

VOLUME 1 – APPENDIX C

THE ACCOUNTING INFORMATION SYSTEM

CHAPTER LEARNING OBJECTIVES

1. Understand basic accounting terminology, double-entry rules, and the accounting equation. It is important to understand the following terms: (1) event, (2) transaction, (3) account, (4) permanent and temporary accounts, (5) ledger, (6) journal, (7) posting, (8) trial balance, (9) adjusting entries, (10) financial statements, (11) closing entries, and (12) reversing entries.

The left side of any account is the debit side; the right side is the credit side. All asset and expense accounts are increased on the left or debit side and decreased on the right or credit side. Conversely, all liability and revenue accounts are increased on the right or credit side and decreased on the left or debit side. Shareholders' equity accounts, Common Shares, and Retained Earnings are increased on the credit side, whereas the shareholders' equity related Dividends account is increased on the debit side.

In a double-entry accounting system, for every debit there must be a credit, and vice versa. This leads us to the basic accounting equation for corporations: $\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity}$. The effect of individual transactions on the statement of financial position can be explained using the basic accounting equation. The shareholders' equity portion of the equation can also be expanded to illustrate the effect of transactions on components of equity such as common shares and retained earnings. Whenever a transaction occurs, the elements of the equation change, but the equality of the two sides of the equation remains unaffected.

2. Identify the steps in the accounting cycle and the steps in the recording process. The basic steps in the accounting cycle are (1) identification and measurement of transactions and other events, (2) journalizing, (3) posting, (4) the unadjusted trial balance, (5) adjustments, (6) the adjusted trial balance, (7) statement preparation, and (8) closing. The first three steps in the accounting cycle form the basis of the recording process used by most medium-sized companies on a daily basis. The simplest journal form is a chronological listing of transactions and events that are expressed as debits and credits to particular accounts. The items entered in a general journal must then be transferred (posted) to the general ledger.

To help prepare financial statements, an unadjusted trial balance should be prepared at the end of a specific period (usually a month, quarter, or year) after the entries have been recorded in the journals and posted to the general ledger.

3. Explain the reasons for and prepare adjusting entries. Adjustments achieve a proper matching of expenses and revenues, which is needed to determine the correct net income for the current period and to achieve an accurate statement of the end-of-the-period balances in assets, liabilities, and shareholders' equity accounts. When preparing adjusting journal entries, you must first determine how the original transaction was recorded. For example, was an asset created earlier in the fiscal year (such as prepaid rent) when the initial payment was made? If so, an adjustment for the related expense is required. Alternatively, if an income statement account was used initially, an adjustment may be required to set up the proper statement of financial position account at the end of the period.

4. Explain how the type of ownership structure affects the financial statements. The type of ownership structure that a business enterprise uses determines the types of accounts that are part of the equity section. In a corporation, ordinary or common shares, contributed surplus, retained earnings, and accumulated other comprehensive income are commonly shown separately on the statement of financial position. In a proprietorship or partnership, a capital account is used to indicate the investment in the company by the owner(s). An owners' drawings or withdrawal account may be used to indicate withdrawals by the owner(s). These two accounts are grouped or netted under owners' equity.

5. Prepare closing entries and consider other matters relating to the closing process. In the closing process, all of the revenue and expense account balances (income statement items) are transferred to a clearing account called Income Summary, which is used only at the end of the fiscal year. Revenues and expenses are matched in the Income Summary account. The net result of this matching, which represents the net income or net loss for the period, is then transferred to a shareholders' equity account (Retained Earnings for a corporation and capital accounts for proprietorships and partnerships). Reversing entries may be used for reversing accrued revenues and accrued expenses. Prepayments may also be reversed if the initial entry to record the transaction is made to an expense or revenue account.

6. Prepare a 10-column work sheet and financial statements. The 10-column work sheet provides columns for the first trial balance, adjustments, adjusted trial balance, statement of comprehensive income, and statement of financial position. The work sheet does not replace the financial statements. Instead, it is the accountant's informal device for accumulating and sorting the information that is needed for the financial statements.

MULTIPLE CHOICE QUESTIONS

Answer	No.	Description
d	1.	Purpose of an accounting system
b	2.	Definition of transaction
d	3.	Purpose of an accounting system
b	4.	Identification of a temporary account
d	5.	Accounting equation
a	6.	Accounting equation
a	7.	Criteria for recording transactions
c	8.	Internal event
b	9.	Definition of journal
a	10.	Impact of transaction on the accounting equation
d	11.	Transaction analysis
c	12.	Transaction analysis
c	13.	Event recording
c	14.	Double-entry accounting system
d	15.	Event recording
b	16.	Trial balance
d	17.	Trial balance
c	18.	Trial balance
d	19.	Uses of adjusting entries
c	20.	Adjusting for accrued expenses
d	21.	Adjusting for accrued revenues

- d 22. Adjusting entries
- c 23. Factors to consider in estimating depreciation
- b 24. Contra-asset account
- a 25. Effect of not recording depreciation
- c 26. Adjusting for bad debts
- c 27. Definition of accrued revenue
- c 28. Adjusting entry for prepaid lease
- a 29. Adjusting entry for interest receivable
- c 30. Adjusting entry for interest expense
- d 31. Adjusting entry for bad debts
- b 32. Adjusting entry for bad debts
- b 33. Adjusting entry for unearned rent
- c 34. Adjusting entry for interest receivable
- d 35. Calculate property tax adjustment
- c 36. Calculate balance in unearned revenue
- c 37. Adjusting entry for investments
- d 38. Adjusting entry for investments
- c 39. Calculate cash received for interest
- a 40. Calculate cash paid for salaries
- c 41. Calculate cash paid for insurance
- c 42. Calculate insurance expense
- d 43. Calculate interest revenue
- d 44. Calculate salary expense
- c 45. Valuation of entity-specific asset
- c 46. Calculate accrued interest payable
- c 47. Calculate balance of unearned revenues
- b 48. Calculate prepaid insurance
- c 49. Calculate interest receivable
- c 50. Calculate accrued salaries
- c 51. Calculate royalty revenue
- b 52. Closing process
- c 53. Closing process
- c 54. Balance sheet
- c 55. Closing process
- b 56. Definition of unearned revenue
- c 57. Closing process
- a 58. Fair value adjustments for investments
- d 59. Closing process
- c 60. Closing net income or loss
- b 61. Post-closing trial balance
- a 62. Trial balance – correct statement
- a 63. Effect of understating ending inventory

- c 64. Closing entry

EXERCISES

Item	Description
E3-65	Definitions
E3-66	Definitions
E3-67	Recordable events
E3-68	The accounting cycle
E3-69	Adjusting entries
E3-70	Adjusting entries
E3-71	Calculation of expense
E3-72	Calculation of revenue
E3-73	Preparing financial statements
E3-74	Calculation of expense
E3-75	Type of ownership structure

PROBLEMS

Item	Description
P3-76	Journal entries
P3-77	Adjusting entries
P3-78	Adjusting entries
P3-79	Adjusting and closing entries
P3-80	Adjusting and closing entries
P3-81	Closing entries
P3-82	Adjusting entries
P3-83	Trial balance correction
P3-84	Accrual accounting
P3-85	Ten-column work sheet
P3-86	Preparation of financial statements

MULTIPLE CHOICE

1. Which of the following statements is true regarding accounting information systems?
- a) Both large and small firms should use the same type of accounting system.
 - b) All firms should have the same types of transactions.
 - c) The volume of data to be handled should not vary between firms.
 - d) The kind of information that management requires of an accounting system will vary, depending on the type of firm.

Answer: d

Difficulty: Easy

Learning Objective: Understand basic accounting terminology, double-entry rules, and the accounting equation.

Section Reference: Accounting System Overview

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

2. An external event involving a transfer or exchange between two or more entities or parties is called a(n)

- a) account.
- b) transaction.
- c) ledger.
- d) accounting system.

Answer: b

Difficulty: Easy

Learning Objective: Understand basic accounting terminology, double-entry rules, and the accounting equation.

Section Reference: Accounting System Overview

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

3. Factors that shape an accounting system include the

- a) nature of the business.
- b) size of the firm.
- c) volume of data to be handled.
- d) All of these answer choices are correct.

Answer: d

Difficulty: Easy

Learning Objective: Understand basic accounting terminology, double-entry rules, and the accounting equation.

Section Reference: Accounting System Overview

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

4. An example of a temporary account is

- a) Unearned Revenue.
- b) Salary Expense.
- c) Inventory.
- d) Retained Earnings.

Answer: b

Difficulty: Easy

Learning Objective: Understand basic accounting terminology, double-entry rules, and the accounting equation.

Section Reference: Accounting System Overview

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

5. Which of the following equations is correct?

- a) Assets plus Liabilities = Equity.
- b) Assets = Liabilities minus Equity.
- c) Liabilities = Assets plus Equity.
- d) Equity = Assets minus Liabilities.

Answer: d

Difficulty: Easy

Learning Objective: Understand basic accounting terminology, double-entry rules, and the accounting equation.

Section Reference: Accounting System Overview

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

6. The accounting equation must remain in balance

- a) throughout each step in the accounting cycle.
- b) only when journal entries are recorded.
- c) only at the time the trial balance is prepared.
- d) only when formal financial statements are prepared.

Answer: a

Difficulty: Easy

Learning Objective: Understand basic accounting terminology, double-entry rules, and the accounting equation.

Section Reference: Accounting System Overview

CPA: Financial Reporting
Bloomcode: Comprehension
AACSB: Analytic

7. Which of the following criteria does NOT have to be met before an event or transaction should be recorded for accounting purposes?
- a) The event or transaction must be an external event.
 - b) The event or transaction can be measured objectively in financial terms.
 - c) The event or transaction is relevant and reliable.
 - d) The event or transaction must meet the definition of an element.

Answer: a

Difficulty: Easy
Learning Objective: Understand basic accounting terminology, double-entry rules, and the accounting equation.
Section Reference: Accounting System Overview
CPA: Financial Reporting
Bloomcode: Comprehension
AACSB: Analytic

8. Which of the following is an internal event?
- a) sale of goods or services
 - b) payment of dividends
 - c) using raw materials in production
 - d) purchase of materials

Answer: c

Difficulty: Easy
Learning Objective: Identify the steps in the accounting cycle and the steps in the recording process.
Section Reference: The Accounting Cycle and the Recording Process
CPA: Financial Reporting
Bloomcode: Comprehension
AACSB: Analytic

9. The book of original entry where transactions and other selected events are first recorded is called the
- a) ledger.
 - b) journal.
 - c) account.
 - d) statement of financial position.

Answer: b

Difficulty: Easy

Learning Objective: Identify the steps in the accounting cycle and the steps in the recording process.

Section Reference: The Accounting Cycle and the Recording Process

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

10. 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) when the financial statements are prepared.

Answer: a

Difficulty: Easy

Learning Objective: Identify the steps in the accounting cycle and the steps in the recording process.

Section Reference: The Accounting Cycle and the Recording Process

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

11. Performing a service for a client on account will

- a) increase one asset and decrease another asset.
- b) decrease an asset and decrease a liability.
- c) increase an asset and decrease equity.
- d) increase an asset and increase equity.

