to research and development
    d. Research findings purchased from another company to aid a particular research project currently in process

25. The proper accounting for the costs incurred in creating computer software products that are to be sold, leased, or otherwise marketed to external parties, is to
    a. capitalize all costs until the software is sold to external parties.
    b. charge research and development expense when incurred until technological feasibility has been established for the product.
    c. charge research and development expense only if the computer software has alternative future uses.
    d. capitalize all costs as incurred until a detailed program design or working model is created.

*26. Which of the following is *not* a method of calculating goodwill?
    a. Capitalize excess earnings
    b. Discount the excess earnings for a limited number of years
    c. Capitalize total average earnings and subtract the fair value of net assets
    d. All of these are methods of calculating goodwill.

27. If the fair value of the net asset acquired is greater than the purchase price the amount is:
    a. negative goodwill
    b. contributed surplus
    c. purchased goodwill
    d. organizational costs

28. Which of the following statements *best* describes the accounting treatment for pre-opening costs for new businesses?
    a. They should always be capitalized.
    b. They should always be expensed.
    c. Certain cost, such as mail order catalogues, may be capitalized under Private Entity GAAP.
    d. Certain cost, such as mail order catalogues, may be capitalized under IFRS.

29. Which of the following is an appropriate method to determine when the development stage is over for an enterprise in the development stage?
    a. b, c, and d
    b. When significant revenue has been earned.
    c. After a specific date.
    d. When a specific level of sales has been reached.

30. Under private-entity GAAP, to determine if there is an impairment loss:
a. Compare the fair value of the identifiable assets to the book value of the assets
b. Compare the fair value of the reporting unit against the carrying value of the reporting unit
c. Compare the imputed current fair value of goodwill with the carrying value of goodwill
d. Compare the imputed carrying value of the assets with the fair value of the assets

31. Under IFRS, to determine if there is an impairment loss:
a. Compare the fair value of the identifiable assets to the book value of the assets
b. Compare the fair value of the reporting unit against the carrying value of the reporting unit
c. Compare the imputed current fair value of goodwill with the carrying value of goodwill
d. Compare the carrying amount of the CGU with the recoverable amount

Multiple Choice Answers—Conceptual

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.
1.	b	5.	d	9.	a	13.	c	17.	b	21.	d	25.	b	29.	a
2.	d	6.	d	10.	d	14.	c	18.	d	22.	d	*26.	d	30.	b
3.	c	7.	c	11.	c	15.	a	19.	a	23.	b	27.	a	31.	c
4.	b	8.	d	12.	a	16.	b	20.	c	24.	a	28.	c		

MULTIPLE CHOICE—Computational

32. The general ledger of Babcock Corporation as of December 31, 2010, includes the following accounts:

Copyrights	$ 25,000
Deposits with advertising agency (will be used to promote goodwill)	16,000
Discount on bonds payable	36,350
Excess of cost over fair value of identifiable net assets of acquired subsidiary	289,000
Trademarks	51,000

In the preparation of Babcock's balance sheet as of December 31, 2010, what should be reported as total intangible assets, excluding goodwill?

a. $76,000.
b. $365,000.
c. $381,000.
d. $401,350.

33. In January, 2005, Targa Corporation purchased a patent for a new consumer product for $900,000. At the time of purchase, the patent was valid for fifteen years. Due to the competitive nature of the product, however, the patent was estimated to have a useful life of only ten years. During 2010 the product was permanently removed from the market under governmental order because of a potential health hazard present in the product. What amount should Targa recognize as an impairment during 2010, assuming amortization is recorded at the end of each year?

a. $600,000.
b. $450,000.
c. $90,000.
d. $60,000.

34. On January 2, 2010, Lear Co. bought a trademark from Parker, Inc. for $300,000. An independent research company estimated that the remaining useful life of the trademark was 30 years. Its unamortized cost on Parker's books was $275,000. Because the asset had a demonstrated limited life beyond 20 years, Lear decided to amortize the trademark over the maximum period. In Lear's 2010 income statement, what amount should be reported as amortization expense?

a. $15,000.
b. $12,000.
c. nil.
d. $10,000

Use the following information for questions 35 to 37

Jeremiah Inc. is being targeted for acquisition by Argo Corporation. As an analyst for Argo, you are asked to determine the goodwill that, pending various assumptions, may be inherent in this potential transaction.
The available information relating to Jeremiah includes the following:
Current net assets: $5.1 million.
Expected return on net asset for industry: 10%
Reported net income for the previous six consecutive years:

Year	Amount	Year	Amount
2005	$710,000	2008	$745,000
2006	$680,000	2009	$815,000
2007	$980,000	2010	$835,000

The earnings for 2007 included a $200,000 gain from the sale of a discontinued part of its business.

35. Estimated goodwill by capitalizing average excess earnings at 14% is
    a. $1,791,667
    b. $760,833
    c. $2,029,762
    d. $1,654,331

36. Assuming that excess earnings are expected to continue for 8 years, and ignoring the time value of money, estimated goodwill is
    a. $2,273,000
    b. $2,006,667
    c. $1,854,333
    d. $1,531,733

37. Assuming that excess earnings are expected to continue for 8 years, and average excess earnings are discounted at 11%, estimated goodwill is (use interest table)
    a. $1,784,331
    b. $1,661,432
    c. $1,462,356
    d. $1,290,818

38. Monarch Football Company had a player contract with Sidka that was recorded in its accounting records at $2.9 million. Markos Football Company had a player contract with Leber that was recorded in its accounting records at $2.8 million. Monarch traded Sidka to Markos for Leber by exchanging each player's contract. The fair value of each contract was $3 million. What amount should be shown in the accounting records after the exchange of player contracts?

	Monarch	Markos
a.	$2,800,000	$2,800,000
b.	$2,800,000	$2,900,000
c.	$2,900,000	$2,800,000
d.	$3,000,000	$3,000,000

39. During 2010, Kurz Company purchased the net assets of Sims Corporation for $635,000. On the date of the transaction, Sims had *no* long-term investments in marketable securities and had $200,000 of liabilities. The fair value of Sims' assets, when acquired were as follows:

Current assets	$ 360,000
Noncurrent assets	840,000
	$1,200,000

How should the $365,000 difference between the fair value of the net assets acquired ($1 million) and the cost ($635,000) be accounted for by Kurz?

a. The $365,000 difference should be credited to retained earnings.
b. The noncurrent assets should be recorded at $475,000.
c. The current assets should be recorded at $250,500 and the noncurrent assets should be recorded at $584,500.
d. It is not possible to answer this question until the components of the assets are known.

40. In 2010, Lawrence Corporation incurred development costs as follows:

Materials and supplies	$120,000
Personnel	130,000
Indirect costs—allocated	160,000
	$410,000

These costs relate to a product that it expects to market in 2011. It is estimated that these costs will be recouped by December 31, 2013. What is the amount of development costs that could be deferred in 2010, assuming that required conditions for capitalization are met?

a. $160,000.
b. $250,000.
c. $410,000.
d. $0.

41. Huber Co. incurred research and development costs in 2010 as follows:

Materials used in research and development projects	$ 325,000
Equipment acquired that will have alternate uses in future research and development projects	2,800,000
Amortization for 2010 on above equipment	315,000
Personnel costs of persons involved in research and development projects	630,000
Consulting fees paid to outsiders for research and development projects	110,000
Indirect costs reasonably allocable to research and development projects	200,000
	$4,380,000

The amount of research and development costs charged to Huber's 2010 income statement or deferred as development costs should be

a. $3,750,000.
b. $1,580,000.
c. $950,000.
d. $3,435,000

42. Decker Inc. incurred the following costs during the year ended December 31, 2010:

Laboratory research aimed at discovery of new knowledge	$120,000
Design of new products involving new technology	43,500
Testing of new products	29,000
Construction of research and development facilities	180,000

The total amount to be classified as development costs in 2010 is

a. $72,500.
b. $120,000.
c. $300,000
d. $163,500

*43. The owners of Dallas' Electronics Store are contemplating selling the business to new interests. The cumulative earnings for the past 5 years amounted to $900,000 including extraordinary gains of $30,000. The annual earnings based on an average rate of return on investment for this industry would have been $138,000. If excess earnings are to be capitalized at 15%, then implied goodwill should be

a. $210,000.
b. $280,000.
c. $240,000.
d. $870,000.