Answer: d

Difficulty: Easy

Learning Objective: Identify the steps in the accounting cycle and the steps in the recording process.

Section Reference: The Accounting Cycle and the Recording Process

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

12. The account credited for a receipt of cash on account is

- a) Cash.
- b) Service Revenue.
- c) Accounts Receivable.
- d) Accounts Payable.

Answer: c

Difficulty: Easy

Learning Objective: Identify the steps in the accounting cycle and the steps in the recording process.

Section Reference: The Accounting Cycle and the Recording Process

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

13. Some events are NOT recorded in the accounting information system because

- a) the service has been provided but the cash has not yet been received.
- b) the service has not been provided but the cash has already been received.
- c) their measurement is too complex.
- d) the amounts are not material.

Answer: c

Difficulty: Easy

Learning Objective: Identify the steps in the accounting cycle and the steps in the recording process.

Section Reference: The Accounting Cycle and the Recording Process

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

14. The double-entry accounting system means

- a) each transaction is recorded with two journal entries.
- b) each item is recorded in a journal entry, then in a general ledger account.
- c) the dual effect of each transaction is recorded with debits and credits of equal amount.
- d) None of these answer choices is correct.

Answer: c

Difficulty: Easy

Learning Objective: Identify the steps in the accounting cycle and the steps in the recording process.

Section Reference: The Accounting Cycle and the Recording Process

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

15. 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.

Answer: d

Difficulty: Easy

Learning Objective: Identify the steps in the accounting cycle and the steps in the recording process.

Section Reference: The Accounting Cycle and the Recording Process

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

16. A trial balance

- a) is a list of all the accounts in the ledger.
- b) is a list of all the accounts and their balances at a specific date.
- c) cannot be used in the preparation of financial statements.
- d) cannot be used as a basis for preparation of adjusting entries.

Answer: b

Difficulty: Easy

Learning Objective: Identify the steps in the accounting cycle and the steps in the recording process.

Section Reference: The Accounting Cycle and the Recording Process

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

17. A trial balance will NOT balance if

- a) an amount is posted to the wrong account.
- b) a transaction has been entered twice.
- c) a transaction has been omitted.
- d) only the debit side of a journal entry has been posted.

Answer: d

Difficulty: Easy

Learning Objective: Identify the steps in the accounting cycle and the steps in the recording process.

Section Reference: The Accounting Cycle and the Recording Process

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

18. The main purpose of a trial balance is

- a) to serve as a basic internal control.
- b) to assist in preparation of the financial statements.
- c) to prove the mathematical equity of debits and credits after posting.
- d) to uncover errors in journalizing and posting.

Answer: c

Difficulty: Easy

Learning Objective: Identify the steps in the accounting cycle and the steps in the recording process.

Section Reference: The Accounting Cycle and the Recording Process

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

19. Adjusting entries are necessary to

- 1. obtain a proper matching of revenue and expense.
 - 2. achieve an accurate statement of assets and equities.
 - 3. adjust assets and liabilities to their fair market value.
- a) 1
 - b) 2
 - c) 3
 - d) 1 and 2

Answer: d

Difficulty: Easy

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

20. 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.

Answer: c

Difficulty: Easy

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

21. For adjusting entries relating to accrued revenues,

- a) a liability-revenue account relationship exists.
- b) the adjusting entry involves a credit to an asset account and a debit to a revenue account.
- c) if an adjustment is not made, assets will be overstated.
- d) before adjustment, both assets and revenues are understated.

Answer: d

Difficulty: Easy

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

22. Which of the following would NOT be a correct form for an adjusting entry?

- a) a debit to a revenue and a credit to a liability
- b) a debit to an expense and a credit to a liability
- c) a debit to a liability and a credit to a revenue
- d) a debit to an asset and a credit to a liability

Answer: d

Difficulty: Easy

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

23. Which of the following must be considered in estimating depreciation on an asset for an accounting period?

- a) only the original cost of the asset
- b) only the asset's useful life
- c) both the original cost of the asset and its useful life
- d) the decline in its fair market value

Answer: c

Difficulty: Easy

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

24. The type of account and normal balance of "Accumulated Depreciation, Equipment" is

- a) Asset, Credit.
- b) Contra-asset, Credit.
- c) Contra-asset, Debit.
- d) Liability, Credit.

Answer: b

Difficulty: Easy

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

25. If the accountant forgets to record an adjustment for Accumulated Depreciation, Building at the end of the accounting period, this will cause

- a) an overstatement of assets.
- b) an understatement of assets.
- c) an overstatement of expenses.
- d) an overstatement of liabilities.

Answer: a

Difficulty: Easy

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

26. An adjusting entry for bad debts will generally

- a) increase an expense account and decrease an asset account.
- b) increase an expense account and increase an asset account.
- c) increase an expense account and increase a contra-asset account.
- d) increase an expense account and increase a liability account.

Answer: c

Difficulty: Easy

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

27. 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

Answer: c

Difficulty: Easy

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

28. On September 1, 2020, Regal Corp. made the annual lease payment of \$ 24,000 for its fleet of delivery trucks. The payment covered the period September 1, 2020 to August 31, 2021. Assuming the entire amount had originally been debited to Lease Expense, the required adjustment at December 31, 2020 is

- a) debit Lease Expense and credit Prepaid Lease \$ 8,000.
- b) debit Prepaid Lease and credit Lease Expense \$ 8,000.
- c) debit Prepaid Lease and credit Lease Expense \$ 16,000.
- d) debit Lease Expense and credit Prepaid Lease \$ 16,000.

Answer: c

Difficulty: Medium

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 24,000 - (\$ 24,000 \times 4 \div 12) = \$ 16,000$

29. Principle Place determines that it has NOT yet recorded the 2020 accrual for interest revenue to be received in 2021. Assuming the amount to be recorded for 2020 is \$ 6,000, the required adjustment at December 31, 2020, is

- a) debit Interest Receivable and credit Interest Revenue \$ 6,000.
- b) debit Interest Revenue and credit Interest Receivable \$ 6,000.
- c) debit Interest Payable and credit Interest Revenue \$ 6,000.
- d) No adjusting entry is required.

Answer: a

Difficulty: Medium

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: No calculation necessary (\$ 6,000 is figure given in the question.)

30. On November 1, 2020, Halton Corp. purchased equipment by signing a 6-month, 4% note for \$ 180,000. The December 31, 2020, adjusting entry required in connection with this note is

- a) debit Interest Expense and credit Interest Payable, \$ 7,200.
- b) debit Interest Expense and credit Interest Payable, \$ 3,600.
- c) debit Interest Expense and credit Interest Payable, \$ 1,200.
- d) debit Interest Expense and credit Cash, \$ 1,200.

Answer: c

Difficulty: Medium

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 180,000 \times 4\% \times 2 \div 12 = \$ 1,200$

31. Tabby Corp.'s account balances at December 31, 2020, included Accounts Receivable, \$ 192,500 debit; Allowance for Doubtful Accounts, \$ 1,250 credit. From a review of the receivables, Blue estimates that \$ 7,000 of the December 31 receivables will be uncollectible. The required adjusting entry would include a credit to the allowance account for

- a) \$ 1,250.
- b) \$ 8,250.
- c) \$ 7,000.
- d) \$ 5,750.

Answer: d

Difficulty: Medium

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 7,000 - \$ 1,250 = \$ 5,750$

32. Siamese Corp.'s account balances at December 31, 2020, included Accounts Receivable, \$ 360,000 debit; Allowance for Doubtful Accounts, \$ 400 debit. Sales during 2020 were \$ 920,000. It is estimated that 2% of sales will be uncollectible. The required adjusting entry would include a credit to the allowance account for

- a) \$ 14,400.
- b) \$ 18,400.
- c) \$ 7,200.
- d) \$ 15,300.

Answer: b

Difficulty: Medium

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 920,000 \times 2\% = \$ 18,400$. (ADA balance is irrelevant)

33. On September 1, 2020, Rudolph Corporation received \$ 54,000 cash from a tenant for one year's rent in advance, and recorded the transaction with a credit to Rent Revenue. The December 31, 2020, required adjusting entry in connection with this would be
- a) debit Rent Revenue and credit Unearned Rent, \$ 18,000.
 - b) debit Rent Revenue and credit Unearned Rent, \$ 36,000.
 - c) debit Unearned Rent and credit Rent Revenue, \$ 18,000.
 - d) debit Cash and credit Unearned Rent, \$ 9,000.

Answer: b

Difficulty: Medium

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $8 \div 12 \times \$ 54,000 = \$ 36,000$

34. On October 31, 2020, Kiwi Inc. lent \$ 63,000 to Plum Inc. in return for a three-month, 4% interest-bearing note. What adjusting entry should Kiwi Inc. make on December 31, 2020, in connection with this note?
- a) Debit Interest Receivable and credit Interest Revenue, \$ 630.
 - b) Debit Cash and credit Interest Revenue, \$ 420.
 - c) Debit Interest Receivable and credit Interest Revenue, \$ 420.
 - d) Debit Interest Revenue and credit Interest Receivable, \$ 210.

Answer: c

Difficulty: Medium

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 63,000 \times 4\% \times 2 \div 12 = \$ 420$

35. Lime Limited has received its invoice for \$ 75,000 for property taxes for the calendar year 2020. The invoice was received and paid in June 2020 and the entire amount was debited to Property Tax Expense. Assuming Lime does NOT prepare interim financial statements, the required adjustment on December 31, 2020, related to the property taxes is

- a) debit Property Tax Expense and credit Prepaid Property Tax \$ 31,250.
- b) debit Prepaid Property Tax and credit Property Tax Expense \$ 37,500.
- c) debit Property Tax Expense and credit Prepaid Property Tax \$ 37,500.
- d) No adjusting entry is required.

Answer: d

Difficulty: Medium

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: No calculation necessary (No adjusting entry is required as prepaid balance at December 31 is zero..)

36. On December 10, 2020, Bella Inc. received a cheque for \$ 13,625 from a customer for services that Bella will be performing in December 2020 and January 2021. By December 31, 2020, Bella had earned 60% of that amount. Assuming the appropriate year-end adjustments were made, the 2020 balance in Bella Unearned Revenue account will be

- a) \$ 8,175.
- b) \$ 6,812.50.
- c) \$ 5,450.
- d) zero.

Answer: c

Difficulty: Medium

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 13,625 \times 40\% = \$ 5,450$

37. On May 15, 2020, Bagle Corp. purchased 1,000 common shares of Holter Inc. for \$ 24,000, as a Fair Value through Other Comprehensive Income (FV-OCI) equity investment. At December 31, 2020, the fair value of these shares was \$ 26,550. The required adjusting entry to reflect this fact is

- a) debit Fair value-OCI Investment, credit Holding Gain on Investment (OCI) \$ 26,550.
- b) debit Holding Gain on Investment (OCI), credit Fair value-OCI Investment \$ 26,550.
- c) debit Fair value-OCI Investment, credit Holding Gain on Investment (OCI) \$ 2,550.
- d) debit Holding Loss on Investment (OCI), credit Fair value-OCI Investment \$ 2,550.