Use the following information for questions 44 to 46

Jessup Corp. will acquire a controlling stake in the outstanding shares of Parasol Inc. for $9.2 million in cash.

44. Assuming the fair value of Parasol's net-assets is $10.2 million, and Jessup acquired a 75% share, goodwill can be calculated as
    a. $1,243,000
    b. $1,000,000
    c. $1,550,000
    d. $750,000

45. Assuming the fair value of Parasol's net-assets is $12.5 million, and Jessup acquired a 75% share, goodwill can be calculated as
    a. $175,000
    b. $175,000 negative
    c. $375,000
    d. nil

46. Parasol's average annual net income is $75,000 above the average for Parasol's industry. Assuming Jessup estimates goodwill by capitalizing excess earnings at 14%, the estimate of goodwill is
    a. nil
    b. $1,050,000
    c. $535,714
    d. $954,333

47. Mouse Software Company has capitalized computer software costs of $3.6 million related to its spreadsheet product. The software is expected to have a four-year economic life and generate future revenues of $25 million. Revenues generated by this software during 2010 (first year) amounted to $7.5 million. The proper amount of software costs amortized to be recognized by Mouse in 2010 should be
    a. $900,000.
    b. $3,600,000.
    c. $2,812,000.
    d. $1,080,000.

Multiple Choice Answers—Computational

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.
32.	a	35.	a	38.	c	41.	b	*44.	c	47.	d
33.	b	36.	b	39.	d	42.	a	*45.	b		
34.	d	37.	d	40.	c	*43.	c	*46.	c		

MULTIPLE CHOICE—CPA Adapted

48. Beasley Corp. incurred $160,000 of basic research and $50,000 of development costs to develop a product for which a patent was granted on January 2, 2005. Legal fees and other costs associated with registration of the patent totalled $60,000. On March 31, 2010, Beasley paid $90,000 for legal fees in a successful defence of the patent. The total amount capitalized for the patent through March 31, 2010 should be
    a. $360,000.
    b. $270,000.
    c. $200,000.
    d. $150,000.

49. On June 30, 2010, Rock, Ltd. exchanged 3,000 of Shale Corp. no par value common shares for a patent owned by Iller Co. The Shale shares were acquired in 2008 at a cost of $80,000. At the exchange date, Shale common shares have a fair value of $45 per share, and the patent had a net carrying value of $160,000 on Iller's books. Rock should record the patent at
    a. $160,000.
    b. $135,000.
    c. $90,000.
    d. $80,000.

50. On May 5, 2010, Mulder Corp. exchanged 5,000 of its common shares for a patent owned by Drucker Co. At May 5, 2010, Mulder's common shares were quoted at $28 per share, and the patent had a carrying value of $130,000 on Drucker's books. Mulder should record the patent at
    a. $130,000.
    b. $110,000.
    c. $140,000.
    d. $120,000.

51. Drip Co. bought a trademark from Gregg Corp. on January 1, 2010, for $163,000. An independent consultant retained by Drip estimated that the remaining useful life is 50 years. Its unamortized cost on Gregg's accounting records was $61,000. Drip decided to write off the trademark over the maximum period allowed. How much should be amortized for the year ended December 31, 2010?
    a. $1,220.
    b. $3,260.
    c. $2,333.
    d. $2,700.

52. On January 2, 2007, Mortensen, Ltd. purchased a patent for a new consumer product for $90,000. At the time of purchase, the patent was valid for 15 years; however, the patent's useful life was estimated to be only 10 years due to the competitive nature of the product. On December 31, 2010, the product was permanently withdrawn from sale under governmental order because of a potential health hazard in the product. What amount should Mortensen charge against income during 2010, assuming amortization is recorded at the end of each year?
   a. $72,000.
   b. $63,000.
   c. $54,000.
   d. $9,000.

53. On January 1, 2006, Robson Company purchased a trademark for $400,000, having an estimated useful life of 16 years. In January 2010, Robson paid $60,000 for legal fees in a successful defence of the trademark. Trademark amortization expense for the year ended December 31, 2010, should be
   a. $30,000.
   b. $28,750.
   c. $25,000.
   d. $0.

54. Which of the following legal fees should be capitalized?

	Legal fees to obtain a franchise	Legal fees to successfully defend a trademark
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

55. Which of the following costs of goodwill should be capitalized?

	Costs of goodwill from a business combination accounted for as a purchase	Costs of developing goodwill internally
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

56. During 2010, Procta Co. incurred the following costs:

Testing in search for process alternatives	$360,000
Routine design of tools, jigs, molds, and dies	250,000
Modification of the formulation of a process	610,000
Development services performed by Meek Corp. for Procta	325,000

In 2010, Procta Co. has development costs of

a. $1,545,000.
b. $1,295,000.
c. $935,000.
d. $610,000.

Multiple Choice Answers—CPA Adapted

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.
48.	c	50.	c	52.	b	54.	c	56.	b		
49.	b	51.	b	53.	a	55.	d				

DERIVATIONS — Computational

No.	Answer	Derivation
32.	a	\$25,000 + \$51,000 = \$76,000
33.	b	(\$900,000 ÷ 10) × 5 = \$450,000.
34.	d	\$300,000 / 30 = \$10,000
35.	a	\$710,000 + \$680,000 + \$980,000 + \$745,000 + \$815,000 + \$835,000 = \$4,765,000 [(\$4,765,000 – \$200,000) ÷ 6] – (\$5,100,000 × .10) = \$250,833 \$250,833 ÷ .14 = \$1,791,667
36.	b	\$250,833 x 8 = \$2,006,667
37.	d	\$250,833 x PVF-OA8,11% = \$250,833 x 5.14612 = \$1,290,818
38.	c	Monarch: \$3,000,000 – \$100,000 (deferred gain) = \$2,900,000. Markos: \$3,000,000 – \$200,000 (deferred gain) = \$2,800,000.
39.	d	Negative goodwill must reduce, on a pro-rata basis, amounts that would be assigned to assets acquired other than cash and cash equivalents, trade receivables, inventory, financial assets carried at fair value, assets to be disposed of by sale, assets of a discontinued operation, and future tax assets.
40.	c	\$410,000 could be deferred in 2010.
41.	b	\$4,380,000 - \$2,800,000 = \$1,580,000
42.	a	\$43,500 + \$29,000 = \$72,500
*43.	c	$\left(\frac{\$900,000 - \$30,000}{5}\right) - \$138,000 = \$36,000.$ $\frac{\$36,000}{.15} = \$240,000.$
*44.	c	\$9,200,000 - (75% x \$10,200,000) = \$1,550,000
*45.	b	\$9,200,000 - (75% x \$12,500,000) = \$175,000 negative
*46.	c	\$75,000 / 0.14 = \$535,714.

DERIVATIONS — Computational (Continued)

No.	Answer	Derivation
47.	d	Greater of $\frac{\$7,500,000}{\$25,000,000} \times \$3,600,000 = \$1,080,000$ or $3,600,000 ÷ 4 = $900,000.

DERIVATIONS — CPA Adapted

No.	Answer	Derivation
48.	c	$60,000 + $90,000 + $50,000 = $200,000.
49.	b	$3,000 × $45 = $135,000.
50.	c	5,000 x $28 = $140,000
51.	b	$163,000 / 50 = $3,260
52.	b	$90,000 – [($90,000 ÷ 10) × 3] = $63,000.
53.	a	($400,000 – [($400,000 ÷ 16) × 4] = $300,000 ($300,000 + $60,000) ÷ 12 = $30,000.
54.	c	Conceptual.
55.	d	Conceptual.
56.	b	$360,000 + $610,000 + $325,000 = $1,295,000.

EXERCISES

Ex. 12-57 - Definitions.

Provide clear, concise answers for the following.

1. What are intangible assets?
2. How are research costs accounted for?
3. How are development costs accounted for?
4. What are the two models that are used to measure intangible assets after initial acquisition?
5. What are the factors that should be considered when determining the useful life of limited life intangible assets?
6. What are the major categories of intangible assets?
7. What are the two models that are used to account for the impairment of intangible assets?

Solution 12-57

1. Intangible assets are assets that are individually identifiable, have a non-physical existence and are non-monetary in nature.

2. Research costs do not, by definition, meet the criteria for recognition as an asset. As a result, they must be recognized as expenses when they are incurred.