Answer: c

Difficulty: Medium

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: \$ 26,550 – \$ 24,000 = \$ 2,550 gain

38. On May 15, 2020, Croissant Corp. purchased 1,000 common shares of Holter Inc. for \$ 24,000, as a Fair Value through Net Income (FV–NI) equity investment. At December 31, 2020, the fair value of these shares was \$ 23,100. The required adjusting entry to reflect this fact is
- a) debit Fair value–Net Income Investment, credit Holding Gain on Investment (OCI) \$ 23,100.
 - b) debit Holding Gain on Investment (OCI), credit Fair value–Net Income Investment \$ 23,100.
 - c) debit Fair value–Net Income Investment, credit Investment Income \$ 15,900.
 - d) debit Investment Loss, credit Fair value–Net Income Investment \$ 900.

Answer: d

Difficulty: Medium

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: \$ 23,100 – \$ 24,000 = \$ 900 loss

Use the following information for questions 56–58.

Orange Corp reported the following items on its calendar 2020 statement of comprehensive income:

Interest revenue	\$ 84,200
Salaries expense.....	72,000
Insurance expense	10,600

As well, their statements of financial position showed the following balances:

	<u>December 31, 2019</u>	<u>December 31, 2020</u>
Accrued interest receivable	\$ 10,100	\$ 8,800
Accrued salaries payable	9,800	5,400
Prepaid insurance	1,500	1,600

39. The cash received for interest during 2020 was

- a) \$ 82,900.
- b) \$ 84,200.
- c) \$ 85,500.
- d) \$ 74,100.

Answer: c

Difficulty: Medium

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 10,100 + \$ 84,200 - \$ 8,800 = \$ 85,500$

40. The cash paid for salaries during 2020 was

- a) \$ 76,400.
- b) \$ 72,000.
- c) \$ 67,600.
- d) \$ 81,800.

Answer: a

Difficulty: Medium

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

Bloomcode: Application

Feedback: $\$ 9,800 + \$ 72,000 - \$ 5,400 = \$ 76,400$

41. The cash paid for insurance premiums during 2020 was

- a) \$ 9,100.
- b) \$ 9,000.
- c) \$ 10,700.
- d) \$ 10,600.

Answer: c

Difficulty: Medium

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 10,600 + \$ 1,600 - \$ 1,500 = \$ 10,700$

Use the following information for questions 59–61.

During the 2020 calendar year, Purple Corp. paid or collected the following items:

Insurance premiums paid	\$ 14,200
Interest collected	21,700
Salaries paid	131,300

As well, the comparative statement of financial position showed the following balances:

	<u>December 31, 2019</u>	<u>December 31, 2020</u>
Prepaid Insurance	\$ 1,400	\$ 1,500
Interest Receivable	2,800	2,100
Salaries Payable	14,700	12,900

42. The insurance expense on the 2019 statement of comprehensive income was

- a) \$ 12,700.
- b) \$ 12,800.
- c) \$ 14,100.
- d) \$ 14,200.

Answer: c

Difficulty: Medium

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 14,200 - \$ 1,500 + \$ 1,400 = \$ 14,100$

43. The interest revenue on the 2020 statement of comprehensive income was

- a) \$ 22,400.
- b) \$ 21,700.
- c) \$ 19,600.
- d) \$ 21,000.

Answer: d

Difficulty: Medium

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 21,700 + \$ 2,100 - \$ 2,800 = \$ 21,000$

44. The salary expense on the 2020 statement of comprehensive income was

- a) \$ 118,400.
- b) \$ 133,100.
- c) \$ 131,300.
- d) \$ 129,500.

Answer: d

Difficulty: Medium

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 131,300 + \$ 12,900 - \$ 14,700 = \$ 129,500$

45. Amazing Company acquires a trade name from Fantastic Ltd. Amazing estimates it will receive \$ 7,200 per year from the name over the next 9 years. Using a discount rate of 4%, what is the value in use to Amazing of this trade name?

- a) \$ 45,528
- b) \$ 58,398
- c) \$ 53,534
- d) \$ 55,676

Answer: c

Difficulty: Medium

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 7,200 \times 7.43533 = \$ 53,534$

46. On September 1, 2019, Culver Corp. issued a 9% note payable to National Bank for \$ 750,000, payable in three equal annual principal payments of \$ 250,000, plus interest. On this

date, the bank's prime rate was 8%. The first payment for interest and principal was made on September 1, 2020. At December 31, 2020, Culver should record accrued interest payable of

- a) \$ 13,333.
- b) \$ 22,500.
- c) \$ 15,000.
- d) \$ 10,000.

Answer: c

Difficulty: Medium

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

CPA: Problem Solving and Decision Making

Bloomcode: Application

AACSB: Analytic

Feedback: $(\$ 750,000 - \$ 250,000) \times 9\% \times 4 \div 12 = \$ 15,000$

47. Rathbone Corp. 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, 2020, 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, 2020.

Service contracts still outstanding at December 31, 2020, expire as follows:

During 2021	\$ 140,000
During 2022	210,000
During 2023	99,000

What amount should be reported as Unearned Service Revenues on Rathbone's December 31, 2020, statement of financial position?

- a) \$ 774,000
- b) \$ 325,000
- c) \$ 449,000
- d) \$ 124,000

Answer: c

Difficulty: Medium

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 140,000 + \$ 210,000 + \$ 99,000 = \$ 449,000$

48. On December 1, 2020, Flynn Consulting paid \$ 27,000 for a three-year insurance policy (December 1, 2020 to November 30, 2023) and debited the entire amount to Prepaid Insurance. The December 31, 2020, required adjusting entry in connection with this policy would be

- a) debit Prepaid Insurance and credit Insurance Expense \$ 750.
- b) debit Insurance Expense and credit Prepaid Insurance \$ 750.
- c) debit Insurance Expense and credit Prepaid Insurance \$ 26,250.
- d) debit Prepaid Insurance and credit Insurance Expense \$ 26,250.

Answer: b

Difficulty: Medium

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 27,000 \times 1 \div 36 = \$ 750$

49. On June 1, 2020, Carr Corp. loaned Farr Corp. \$ 600,000 on a 5% note, payable in five annual instalments of \$ 120,000 (plus interest), beginning January 2, 2021. Interest on the note is payable on the first day of each month beginning July 1, 2020. Farr made timely payments through November 1, 2020. On January 2, 2021, Carr received payment of the first principal instalment plus all interest due. At December 31, 2020, Carr's interest receivable on this loan is

- a) \$ 0.
- b) \$ 2,500.
- c) \$ 5,000.
- d) \$ 7,500.

Answer: c

Difficulty: Medium

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 600,000 \times 5\% \times 2 \div 12 = \$ 5,000$

50. Grant Limited pays all salaried employees on a biweekly basis. Overtime pay, however, is paid in the next biweekly period. Grant accrues salaries expense only at its December 31 year end. Data relating to salaries earned in December 2020 are as follows:

Last payroll was paid on Dec 27, 2020, for the two-week period ended Dec 27, 2020.

Overtime pay earned in the two-week period ended Dec 27, 2020 was \$ 7,000.

Remaining work days in 2020 were December 28, 29, 30, on which days there was no overtime.

The regular biweekly salaries total \$ 100,000. Assuming a five-day work week, Grant should record a liability at December 31, 2020 for accrued salaries of

- a) \$ 24,000.
- b) \$ 29,000.
- c) \$ 37,000.
- d) \$ 53,000.

Answer: c

Difficulty: Medium

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 7,000 + (\$ 100,000 \div 10 \times 3) = \$ 37,000$

51. Mark-Wall Corp.'s trademark was licensed to Rodgers Inc. for royalties of 12% of sales of the trademarked items. Royalties are payable semi-annually on March 15 for sales in July through December of the previous year, and on September 15 for sales in January through June of the same year. Mark-Wall received the following royalties from Rodgers:

	<u>March 15</u>	<u>September 15</u>
During 2019	\$ 5,000	\$ 9,000
During 2020	8,000	6,000

Rodgers estimates that sales of the trademarked items would total \$ 67,000 for July through December 2020. On their statement of comprehensive income for calendar 2020, Mark-Wall's royalty revenue should be

- a) \$ 8,040.
- b) \$ 14,000.
- c) \$ 14,040.
- d) \$ 21,000.

Answer: c

Difficulty: Medium

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$6,000 + (\$67,000 \times 12\%) = \$14,040$

52. What account are the net revenues and expenses transferred to at the end of the accounting cycle?

- a) Comprehensive Income
- b) Retained Earnings
- c) Accumulated Other Comprehensive Income
- d) Share Capital

Answer: b

Difficulty: Easy

Learning Objective: Explain how the type of ownership structure affects the financial statements.

Section Reference: Financial Statements and Ownership Structure

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

53. Which of the following is NOT an account appearing in the equity section of a corporation's statement of financial position?

- a) Contributed Surplus
- b) Common Shares
- c) Owner's Equity
- d) Accumulated Other Comprehensive Income

Answer: c

Difficulty: Easy

Learning Objective: Explain how the type of ownership structure affects the financial statements.

Section Reference: Financial Statements and Ownership Structure

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

54. Zack Jones operates a sole proprietorship, selling sporting equipment. He has recently prepared financial statements for the fiscal year end of the business. Which equity accounts would you expect to see on the balance sheet?

- a) Common Shares, Dividends, and Owner's Equity

- b) Common Shares, Capital, and Withdrawals
- c) Capital and Withdrawals, grouped or added under Owner's Equity
- d) Owner's Equity and Dividends, netted together as Retained Earnings

Answer: c

Difficulty: Easy

Learning Objective: Explain how the type of ownership structure affects the financial statements.

Section Reference: Financial Statements and Ownership Structure

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

55. Marvin holds 10% of the common shares of Pink Limited. For the 2020 fiscal year end, all shareholders received a cash payment to represent their share in the net income of Pink Limited. How would this cash payment be reported in the equity section of Pink Limited's financial statements?

- a) as a reduction in the Owner's Equity account
- b) as an owner withdrawal, reducing Shareholder's Equity of Pink Limited
- c) as a dividend, reducing Shareholder's Equity of Pink Limited
- d) This payment would not impact the equity section of the financial statements.

Answer: c

Difficulty: Easy

Learning Objective: Explain how the type of ownership structure affects the financial statements.

Section Reference: Financial Statements and Ownership Structure

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

56. 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.

Answer: b

Difficulty: Easy

Learning Objective: Prepare closing entries and consider other matters relating to the closing process.

Section Reference: The Closing Process

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

57. Which type of account is always debited during the closing process?

- a) dividends
- b) expense
- c) revenue
- d) retained earnings

Answer: c

Difficulty: Easy

Learning Objective: Prepare closing entries and consider other matters relating to the closing process.

Section Reference: The Closing Process

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

58. Which of the following statements is INCORRECT regarding fair value adjustments for investments?

- a) Both FV–NI investments and FV–OCI investments could include equity investments or investments in debt securities.
- b) FV–OCI investments exclude debt securities.
- c) At each period end, an estimate is made of the fair value of both FV–NI and FV–OCI investments.
- d) An adjusting entry is required to record a holding gain or loss on FV–NI investments.

Answer: a

Difficulty: Easy

Learning Objective: Prepare closing entries and consider other matters relating to the closing process.