3. Development costs may be recognized as intangible assets, provided that future economic benefits can be demonstrated. That demonstration includes the satisfaction of six specific conditions.

4. The models are the cost model and the revaluation model.

5. The factors to be considered are the expected use of the asset, legal or regulatory provisions, potential obsolescence and the expected expenditures for its maintenance.

6. The major categories are marketing-related, customer-related, artistic-related, contract-based and technology-based intangible assets.

7. The two models are the cost recovery impairment model and the rational entity impairment model. The first is used for Private Entity GAAP and the latter is used in IFRS.

Ex. 12-58 - Terminology.

In the space provided at right, write the word or phrase that is defined or indicated.

1. An intangible asset that is not individually Identifiable. 1. ________________
2. When identifiable net assets are acquired at a price that is below their fair value. 2. ________________
3. A lease that includes terms that are more favourable than the current market terms for a comparable lease. 3. ________________
4. The phase of the process of generating an intangible asset during which *new* knowledge is obtained. 4. ________________
5. The phase of the process of generating an intangible asset during which previously obtained knowledge is translated into a plan. 5. ________________
6. A database with demographical and other information for a list of customers. 6. ________________
7. A right that is granted for the life of the creator plus fifty years. 7. ________________

Solution 12-58

1. Goodwill
2. Negative goodwill or bargain purchase
3. A favourable lease
4. Research phase
5. Development phase
6. Customer-related intangible assets
7. Copyright

Ex. 12-59—Intangible assets theory.

It has been argued on the grounds of conservatism that all intangible assets should be written off immediately after acquisition. Discuss the accounting arguments against this treatment.

Solution 12-59

Intangible assets may have future revenue producing ability as do tangible assets. The costs, therefore, should be capitalized, deferred, and matched as nearly as possible against those revenues. Intangible assets, like tangible assets, should be written off over their useful life.

Ex. 12-60—Alternative treatments of goodwill after recognition.

Once goodwill has been recognized in the accounts there has been much disagreement over how it should be treated in subsequent periods. Discuss the alternative treatment approaches.

Solution 12-60

a. Charge goodwill off immediately to shareholders' equity. Goodwill is not an asset that is separable from the business itself and therefore should not be recognized as a separate asset. In addition, immediate expensing would be consistent with the expensing of costs of internally generated goodwill. As well, there is no rational method to amortize goodwill, due to the many uncertainties involved; therefore, financial statements will be more reliable if it is expensed.

b. Amortize goodwill over its useful life. Goodwill at the time of purchase erodes in value over time and therefore it should be charged to income over the estimated period in which it is expected to benefit the business.

c. Retain goodwill indefinitely unless impairment occurs. Current and future expenses help to maintain existing goodwill; therefore, it can have an indefinite life. Amortization of goodwill is entirely arbitrary and leads to distortions of net income.

Ex. 12-61— Criteria for development cost capitalization.

List the criteria that must be met before development costs of a project may be capitalized.

Solution 12-61

i. Technical feasibility of completing the intangible asset
ii. The entity's intention to complete it for use or sale
iii. The entity's ability to use or sell it
iv. Availability of technical, financial, and other resources needed to complete it, and to use or sell it
v. The way in which the future economic benefits will be received; including the existence of a market for the asset if it will be sold, or its usefulness to the entity if it will be used internally
vi. The ability to reliably measure the costs associated with and attributed to the intangible asset during its development

Ex. 12-62—Carrying value of patent.

Bauer Co. purchased a patent from Morgan Co. for $60,000 on July 1, 2007. Expenditures of $11,000 for successful litigation in defence of the patent were paid on July 1, 2010. Bauer estimates that the useful life of the patent will be 15 years from the date of acquisition.

Instructions
Prepare a calculation of the carrying value of the patent at December 31, 2010.

Solution 12-62

Cost of patent	$60,000
Amortization 7/1/07 to 7/1/10 [($60,000 ÷ 15) × 3]	(12,000)
Carrying value at 7/1/10	48,000
Cost of successful defence	11,000
Carrying value	59,000
Amortization 7/1/10 to 12/31/10 [$59,000 × 1/(15 – 3) × 1/2]	(2,458)
Carrying value at 12/31/10	$56,542

Ex. 12-63—Acquisition of tangible and intangible assets.