Section Reference: The Closing Process

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

59. In the closing process, all the revenue and expense accounts are transferred to a clearing or suspense account called

- a) Other Comprehensive Income.
- b) Common Shares.
- c) Retained Earnings.
- d) Income Summary.

Answer: d

Difficulty: Easy

Learning Objective: Prepare closing entries and consider other matters relating to the closing process.

Section Reference: The Closing Process

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

60. A corporation's net income or loss is closed at year end to

- a) Accumulated Other Comprehensive Income.
- b) Common Shares.
- c) Retained Earnings.
- d) Other Comprehensive Income.

Answer: c

Difficulty: Easy

Learning Objective: Prepare closing entries and consider other matters relating to the closing process.

Section Reference: The Closing Process

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

61. 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 expense accounts.

Answer: b

Difficulty: Easy

Learning Objective: Prepare closing entries and consider other matters relating to the closing process.

Section Reference: The Closing Process

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

62. Which of the following statements about the trial balance is correct?

- a) The 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) The post-closing trial balance is used to prepare the financial statements.

Answer: a

Difficulty: Easy

Learning Objective: Prepare closing entries and consider other matters relating to the closing process.

Section Reference: The Closing Process

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

63. If the inventory account at the end of the year is understated, the effect will be to

- a) overstate the cost of goods sold.
- b) understate the net purchases.
- c) overstate the gross profit on sales.
- d) overstate the goods available for sale.

Answer: a

Difficulty: Easy

Learning Objective: Prepare closing entries and consider other matters relating to the closing process.

Section Reference: The Closing Process

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

64. Frog Corporation had revenues of \$ 300,000, expenses of \$ 200,000, and dividends of \$ 45,000. When Income Summary is closed to Retained Earnings, the amount of the debit or credit to Retained Earnings is a

- a) debit of \$ 55,000.

- b) debit of \$ 100,000.
- c) credit of \$ 55,000.
- d) credit of \$ 100,000.

Answer: c

Difficulty: Medium

Learning Objective: Prepare closing entries and consider other matters relating to the closing process.

Section Reference: The Closing Process

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 300,000 - \$ 200,000 - \$ 45,000 = \$ 55,000$

EXERCISES

Ex. 3-65 Definitions

Define the following terms:

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

Solution 3-65

1. An event is something of consequence that happens. For a business, an event is generally the source or cause of changes in assets, liabilities, and equity.
2. Work sheets are used as informal tools to help accountants prepare financial statements.
3. Permanent 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 the business' accounts and may include subsidiary ledgers for specific accounts.

Difficulty: Easy

Learning Objective: Understand basic accounting terminology, double-entry rules, and the accounting equation.

Section Reference: Accounting System Overview

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

Ex. 3-66 Definitions

Provide clear, concise answers for the following:

1. What is the accrual basis of accounting?
2. What is an accrued expense?
3. What is accrued revenue?
4. What is a prepaid expense?
5. What is unearned revenue?
- *6. State the rule that indicates which adjusting entries for prepaid and unearned items should be reversed.

Solution 3-66

1. The accrual basis of accounting recognizes revenue when the performance obligation is satisfied and recognizes expenses in the period incurred.
2. An accrued expense is an expense that is incurred but not paid in cash or recorded.
3. An accrued revenue is a revenue that is recognized but not yet received in cash or recorded.
4. A prepaid expense is an expense paid in cash and recorded as an asset before it is used.
5. Unearned revenues are the revenues received in cash and recorded as liabilities before they are recognized.
- *6. Reversing entries are used for accrued revenues and accrued expenses.

Difficulty: Easy

Learning Objective: Understand basic accounting terminology, double-entry rules, and the accounting equation.

Section Reference: Accounting System Overview

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

Ex. 3-67 Recordable events

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

Instructions

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. HST collections for the current month are forwarded to the CRA.

Solution 3-67

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

Difficulty: Easy

Learning Objective: Understand basic accounting terminology, double-entry rules, and the accounting equation.

Section Reference: Accounting System Overview

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

Ex. 3-68 The accounting cycle

Summarize the steps in the accounting cycle.

Solution 3-68

The accounting cycle may be summarized in 10 steps as follows:

1. identification and measurement of transactions and other events
2. journalization of current period's entries into journals
3. posting of journals to the general ledger
4. preparation of trial balance (unadjusted)
5. preparation and posting of adjusting entries
6. preparation of adjusted trial balance
7. preparation of financial statements
8. preparation and posting of closing entries
9. preparation of post-closing trial balance
10. preparation and posting of reversing entries (optional)

Difficulty: Easy

Learning Objective: Identify the steps in the accounting cycle and the steps in the recording process.

Section Reference: The Accounting Cycle and the Recording Process

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

Ex. 3-69 Adjusting entries

Present, in journal form, the adjustments that would be made on July 31, 2020, the end of the fiscal year, for each of the following:

1. The supplies inventory on August 1, 2019, was \$ 8,350. Supplies costing \$ 16,650 were purchased during the fiscal year and debited to Supplies Inventory. A count on July 31, 2020, indicated supplies on hand of \$ 6,810.
2. On April 30, a ten-month, 4% note for \$ 40,000 was received from a customer.

3. On March 1, \$ 8,400 was collected as rent for one year and a nominal (temporary) account was credited.

Solution 3-69

1. Supplies Expense (8,350 + 16,650 – 6,810)	18,190	
Supplies Inventory		18,190
2. Interest Receivable (40,000 x 4% x 3 ÷ 12)	400	
Interest Revenue		400
3. Rent Revenue (8,400 x 7 ÷ 12 unearned)	4,900	
Unearned Revenue		4,900

Difficulty: Medium

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 3-70 Adjusting entries

Reed Co. wishes to record 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; as well, record the adjusting entry on December 31, 2020. (Two entries for each part.)

1. An insurance policy for two years was purchased on April 1, 2020, for \$ 18,000.
2. Rent of \$ 12,000 for six months for a portion of the building was received on November 1, 2020.

Solution 3-70

1. Prepaid Insurance	18,000	
Cash		18,000
Insurance Expense (18,000 x 9 ÷ 24)	6,750	
Prepaid Insurance		6,750
2. Cash	12,000	
Unearned Rent		12,000
Unearned Rent (12,000 x 2 ÷ 6)	4,000	
Rent Revenue		4,000

Difficulty: Medium

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

Bloomcode: Application

Ex. 3-71 Calculation of expense

The records for Jay Inc. showed the following for 2020:

	<u>Jan 1</u>	<u>Dec 31</u>
Accrued expenses.....	\$ 2,000	\$ 3,600
Prepaid expenses	900	800
Cash paid during the year for expenses ...		\$ 55,000

Instructions

Calculate the total amount of expenses that should be reported on the 2020 statement of comprehensive income.

Solution 3-71

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

Difficulty: Medium

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 3-72 Calculation of revenue

The records for Oriole Corp. showed the following for 2020:

	<u>Jan 1</u>	<u>Dec 31</u>
Unearned revenue	\$ 3,000	\$ 3,400
Accrued revenue	1,400	1,100
Cash collected during the year from revenue		\$ 85,000

Instructions

Show the calculation of the amount of revenue that should be reported on the 2020 statement of comprehensive income.

Solution 3-72

$$\$ 85,000 + \$ 3,000 - \$ 3,400 - \$ 1,400 + \$ 1,100 = \$ 84,300.$$

Difficulty: Medium

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 3-73 Preparing financial statements

The adjusted trial balance of Ryan Financial Planners appears below.

Instructions

Using the information from the adjusted trial balance, you are to prepare for the month ended December 31:

- an income statement.
- a retained earnings statement.
- a balance sheet.

Ryan Financial Planners Adjusted Trial Balance December 31, 2020

	<u>Debit</u>	<u>Credit</u>
Cash	\$ 2,900	
Accounts Receivable	2,200	
Supplies	1,800	
Equipment		16,000
Accumulated Depreciation—Equipment		\$ 4,000
Accounts Payable		3,300
Unearned Service Revenue		5,000
Common Shares		10,000
Retained Earnings		4,400
Dividends	2,000	
Service Revenue		4,200
Supplies Expense	600	
Depreciation Expense	2,500	
Rent Expense	2,900	
	<u>\$ 30,900</u>	<u>\$ 30,900</u>

Solution 3-73

a)

Ryan Financial Planners Income Statement For the Month Ended December 31, 2020

Revenues		
Service revenue		\$ 4,200
Expenses		
Rent expense	\$ 2,900	
Depreciation expense	2,500	
Supplies expense	<u>600</u>	
Total expenses		<u>6,000</u>
Net loss		<u>\$ (1,800)</u>

b)

Ryan Financial Planners
Retained Earnings Statement
For the Month Ended December 31, 2020

Retained earnings, December 1		\$ 4,400
Less: Net loss	\$ 1,800	
Dividends	<u>2,000</u>	<u>3,800</u>
Retained earnings, December 31		<u>\$ 600</u>

c)

Ryan Financial Planners
Balance Sheet
December 31, 2020

Assets		
Cash		\$ 2,900
Accounts receivable		2,200
Supplies		1,800
Equipment	\$ 16,000	
Less: Accumulated depreciation—equipment	<u>4,000</u>	<u>12,000</u>
Total assets		<u>\$ 18,900</u>
Liabilities and Shareholders' Equity		
Liabilities		
Accounts payable	\$ 3,300	
Unearned service revenue	<u>5,000</u>	
Total liabilities		\$ 8,300
Stockholders' Equity		
Common shares	10,000	
Retained earnings	<u>600</u>	<u>10,600</u>

Total liabilities and shareholders' equity \$ 18,900

Difficulty: Medium

Learning Objective: Explain the reasons for and prepare adjusting entries.

Learning Objective: Prepare closing entries and consider other matters relating to the closing process.

Section Reference: Adjusting Entries

Section Reference: The Closing Process

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 3-74 Calculation of expense

Sales salaries paid during 2020 were \$ 90,000. Advances to salesmen were \$ 1,300 on January 1, 2020, and \$ 800 on December 31, 2020. Sales salaries payable were \$ 1,300 on January 1, 2020, and \$ 1,400 on December 31, 2020.

Instructions

Calculate the Sales Salaries Expense for calendar 2020.

Solution 3-74

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

Difficulty: Medium

Learning Objective: Explain the reasons for and prepare adjusting entries.

Learning Objective: Prepare closing entries and consider other matters relating to the closing process.

Section Reference: Adjusting Entries

Section Reference: The Closing Process

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 3-75 Type of ownership structure

Explain whether the financial statement excerpt below is from the financial statements of a corporation, a sole proprietorship, or a partnership:

Abhrams, Capital.....	\$ 20,000
Johnston, Capital.....	25,000
Zinck, Capital.....	<u>20,000</u>
Total.....	\$ 65,000

Solution 3-75

This is an excerpt from partnership financial statements. A corporation would have share capital accounts (common shares and, possibly, preferred shares) and would report Retained Earnings of the firm. Therefore, we know that this excerpt is not a corporation. Since there are capital accounts for more than one individual, it cannot be a sole proprietorship. Therefore, based on the multiple owners' capital accounts, it can be concluded that this is an excerpt from a partnership's financial statements.