Carswell Manufacturing Company decided to expand further by purchasing Fisher Company. The balance sheet of Fisher Company as of December 31, 2010 was as follows:

Fisher Company
Balance Sheet
December 31, 2010

Assets		Equities	
Cash	$ 210,000	Accounts payable	$ 325,000
Receivables	450,000	Common shares	800,000
Inventory	275,000	Retained earnings	835,000
Plant assets (net)	1,025,000		
Total assets	$1,960,000	Total equities	$1,960,000

An appraisal, agreed to by the parties, indicated that the fair market value of the inventory was $320,000 and that the fair market value of the plant assets was $1,225,000. The fair market value of the receivables is equal to the amount reported on the balance sheet. The agreed purchase price was $3 million, and this amount was paid in cash to the previous owners of Fisher Company.

Instructions
Determine the amount of goodwill (if any) implied in the purchase price of $3 million. Show calculations.

Solution 12-63

Purchase price		$3,000,000
Less tangible net assets acquired:		
Book value	$1,635,000	
Appraisal increment—inventory	45,000	
Appraisal increment—plant assets	200,000	
Total fair market value of tangible net assets acquired		1,880,000
Goodwill		$1,120,000

***Ex. 12-64**—Calculation of goodwill. (Interest tables needed.)

Haddock Co. expects excess earnings of $48,000 for each of the next eight years. Assume half of the excess is earned at the end of each six months. Calculate the estimated goodwill if it is based on the present value of excess earnings discounted at 10%, compounded semi-annually.

***Solution 12-64**

Present value of $24,000 for 16 periods at 5%; 10.83777 × $24,000 = $260,106.

***Ex. 12-65**—Goodwill calculation.

The net assets of Taylor, Ltd., excluding goodwill, have a total fair market value of $4 million and earnings for the last five years total $2.2 million. Included in the latter figure are nonrecurring gains and losses of $200,000 and $140,000 respectively, as well as sales commissions of $25,000. A 10% return on identifiable net assets is considered normal for the industry and annual excess earnings are to be capitalized at 16% in arriving at goodwill in developing a sales price for the business.

Instructions
Calculate the company's goodwill (label all calculations).

***Solution 12-65**

Goodwill is $175,000.

Earnings for 5 years	$2,200,000
Less nonrecurring gains	200,000
	2,000,000
Add nonrecurring losses	140,000
Adjusted 5-year total earnings	$2,140,000
Average earnings ($2,140,000 ÷ 5)	$428,000
Normal earnings ($4,000,000 × .10)	400,000
Excess annual earnings	$ 28,000
Excess earnings capitalized at 16% ($28,000 ÷ .16)	$175,000

***Ex. 12-66**—Goodwill.

Net income figures for Jasper Company are as follows:

2006—$505,000
2007—$430,000
2008—$510,000
2009—$525,000
2010—$560,000

Tangible net assets of Jasper are appraised at $3 million on December 31, 2010. This business is to be acquired by Solinger Corporation early in 2011. What amount should be paid for goodwill if:

1. 15% is assumed to be a normal rate of return on tangible net assets and average excess earnings for the last 5 years are to be capitalized at 16%? (Show calculations.)

2. 13% is assumed to be a normal rate of return on tangible net assets and payment is to be made for the dollar amount of excess earnings for the last four years? (Show calculations.)

***Solution 12-66**

1.

$2,530,000 ÷ 5 years =	$506,000 actual average net income
$3,000,000 × .15 =	450,000 normal return
	$ 56,000 ÷ 16% = $350,000 goodwill

2.

$3,000,000	2010	($560,000 – $390,000)	$170,000
× .13	2009	($525,000 – $390,000)	135,000
$ 390,000	2008	($510,000 – $390,000)	120,000
	2007	($430,000 – $390,000)	40,000
		Payment for goodwill	$465,000

***Ex. 12-67**—Calculation of goodwill.

The owners of Loreem Co. are planning to sell the business. The cumulative earnings for the past five years are $600,000 including nonrecurring losses of $100,000. The annual earnings based on an average rate of return for this industry would be $80,000. If excess earnings are to be capitalized at 12%, what is the implied goodwill?