Difficulty: Easy

Learning Objective: Explain how the type of ownership structure affects the financial statements.

Section Reference: Financial Statements and Ownership Structure

CPA: Communication

CPA: Financial Reporting

AACSB: Communication

PROBLEMS

Pr. 3-76 Journal entries

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

January:

1. He invested \$ 300,000 in his business.
2. He bought a greenhouse for \$ 100,000 cash.

May:

3. He hired a greenhouse supervisor at an annual salary of \$ 34,000.

June:

4. He ordered and paid for a shipment of flowers costing \$ 80,000.
5. He sold flowers for \$ 40,000. Half of these sales were made on account.

August:

6. He received a deposit of \$ 5,000 from a customer to put merchandise "on hold".
7. He paid current month's salaries of \$ 3,000.

Instructions

Prepare all required journal entries.

Solution 3-76

1. Cash	300,000	
Jonathan Green, Capital.....		300,000
2. Building	100,000	

Cash		100,000
3. No entry required.		
4. Inventories.....	80,000	
Cash		80,000
5. Cash	20,000	
Accounts Receivable	20,000	
Sales		40,000
6. Cash	5,000	
Unearned Revenue.....		5,000
7. Salaries Expense	3,000	
Cash		3,000

Difficulty: Medium

Learning Objective: Identify the steps in the accounting cycle and the steps in the recording process.

Section Reference: The Accounting Cycle and the Recording Process

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 3-77 Adjusting entries

The information shown below relates to Flower Corporation. At December 31, 2020, Flower's general ledger shows the following balances:

Prepaid lease	\$ 7,000	Debit
Prepaid insurance	\$ 1200	Debit
Unearned revenue	\$ 84,000	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, 2020.

Solution 3-77

1. Lease Expense	7,000

Prepaid Lease		7,000
2. Insurance Expense (1,200 x 1 ÷ 3)	400	
Prepaid Insurance		400
3. Unearned Revenue (84,000 x 1/2)	42,000	
Revenue		42,000

Difficulty: Medium

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 3-78 Adjusting entries

Part I – Maison Corp. has reported pre-tax income of \$ 250,000 for calendar 2020, before considering the five items below. Prepare the adjusting entries needed at December 31, 2020 in order to correctly state the 2020 pre-tax income. If no entry is needed, write NONE.

1. Interest on a \$ 42,000, 7%, six-year note payable was last paid on September 1, 2019.
2. On May 31, 2020, Maison entered into a contract to provide services to a customer for 18 months beginning June 1. The customer paid the \$ 18,000 fee in full on June 1 and Maison credited it to Service Revenue.
3. On August 1, 2020, Maison paid a year's rent in advance on a warehouse, and debited the \$ 48,000 payment to Prepaid Rent.
4. Depreciation on office equipment for 2020 is \$ 17,000.
5. On December 18, 2020, Maison paid the local newspaper \$ 1,000 for an advertisement to be run in January of 2021, debiting it to Prepaid Advertising.

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

Reported 2020 pre-tax income	\$ 250,000
Add (deduct) Item (1)	
(2)	
(3)	
(4)	
(5)	
Correct 2020 pre-tax income	\$ _____

Solution 3-78

Part I

1. Interest Expense (42,000 x 7% x 4 ÷ 12)	980	
Interest Payable		980
2. Service Revenue (18,000 x 11 ÷ 18 unearned)	11,000	
Unearned Service Fees		11,000
3. Rent Expense (48,000 x 5 ÷ 12)	20,000	
Prepaid Rent		20,000
4. Depreciation Expense	17,000	
Accumulated Depreciation		17,000
5. NONE		

Part II

Reported 2020 pre-tax income	\$ 250,000
Add (deduct) Item(1) (980)	
(2) (11,000)	
(3) (20,000)	
(4) (17,000)	
(5)	
Correct 2020 pre-tax income	<u>\$ 201,020</u>

Difficulty: Medium

Learning Objective: Explain the reasons for and prepare adjusting entries.

Section Reference: Adjusting Entries

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 3-79 Adjusting and closing entries

The following trial balance was taken from the books of Kaslo Corporation at December 31, 2020:

<u>Account</u>	<u>Debit</u>	<u>Credit</u>
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		15,000
Accounts Payable		10,800

Common Shares		44,000	
Retained Earnings		65,000	
Sales		410,000	
Cost of Goods Sold	128,000		
Salaries Expense	53,000		
Rent Expense	12,800		
Totals	<u>\$ 546,600</u>	<u>\$ 546,600</u>	

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

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

Instructions

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

Solution 3-79

a) Adjusting Entries

1. Insurance Expense	3,000	
Unexpired Insurance		3,000
2. Bad Debt Expense (410,000 x 1%)	4,100	
Allowance for Doubtful Accounts		4,100
3. Depreciation Expense (138,000 x 10%)	13,800	
Accumulated Depreciation		13,800
4. Interest Receivable (8,000 x 9%)	720	
Interest Revenue		720
5. Prepaid Rent	6,800	
Rent Expense		6,800
6. Salaries Expense	6,200	
Salaries Payable		6,200

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

Difficulty: Medium

Learning Objective: Explain the reasons for and prepare adjusting entries.

Learning Objective: Prepare closing entries and consider other matters relating to the closing process.

Section Reference: Adjusting Entries

Section Reference: The Closing Process

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 3-80 Adjusting and closing entries

- Using the adjusted trial balance of Charles Corporation from Pr. 3-99, journalize the adjustments that were made.
- Using the adjusted trial balance of Charles Corporation from Pr. 3-99, journalize the closing entries that are required.

Solution 3-80

1. 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
2. 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

Difficulty: Medium

Learning Objective: Explain the reasons for and prepare adjusting entries.

Learning Objective: Prepare closing entries and consider other matters relating to the closing process.

Section Reference: Adjusting Entries

Section Reference: The Closing Process

CPA: Financial Reporting

Bloomcode: Analysis

AACSB: Analytic

Pr. 3-81 Closing entries

Below is a selection of account balances for Howard Ltd. at December 31, 2020:

Sales.....	\$ 856,000
Sales returns.....	40,000
Cost of goods sold.....	456,000
Advertising expense.....	38,000
Salaries expense.....	113,000
Depreciation expense.....	31,000
Insurance expense.....	9,000
Administrative expense.....	10,000

All accounts have their normal balances.

Instructions

Prepare all necessary closing entries at December 31, 2020.

Solution 3-81

Sales.....	856,000	
Sales returns.....		40,000
Income summary		816,000
Income summary	657,000	
Administrative expense		10,000
Advertising expense		38,000
Depreciation expense		31,000
Cost of goods sold		456,000
Insurance expense		9,000
Salaries expense.....		113,000
Income summary	159,000	
Retained earnings		159,000

Difficulty: Medium

Learning Objective: Explain the reasons for and prepare adjusting entries.

Learning Objective: Prepare closing entries and consider other matters relating to the closing process.

Section Reference: Adjusting Entries

Section Reference: The Closing Process

CPA: Financial Reporting

Bloomcode: Analysis

AACSB: Analytic

Pr. 3-82 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 January 1, 2020, was \$ 2,000. During 2020, cash received from debtors for interest on outstanding notes receivable was \$ 4,700. The 2020 statement of comprehensive income showed Interest Revenue of \$ 4,900. You are to prepare the missing adjusting entry that must have been made, assuming reversing entries are not made.
2. Unearned rent at January 1, 2020 was \$ 5,300, and at December 31, 2020 was \$ 6,000. The records indicate cash receipts from rental sources during 2020 were \$ 45,000, all of which were credited to the Unearned Rent Account. You are to prepare the missing adjusting entry.

3. Accumulated Depreciation—Equipment at January 1, 2020, was \$ 120,000, and at December 31, 2020, was \$ 150,000. During 2020, one piece of equipment was sold. The equipment had an original cost of \$ 10,000 and was three-quarters depreciated when sold. You are to prepare the missing adjusting entry.
4. Allowance for doubtful accounts on January 1, 2020, was \$ 50,000. The balance in the allowance account on December 31, 2020, after making the annual adjusting entry, was \$ 65,000. During 2020 bad debts of \$ 30,000 were written off. You are to provide the missing adjusting entry.
5. Prepaid rent at January 1, 2020, was \$ 24,000. During 2020 rent payments of \$ 160,000 were made and debited to Rent Expense. The 2020 statement of comprehensive income shows Rent Expense of \$ 180,000. You are to prepare the missing adjusting entry that must have been made, assuming reversing entries are not made.
6. Retained earnings at January 1, 2020, was \$ 150,000 and at December 31, 2020, it was \$ 210,000. During 2020, cash dividends of \$ 50,000 were paid, which were correctly debited to Retained Earnings. You are to prepare the missing closing entry to close the Income Summary account.

Solution 3-82

1. Interest Receivable	2,200	
Interest Revenue		2,200
Interest revenue per books	\$ 4,900	
Interest revenue received related to 2020		
(\$ 4,700 – \$ 2,000)	<u>2,700</u>	
Interest accrued	<u>\$ 2,200</u>	
2. Unearned Rent Revenue	44,300	
Rent Revenue		44,300
Cash receipts	\$ 45,000	
Beginning balance	5,300	
Ending balance	<u>(6,000)</u>	
Rent revenue	<u>\$ 44,300</u>	
3. Depreciation Expense	37,500	
Accumulated Depreciation—Equipment		37,500
Ending balance	\$ 150,000	
Beginning balance	<u>120,000</u>	
Difference	30,000	
Write-off at time of sale $3 \div 4 \times \$ 10,000$ (debit)	<u>7,500</u>	
	<u>\$ 37,500</u>	
4. Bad Debt Expense	45,000	
Allowance for Doubtful Accounts		45,000

Ending balance	\$ 65,000	
Beginning balance	<u>50,000</u>	
Difference	15,000	
Written off	<u>30,000</u>	
	<u>\$ 45,000</u>	
5. Rent Expense	20,000	
Prepaid Rent		20,000
Rent expense	\$ 180,000	
Less cash paid	<u>160,000</u>	
Reduction in prepaid rent account	<u>\$ 20,000</u>	
6. Income Summary	110,000	
Retained Earnings		110,000
Ending balance	\$ 210,000	
Beginning balance	<u>150,000</u>	
Difference	60,000	
Cash dividends	<u>50,000</u>	
Net income must be	<u>\$ 110,000</u>	

Difficulty: Medium

Learning Objective: Explain the reasons for and prepare adjusting entries.

Learning Objective: Prepare a 10-column work sheet and financial statements.

Section Reference: Adjusting Entries

Section Reference: Using a Work Sheet

CPA: Financial Reporting

Bloomcode: Analysis

AACSB: Analytic

Pr. 3-83 Trial balance correction

The Controller of SHD Corporation asks his assistant to correct the company's December 31, 2020, trial balance.

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

**SHD Corporation
Trial Balance
December 31, 2020**

	<u>Debit</u>	<u>Credit</u>
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	<u>2,550</u>	
	<u>\$ 143,300</u>	<u>\$ 138,690</u>

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 3-83

SHD Corporation Corrected Trial Balance December 31, 2020

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

Difficulty: Medium

Learning Objective: Explain how the type of ownership structure affects the financial statements.

Section Reference: Financial Statements and Ownership Structure

CPA: Financial Reporting

Bloomcode: Analysis

AACSB: Analytic

Pr. 3-84 Accrual accounting

Prudence Corp.'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 \$ 30,000, Dec 31, balance \$ 37,000, uncollectible accounts written off during the year, \$ 4,000; accounts receivable collected during the year, \$ 134,000. Prepare the entry to record sales for the year.
2. Allowance for Doubtful Accounts: Jan 1, balance \$ 3,800, Dec 31 balance \$ 7,700, uncollectible accounts written off during the year, \$ 28,000. 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, \$ 3,000, Dec 31 accrued, \$ 3,500, earned for the year, \$ 14,000. Prepare the entry to record cash interest received.

Solution 3-84

1. Ending balance	\$ 37,000	Ending balance	\$ 37,000
Beginning balance	<u>30,000</u>	Plus: Rec. collected	134,000
Difference	7,000	Write-offs	<u>4,000</u>
Uncollectible accounts	4,000		175,000
Receivables collected	<u>134,000</u>	Less: Beginning balance	<u>30,000</u>
Sales for period	<u>\$ 145,000</u>	Sales for period	<u>\$ 145,000</u>

Accounts Receivable	145,000	
Sales.....		145,000

2. Ending balance	\$ 7,700	Ending balance	\$ 7,700
Beginning balance	<u>3,800</u>	Write-off	<u>28,000</u>
Difference	3,900		35,700
Write-off	<u>28,000</u>	Beginning balance	<u>3,800</u>
Adjusting entry	<u>\$ 31,900</u>	Adjusting entry	<u>\$ 31,900</u>

Bad Debts Expense.....	31,900		
Allowance for Doubtful Accounts			31,900
3. Ending balance	\$ 33,000	Beginning balance	\$ 20,000
Beginning balance	<u>20,000</u>	Plus purchases	<u>110,000</u>
Difference	13,000		130,000
Purchases	<u>110,000</u>	Less ending balance	<u>33,000</u>
Payments	<u>\$ 97,000</u>	Payments	<u>\$ 97,000</u>
Accounts Payable.....	97,000		
Cash			97,000
4. Revenue Earned	\$ 14,000	Beginning balance	\$ 3,000
Less: Dec. 31 accrual	(3,500)	Plus revenue earned	<u>14,000</u>
Plus: Jan. 1 accrual	<u>3,000</u>		17,000
Cash received	<u>\$ 13,500</u>	Less ending balance	<u>3,500</u>
		Cash received	<u>\$ 13,500</u>
Cash	13,500		
Interest Receivable.....			13,500
(This entry assumes that the \$ 14,000 interest earned was first recorded as a receivable.)			

Difficulty: Medium

Learning Objective: Prepare closing entries and consider other matters relating to the closing process.

Section Reference: The Closing Process

CPA: Financial Reporting

Bloomcode: Analysis

AACSB: Analytic

Pr. 3-85 Ten-column work sheet

The work sheet and trial balance of Santos Corporation is reproduced below. The information given 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 permanent and temporary accounts.

Instructions

As the accountant for Santos, 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 statement of financial position. Carefully key your adjustments and label all items. (An adjusted trial balance is not required, but is included in the solution.) 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 residual (salvage) value.
- (c) Salesmen are paid commissions of 11% of sales. Commissions on sales for the last week of December have not been paid.
- (d) The note was issued on October 1, 2020, with interest at 8%, due Feb. 1, 2021.
- (e) A physical inventory of supplies indicated \$ 280 of supplies currently on hand.
- (f) Provisions of the company's lease contract specify rent payments must be made one month in advance, with monthly payments of \$ 900/mo. This provision has been complied with as at Dec. 31, 2020.

Santos Corporation
Work Sheet
Year ended December 31, 2020

	<u>Trial Balance</u>		<u>Adjustments</u>		<u>Adjusted Trial Balance</u>		<u>Statement of Comp. Income</u>		<u>Statement of Financial Position</u>	
<u>Accounts</u>	<u>Dr.</u>	<u>Cr.</u>	<u>Dr.</u>	<u>Cr.</u>	<u>Dr.</u>	<u>Cr.</u>	<u>Dr.</u>	<u>Cr.</u>	<u>Dr.</u>	<u>Cr.</u>
Cash	5,400									
Marketable Securities	4,050									
Accounts Receivable	40,000									
Allow. for D. A.		420								
Inventory	16,800									
Supplies	1,040									
Equipment	49,000									
Accum. Depr.-Equip.		9,500								
Accounts Payable		4,400								
Notes Payable		4,250								
Common Shares		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		<u>330,100</u>								
Totals	<u>414,010</u>	<u>414,010</u>								

Solution 3-85

Santos Corporation
Work Sheet

December 31, 2020

	<u>Trial Balance</u>		<u>Adjustments</u>		<u>Adjusted Trial Balance</u>		<u>Statement of Comp. Income</u>		<u>Statement of Financial position</u>	
<u>Accounts</u>	<u>Dr.</u>	<u>Cr.</u>	<u>Dr.</u>	<u>Cr.</u>	<u>Dr.</u>	<u>Cr.</u>	<u>Dr.</u>	<u>Cr.</u>	<u>Dr.</u>	<u>Cr.</u>
Cash	5,400				5,400				5,400	
Marketable Securities	4,050				4,050				4,050	
Accounts Receivable	40,000				40,000				40,000	
Allow. for D. A.		420		(a) 780		1,200				1,200
Mdse. Inventory	16,800				16,800				16,800	
Supplies	1,040			(e) 760	280				280	
Equipment	49,000				49,000				49,000	
Accum. Depr.-Equip.		9,500		(b) 6,000		15,500				15,500
Accounts Payable		4,400				4,400				4,400
Notes Payable		4,250				4,250				4,250
Common Shares		40,000				40,000				40,000
Retained Earnings		25,340				25,340				25,340
Cost of Goods Sold	238,520				238,520		238,520			
Office Salaries	20,800				20,800		20,800			
Sales Commissions	29,000		(c) 7,311		36,311		36,311			
Rent Expense	7,200			(f) 900	6,300		6,300			
Misc. Expense	2,200				2,200		2,200			
Sales		<u>330,100</u>				330,100		330,100		
Totals	<u>414,010</u>	<u>414,010</u>								
Bad Debt Expense			(a) 780		780		780			
Depr. Expense			(b) 6,000		6,000		6,000			
Sales Com. Payable				(c) 7,311		7,311				7,311
Interest Expense			(d) 85		85		85			
Interest Payable				(d) 85		85				85
Supplies Expense			(e) 760		760		760			
Prepaid Rent			<u>(f) 900</u>		900				<u>900</u>	
Totals			<u>15,836</u>	<u>15,836</u>			311,756	330,100	116,430	98,086
Net Income							<u>18,344</u>			<u>18,344</u>
Totals					<u>428,186</u>	<u>428,186</u>	<u>330,100</u>	<u>330,100</u>	<u>116,430</u>	<u>116,430</u>

Santos Corporation
Work Sheet
Adjusted Trial Balance

<u>Accounts</u>	<u>Debit</u>	<u>Credit</u>
Cash	5,400	
Marketable Securities	4,050	
Accounts Receivable	40,000	
Allow. for D. A.....		1,200
Mdse. Inventory	16,800	
Supplies	280	
Equipment	49,000	
Accum. Depr.–Equipment.....		15,500
Accounts Payable		4,400
Notes Payable.....		4,250
Common Shares		40,000
Retained Earnings		25,340
Cost of Goods Sold	238,520	
Office Salaries.....	20,800	
Sales Commissions	36,311	
Rent Expense	6,300	
Misc. Expense	2,200	
Sales.....		330,100
Bad Debt Expense	780	
Depr. Expense.....	6,000	
Sales Com. Payable		7,311
Interest Expense.....	85	
Interest Payable		<u>85</u>
Supplies Expense	760	
Prepaid Rent.....	<u>900</u>	
Totals	<u>428,186</u>	<u>428,186</u>

Adjusting entries and explanations

1. Bad Debt Expense 780

Allowance for Doubtful Accounts..... 780

(3% of accounts receivable is $3\% \times \$40,000$, which is \$1,200. Since the allowance account has a credit balance of \$420 before adjustment, \$780 must be added to the allowance account.)
2. Depreciation Expense 6,000

Accumulated Depreciation—Equipment	6,000	
(\$ 49,000 – \$ 1,000 is \$ 48,000. One-eighth of \$ 48,000 is \$ 6,000.)		
3. Sales Commissions	7,311	
Sales Commissions Payable		7,311
(11% of sales is $11\% \times \$ 330,100$, 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.)		
4. Interest Expense.....	85	
Interest Payable		85
(\$ 4,250 $\times .08 \times 3 \div 12 = \$ 85$)		
5. 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.)		
6. 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.)		

Difficulty: Medium

Learning Objective: Prepare closing entries and consider other matters relating to the closing process.

Section Reference: The Closing Process

CPA: Financial Reporting

Bloomcode: Analysis

AACSB: Analytic

Pr. 3-86 Preparation of financial statements

Use the following information to prepare a multi-step Statement of Comprehensive Income, a Statement of Changes in Shareholders Equity, and a classified Statement of Financial Position.

**Charles Corporation
Adjusted Trial Balance
December 31, 2020**

	<u>Debit</u>	<u>Credit</u>
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 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	
Interest Payable		<u>22,000</u>
Totals	<u>2,011,400</u>	<u>2,011,400</u>

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 within 12 months.
4. Repair expense is 100% administrative.

Solution 3-86

Charles Corporation
Statement of Comprehensive Income
Year Ended December 31, 2020

Sales revenue	
Sales.....	\$ 1,494,400
Less: Sales returns and allowances.....	<u>8,400</u>
Net sales	1,486,000
Cost of goods sold	<u>994,800</u>
Gross profit	491,200

Operating expenses

Selling expenses

Salaries expense	\$ 196,000	
(\$ 280,000 x 70%)		
Advertising expense	52,800	
Rent expense	38,400	
(\$ 48,000 x 80%)		
Delivery expense	33,400	
Utilities expense	22,400	
(\$ 28,000 x 80%)		
Depr. exp.—store equipment	18,000	
Depr. exp.—delivery equipment	14,000	
Store supplies expense	<u>4,000</u>	
Total selling expenses		\$ 379,000

Administrative expenses

Salaries expense	84,000	
(\$ 280,000 x 30%)		
Repair expense	24,200	
Rent expense	9,600	
(\$ 48,000 x 20%)		
Utilities expense	<u>5,600</u>	
(\$ 28,000 x 20%)		
Total admin. expenses		<u>123,400</u>

Total operating expenses		<u>502,400</u>
Loss from operations		11,200
Other expenses and losses		
Interest expense		<u>22,000</u>
Net loss		<u>\$ 33,200</u>

Charles Corporation
Statement of Changes in Shareholders' Equity
for Year Ended December 31, 2020

	Total	Common Shares	Comprehensive Income	Retained Earnings (Deficit)
Beginning, Jan 1, 2020	\$ 216,000	\$ 200,000	0	\$ 16,000
Net loss for 2020	(33,200)		(33,200)	(33,200)
Other comprehensive income			<u>0</u>	
Comprehensive income			<u>(33,200)</u>	
Ending, Dec 31, 2020	182,800	200,000		(17,200)

Charles Corporation
Statement of Financial Position
December 31, 2020

Assets			
Current assets			
Cash			\$ 33,400
Accounts receivable			87,400
Merchandise inventory			90,000
Store supplies.....			<u>7,000</u>
Total current assets			217,800
Non-current assets			
Store equipment	\$ 170,000		
Accumulated depreciation—store equipment	<u>54,000</u>	\$ 116,000	
Delivery equipment.....	96,000		
Accumulated depreciation—delivery equipment	<u>26,000</u>	<u>70,000</u>	<u>186,000</u>
Total assets			<u>\$ 403,800</u>
Liabilities and Shareholders' Equity			
Current liabilities			
Current portion of notes payable			\$ 60,000
Accounts payable			117,000
Interest payable			<u>22,000</u>
Total current liabilities.....			199,000
Non-current liabilities			
Notes payable			<u>22,000</u>
Total liabilities.....			221,000
Shareholders' equity			
Common Shares.....	\$ 200,000		
Deficit.....	<u>(17,200)</u>		<u>182,800</u>
Total liabilities and shareholders' equity			<u>\$ 403,800</u>

Difficulty: Medium

Learning Objective: Prepare a 10-column work sheet and financial statements.