***Solution 12-67**

($600,000 + $100,000)/5 = $140,000

Average earnings	$ 140,000
Normal earnings	80,000
Excess earnings	$ 60,000
Goodwill ($60,000 ÷.12)	$500,000

PROBLEMS

Pr. 12-68—Intangible assets.

The following transactions involving intangible assets of Vortage Corporation occurred on or near December 31, 2010. Complete the chart below by writing the journal entry(ies) needed at that date to record the transaction and at December 31, 2011 to record any resultant amortization. If no entry is required at a particular date, write "none needed."

	On Date of Transaction	On December 31, 2011
1. Vortage paid Jorex Company $200,000 for the exclusive right to market a particular product, using the Jorex name and logo in promotional material. The franchise runs for as long as Vortage is in business. Vortage decided to amortize the franchise over 25 years.		
2. Vortage spent $300,000 developing a new manufacturing process and has applied for a patent. It believes that its application will be successful and that the process will be successfully implemented and used for 10 years.		
3. In January, 2011, Vortage 's application for a patent (#2 above) was granted. Legal and registration costs incurred were $35,000. The patent runs for 17 years from the grant date. The manufacturing process will be useful to Vortage for 10 years.		
4. Vortage incurred $90,000 in successfully defending one of its patents in an infringement suit. The patent expires during December, 2014.		
5. Vortage incurred $200,000 in an unsuccessful patent defence. As a result of the adverse verdict, the patent, with a remaining unamortized cost of $99,000, is deemed worthless.		
6. Vortage paid Lysek Laboratories $52,000 for research work performed by Lysek under contract for Vortage.		

Solution 12-68

On Date of Transaction			On December 31, 2011		
1. Franchise	200,000		1. Franchise Amort. Exp.	8,000	
Cash		200,000	Acc Amortization Franchise		8,000
2. Deferred Devel. Costs........	300,000		2. Devel. Cost Amortization Expense	30,000	
Cash.............		300,000	Deferred Devel. Costs		30,000
3. Patents................	35,000		3. Patent Amortization Expense	3,500	
Cash.............		35,000	Acc Amortization Patents		3,500
4. Patents................	90,000		4. Patent Amortization Expense	22,500	
Cash.............		90,000	Acc Amortization Patents		22,500
5. Legal Fees Exp. ..	200,000		5. "None needed."		
Cash.............		200,000			
Loss on Impair. of Patent	99,000				
Acc impairment losses		99,000			
6. Research Expense	52,000		6. "None needed."		
Cash.............		52,000			

Pr. 12-69 - Journal entries for impairment of intangible assets

Schroder Corporation, a large, but privately held company is preparing its year-end entries. As senior accountant, you have been asked to prepare the entries related to the company's intangible assets.

Schroder currently carries the following intangible assets* on its balance sheet:

Trade name	$125,000	net of accumulated amortization of $75,000
Patent	$126,000	net of accumulated amortization of $54,000
Other intangibles	$340,000	no amortization recorded
Trademark	$120,000	net of accumulated amortization of $30,000
	$711,000	

*Current year amortization has already been recorded

The following additional information is available:

After recent negative press releases relating to the technology that underlies the patent, the company had carried out a recoverability test that indicated that the patent's carrying value was higher than its net recoverable amount. The patent's fair value was subsequently estimated at $84,000.

The item classified as other intangibles relates to research costs that the company incurred in the current year. According to a statement from the company's President, *"the costs were incurred with the intention to gain new knowledge. At the moment we don't know exactly how to use this information, but we are confident that eventually we will be able to use it."*

Instructions

Based on the information provided, prepare all journal entries that are required to adjust Schroder's records as would be required under Private Entity GAAP.

Solution 12-69

To record impairment loss:
Impairment loss......................... 42,000
        Accumulated impairment losses 42,000
$126,000 - $84,000 = $42,000

To expense research costs that had been incorrectly capitalized:
Research expense 340,000
        Other intangible assets 340,000
According to the information provided, these costs appear to be research costs, rather than development costs (that might qualify for capitalization). Research costs do not, by definition not meet the criteria that are required to recognize these costs as an asset. As a result, they should be expensed.

LEGAL NOTICE