Section Reference: Using a Work Sheet

CPA: Financial Reporting

CPA: Management Accounting

Bloomcode: Analysis

AACSB: Analytic

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CHAPTER 1

THE CANADIAN FINANCIAL REPORTING ENVIRONMENT

CHAPTER STUDY OBJECTIVES

1. *Understand the financial reporting environment.* Accounting provides reliable, relevant, and timely information to managers, investors, and creditors so that resources are allocated to the most efficient enterprises. Accounting also provides measurements of efficiency (profitability) and financial soundness. Investors, creditors, management, securities commissions, stock exchanges, analysts, credit rating agencies, auditors, and standard setters are some of the major stakeholders. Illustration 1-4 explains what is at stake for each one. The objective of financial reporting is to communicate information that is useful to key decision makers such as investors and creditors in making resource allocation decisions (including assessing management stewardship) about the resources and claims to resources of an entity and how these are changing. Ideally, all stakeholders should have access to the same information in order to ensure that good decisions are made in the capital marketplace. (This is known as information symmetry.) However, this is not the case—there is often information asymmetry. Of necessity, management has access to more information so that it can run the company. It must also make sure that it does not give away information that might harm the company, such as in a lawsuit where disclosure might cause the company to lose. Aside from this, information asymmetry exists because of management bias whereby management acts in its own self-interest, such as wanting to maximize management bonuses. This is known as moral hazard in accounting theory. Information asymmetry causes markets to be less efficient. It may cause stock prices to be discounted or costs of capital to increase. In addition, it might detract good companies from raising capital in the particular market where relevant information is not available (referred to as adverse selection in accounting theory). The efficient markets hypothesis is felt to exist only in a semi-strong form, meaning that only publicly available information is assimilated into stock prices.

2. *Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.* The accounting profession has tried to develop a set of standards that is generally accepted and universally practised. This is known as GAAP (generally accepted accounting principles). Without this set of standards, each enterprise would have to develop its own standards, and readers of financial statements would have to become familiar with every company's particular accounting and reporting practices. As a result, it would be almost impossible to prepare statements that could be compared. In addition, accounting standards help deal with the information asymmetry problem. The Canadian Accounting Standards Board (AcSB) is the main standard-setting body in Canada for private companies, pension plans, and not-for-profit entities. Its mandate comes from the Canada Business Corporations Act and Regulations as well as provincial acts of

incorporation. For public companies, GAAP is International Financial Reporting Standards (IFRS) as established by the International Accounting Standards Board (IASB). Public companies are required to follow GAAP in order to access capital markets, which are monitored by provincial securities commissions. The Financial Accounting Standards Board (FASB) is also important as it influences IFRS standard setting. Private companies may choose to follow IFRS. Public companies that list on U.S. stock exchanges may choose to follow U.S. GAAP.

3. Explain the meaning of generally accepted accounting principles (GAAP) and the significance of professional judgement in applying GAAP. Generally accepted accounting principles are either principles that have substantial authoritative support, such as the *CPA Canada Handbook*, or those arrived at through the use of professional judgement and the conceptual framework.

Professional judgement plays an important role in Accounting Standards for Private Enterprises (ASPE) and IFRS since much of GAAP is based on general principles, which need to be interpreted.

4. Discuss some of the challenges and opportunities for accounting. Some of the challenges facing accounting are oversight in the capital markets, centrality of ethics, standard setting in a political environment, principles- versus rules-based standard setting, the impact of technology, and integrated reporting. All of these require the accounting profession to continue to strive for excellence and to understand how accounting adds value in the capital marketplace.

MULTIPLE CHOICE QUESTIONS

Answer	No.	Description
d	1.	Accounting characteristics
a	2.	Nature of financial accounting
c	3.	Definition of financial accounting
b	4.	Definition of management accounting
d	5.	Efficient use of resources
c	6.	Capital allocation process
d	7.	Importance of accounting information
d	8.	Primary exchange mechanism(s) for allocating resources
c	9.	Changing financial reporting environment
b	10.	Stakeholders in the financial reporting environment
d	11.	Preparation of audited financial statements
a	12.	Auditor's responsibility
c	13.	Causes of subprime lending crisis
a	14.	Management's <i>primary</i> responsibility with respect to financial statements
c	15.	Primary responsibility of security and exchange commissions
b	16.	Objectives of financial reporting
b	17.	Appropriate objectives of general-purpose financial reporting
b	18.	Accrual-basis accounting
c	19.	Preparation of biased information
c	20.	Existence of information asymmetry
b	21.	Efficient markets hypothesis
d	22.	Management bias
a	23.	Moral hazard

- d 24. Conservative accounting
- b 25. Reduction of information asymmetry
- b 26. Development of GAAP
- c 27. Financial reporting before 1900
- c 28. Responsibility of the AcSB
- a 29. Oversight of AcSB
- c 30. Authority over accounting standards in the U.S
- d 31. Development of financial reporting standards in Canada
- b 32. Adoption of IFRS
- d 33. Activities and authority of the Ontario Securities Commission (OSC)
- b 34. Use of ASPE
- a 35. IASB's standard-setting process
- c 36. Primary sources of GAAP under ASPE
- c 37. Sources of GAAP
- d 38. Exercise of professional judgement
- c 39. Rules-based vs. principles-based approach
- c 40. Comparison of Canadian GAAP and U.S. GAAP
- b 41. SOX
- a 42. Advancement of technology on financial reporting
- a 43. IASB principles regarding funding
- c 44. Rules-based GAAP body of knowledge

EXERCISES

Item	Description
E1-45	Effective capital allocation
E1-46	Financial statements in practice and theory
E1-47	Stakeholders in the financial reporting environment
E1-48	Sources of capital and stages of company growth
E1-49	Objectives of financial reporting
E1-50	Traditional users vs. others
E1-51	Imperfection of the stakeholder ecosystem
E1-52	Entity vs. proprietary perspective
E1-53	User needs
E1-54	The decision-usefulness approach to financial reporting
E1-55	Merits of accrual- vs. cash-basis accounting
E1-56	Information asymmetry
E1-57	Maintaining competitive advantage
E1-58	Management bias in financial statement presentation
E1-59	Financial versus managerial accounting
E1-60	Role of securities commissions and stock exchanges
E1-61	Standard setting

E1-62	Purpose of accounting standards
E1-63	ASPE vs. IFRS
E1-64	IFRS Discussion Group
E1-65	Sources of GAAP
E1-66	Sources of GAAP
E1-67	Professional judgement
E1-68	SOX and standard setting
E1-69	Challenges facing financial reporting
E1-70	Role of executives and management in a post-SOX world
E1-71	Technology and financial information
E1-72	Extensible business reporting
E1-73	IFRS taxonomy
E1-74	Principles- versus rules-based approaches

PROBLEMS

Item	Description
P1-75	U.S. GAAP impact on Canadian GAAP
P1-76	Shortcomings of rules-based approach

MULTIPLE CHOICE

1. The essential characteristic(s) of accounting is (are)
- a) communication of financial information to interested internal parties only.
 - b) communication of economic information to external parties.
 - c) identification and measurement of financial information only.
 - d) identification, measurement, and communication of financial information.

Answer: d

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

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.

Answer: a

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

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 external users and Canada Revenue Agency.

Answer: c

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

4. Management accounting can be broadly defined as the area of accounting that communicates financial information

- a) to investors only.
- b) to parties internal to the business enterprise only.
- c) to parties both internal and external to the business enterprise.
- d) primarily to external users and Canada Revenue Agency.

Answer: b

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

CPA: Management Accounting

Bloomcode: Knowledge

AACSB: Analytic

5. Whether a business is successful and thrives is determined by

- a) free enterprise or competition.
- b) competition and markets only.
- c) markets and free enterprise only.
- d) markets, competition, and free enterprise.

Answer: d

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

CPA: Strategy & Governance

Bloomcode: Knowledge

AACSB: Analytic

5. Whether a business is successful and thrives is determined by

- a) free enterprise or competition.
- b) competition and markets only.
- c) markets and free enterprise only.
- d) markets, competition, and free enterprise.

Answer: d

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

CPA: Strategy & Governance

Bloomcode: Knowledge

AACSB: Analytic

6. Which of the following is correct?

- a) Reported accounting numbers do not affect the transfer of resources.
- b) Credit rating agencies use accounting information to assess only assets.
- c) Efficient capital markets promote productivity and encourage innovation.
- d) Efficient capital markets promote productivity but do not encourage innovation.

Answer: c

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

CPA: Strategy & Governance

Bloomcode: Knowledge

AACSB: Analytic

7. Information provided by accounting is important because it enables investors and creditors to

- a) compare income and assets of companies.
- b) assess the relative risks and returns of investment opportunities.
- c) channel their resources more effectively.
- d) all of the above

Answer: d

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

CPA: Strategy & Governance

Bloomcode: Knowledge

AACSB: Analytic

8. In Canada, the primary exchange mechanism(s) for allocating resources is (are)

- a) debt and equity markets.
- b) financial Institutions such as banks.
- c) government authorities such as the Canada Revenue Agency (CRA).
- d) both a and b

Answer: d

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

9. Which of the following is/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 who want more information regarding environmental and social issues
- d) increased use of the Internet

Answer: c

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

Learning Objective: Discuss some of the challenges and opportunities for accounting.

Section Reference: Challenges and Opportunities for the Accounting Profession

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

10. Stakeholders who help in the efficient allocation of resources include

- a) investors and creditors.
- b) financial analysts and regulators.
- c) creditors and auditors.
- d) management and auditors.

Answer: b

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

11. Audited financial statements are prepared by

- a) auditors.

- b) financial analysts.
- c) Canada Revenue Agency.
- d) management.

Answer: d

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

12. The auditor's primary responsibility is to
- a) review financial statements and discuss them with management.
 - b) prepare financial statements.
 - c) report to Canada Revenue Agency.
 - d) report to standard setters.

Answer: a

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Audit & Assurance

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

13. 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) the practice of securitizing assets.
 - d) a lack of investor understanding of the investment's true risk.

Answer: c

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Finance

CPA: Professional & Ethical Behaviour

CPA: Strategy & Governance

Bloomcode: Knowledge

AACSB: Analytic

14. Management's primary responsibility with respect to financial statements is to
- a) prepare them, as they have the best insight and know what should be included.
 - b) audit them, as they are distant enough from daily operations.
 - c) rely on them to make decisions.
 - d) None of the above are true.

Answer: a

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

CPA: Strategy & Governance

Bloomcode: Knowledge

AACSB: Analytic

15. The primary responsibility of security and exchange commissions with respect to financial statements is to
- a) set generally accepted accounting principles (GAAP), which must be followed in their preparation.
 - b) review accounting choices made by companies in their financial statements to ensure decision-making logic is sound.
 - c) monitor financial statements to ensure full and plain disclosure of material information, thus maintaining compliance with listing requirements.
 - d) monitor and analyze the information looking for signs of an improved or weakened financial condition.

Answer: c

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

CPA: Strategy & Governance

Bloomcode: Knowledge

AACSB: Analytic

16. Objectives of financial reporting do NOT include
- a) providing information that is useful to users in making resource allocation decisions.
 - b) providing information about the liquidation value of an enterprise.
 - c) providing information about an entity's economic resources, obligations, and equity/net assets.
 - d) providing information about changes in an entity's economic resources, obligations, and equity/net assets.

Answer: b

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

17. As part of the objective of general-purpose financial reporting, which of the following perspectives are considered appropriate?
- a) proprietary perspective
 - b) entity perspective
 - c) stakeholder perspective
 - d) None of the above perspectives are considered appropriate.

Answer: b

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

18. Which of the following is NOT true regarding accrual-basis accounting?

- a) A company records events that change its financial statements in the periods in which the events occur.
- b) Revenues and expenses are recognized in the periods in which the company receives or pays cash.
- c) It has greater potential to depict meaningful trends in revenues and expenses.
- d) Revenues and expenses can be more easily related to the economic environment of the period in which they occurred.

Answer: b

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

19. The preparation by some companies of biased information is sometimes referred to as

- a) conservative financial reporting.
- b) full disclosure of all material facts.
- c) aggressive financial reporting.
- d) stewardship.

Answer: c

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

20. Where information asymmetry exists, the capital market may attract the wrong kind of company. This is known as

- a) moral hazard.
- b) conservative accounting.
- c) adverse selection.
- d) an inefficient marketplace.

Answer: c

Difficulty: Easy

Learning Objective: Understand the financial reporting environment. .

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

CPA: Professional & Ethical Behaviour

Bloomcode: Knowledge

AACSB: Analytic

21. The “efficient markets hypothesis” proposes that

- a) market prices reflect information known only to internal stakeholders.
- b) market prices reflect all information about a company.
- c) market prices reflect information known only to external stakeholders.
- d) information asymmetry is required.

Answer: b

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Finance

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

22. Which of the following does NOT describe a cause of management bias?

- a) the need to comply with contracts, such as debt covenants
- b) the desire to meet financial analysts’ expectations
- c) the tendency to downplay negative events
- d) the desire for all stakeholders to have access to all information

Answer: d

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Audit & Assurance

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

23. Where people think that no one is watching, they will often shirk their responsibilities. This is known as

- a) moral hazard.
- b) conservative accounting.
- c) adverse selection.
- d) an inefficient marketplace.

Answer: a

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

24. Conservative accounting refers to

- a) a manager's tendency to shirk his stewardship responsibilities.
- b) a manager's engagement in greater risk taking.
- c) a decision to downplay the negative and focus on the positive.
- d) a decision to downplay the positive and focus on the negative.

Answer: d

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

CPA: Strategy & Governance

Bloomcode: Knowledge

Feedback: a, b, and c describe aggressive accounting.

AACSB: Analytic

25. The problem of information asymmetry can be reduced by

- a) aggressive accounting.
- b) accounting standards.
- c) adverse selection.
- d) only focusing on positive events.

Answer: b

Difficulty: Easy

Learning Objective: Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.

Section Reference: Standard Setting

CPA: Financial Reporting

CPA: Strategy & Governance

Bloomcode: Knowledge

AACSB: Analytic

26. Which of the following sources of generally accepted accounting principles (GAAP) are NOT developed by the Canadian Accounting Standards Board (AcSB)?

- a) Accounting Standards for Private Enterprises (ASPE)
- b) International Financial Reporting Standards (IFRS)
- c) GAAP for pension plans
- d) GAAP for not-for-profit entities

Answer: b

Difficulty: Easy

Learning Objective: Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.

Section Reference: Standard Setting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

27. Before 1900, which of the following accurately describes financial reports?

- a) They emphasized the need for standardized and increased corporate disclosures.
- b) They were for widespread use and distribution.
- c) They emphasized solvency and liquidity.
- d) None of the above accurately describe financial reports pre-1900.

Answer: c

Difficulty: Easy

Learning Objective: Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.

Section Reference: Standard Setting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

28. As of 2011, the responsibilities of the Accounting Standards Board (AcSB) in Canada relate to setting standards for

- a) publicly accountable entities only.
- b) both publicly accountable entities and private enterprises.
- c) private enterprises, not-for-profit entities, and pension plans.
- d) not-for-profit entities and pension plans only.

Answer: c

Difficulty: Easy

Learning Objective: Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.

Section Reference: Standard Setting

CPA: Audit & Assurance

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

29. In Canada, the body that has the responsibility of overseeing the Accounting Standards Board (AcSB) is the

- a) Accounting Standards Oversight Council (AcSOC).
- b) International Accounting Standards Board (IASB).
- c) Canadian Institute of Chartered Accountants (CICA).
- d) Financial Accounting Standards Board (FASB).

Answer: a

Difficulty: Easy

Learning Objective: Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.

Section Reference: Standard Setting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

30. In the United States, the body that has the final authority over accounting standards is the

- a) Financial Accounting Standards Board (FASB).
- b) International Accounting Standards Board (IASB).
- c) Securities Exchange Commission (SEC).
- d) Accounting Standards Oversight Council (AcSOC).

Answer: c

Difficulty: Easy

Learning Objective: Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.

Section Reference: Standard Setting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

31. In Canada, the body that is NOT instrumental in the development of financial reporting standards is the

- a) Accounting Standards Board (AcSB).
- b) Financial Accounting Standards Board (FASB).
- c) International Accounting Standards Board (IASB).
- d) American Institute of Certified Public Accountants.

Answer: d

Difficulty: Easy

Learning Objective: Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.

Section Reference: Standard Setting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

32. The adoption of International Financial Reporting Standards in Canada 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) the desire of most private companies to expand internationally.

Answer: b

Difficulty: Easy

Learning Objective: Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.

Section Reference: Standard Setting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

33. 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.

Answer: d

Difficulty: Easy

Learning Objective: Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.

Section Reference: Standard Setting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

34. Which of the following does NOT support the use of Accounting Standards for Private Enterprises (ASPE)?

- a) Private enterprises usually have less complex business models.
- b) Private enterprises that are "going public."
- c) Private enterprises usually have fewer users.
- d) Private enterprises' financial statement users tend to have first-hand information.

Answer: b

Difficulty: Easy

Learning Objective: Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.

Section Reference: Standard Setting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

35. Which of the following does NOT describe a step in the IASB's standard-setting process?

- a) appointing trustees to the IFRS Foundation
- b) development of an exposure draft
- c) provision of strategic advice by the IFRS Advisory Council
- d) public consultation

Answer: a

Difficulty: Easy

Learning Objective: Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.

Section Reference: Standard Setting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

36. Under ASPE, the primary sources of GAAP include

- a) accounting textbooks and journals.
- b) International Financial Reporting Standards.
- c) the CICA Handbook and appendices.
- d) research studies.

Answer: c

Difficulty: Easy

Learning Objective: Explain the meaning of generally accepted accounting principles (GAAP) and the significance of professional judgement in applying GAAP.

Section Reference: Generally Accepted Accounting Principles

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

37. Under ASPE, the other (as opposed to primary) sources of GAAP include

- a) the CICA Handbook and appendices.
- b) Accounting Guidelines, including appendices.
- c) pronouncements by accounting standard-setting bodies in other jurisdictions.
- d) All of these are primary sources of GAAP.

Answer: c

Difficulty: Easy

Learning Objective: Explain the meaning of generally accepted accounting principles (GAAP) and the significance of professional judgement in applying GAAP.

Section Reference: Generally Accepted Accounting Principles

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

38. The exercise of professional judgement does NOT involve

- a) the use of knowledge gained through education.

- b) the application of knowledge gained through experience.
- c) the use of ethical decision making.
- d) aggressive accounting.

Answer: d

Difficulty: Easy

Learning Objective: Explain the meaning of generally accepted accounting principles (GAAP) and the significance of professional judgement in applying GAAP.

Section Reference: Generally Accepted Accounting Principles

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

39. In a rules-based approach (such as U.S. GAAP), compared to a principles-based approach (such as Canadian GAAP),

- a) the body of knowledge is smaller.
- b) the importance of communicating the best information to users is emphasized.
- c) since it is more prescriptive, it may be easier to defend how to account for a particular item.
- d) companies frequently do not interpret the rules literally.

Answer: c

Difficulty: Easy

Learning Objective: Explain the meaning of generally accepted accounting principles (GAAP) and the significance of professional judgement in applying GAAP.

Section Reference: Generally Accepted Accounting Principles

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

40. In a principles-based standard-setting system (such as Canadian GAAP), compared to a rules-based approach (such as U.S. GAAP),

- a) which is more prescriptive, it may be easier to defend how to account for a particular item.
- b) there is a rule for every situation.
- c) accountants either apply specific standards based on the conceptual framework, or, professional judgement consistent with the framework.
- d) it is expected that professional accountants might encounter situations where they are unable to apply the principles appropriately.

Answer: c

Difficulty: Easy

Learning Objective: Explain the meaning of generally accepted accounting principles (GAAP) and the significance of professional judgement in applying GAAP.

Section Reference: Generally Accepted Accounting Principles

Learning Objective: Discuss some of the challenges and opportunities for accounting.

Section Reference: Challenges and Opportunities for the Accounting Profession

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

41. 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.

Answer: b

Difficulty: Easy

Learning Objective: Discuss some of the challenges and opportunities for accounting.

Section Reference: Challenges and Opportunities for the Accounting Profession

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

42. Which of the following is likely to be an advantage of the advancement of technology on financial reporting?
- a) Users of financial information will have access to more information.
 - b) The quality and reliability of the information may be compromised.
 - c) Equal and fair access may be at issue.
 - d) Internet reporting will increase costs.

Answer: a

Difficulty: Easy

Learning Objective: Discuss some of the challenges and opportunities for accounting.

Section Reference: Challenges and Opportunities for the Accounting Profession

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Technology

43. One political factor influencing the standard-setting process is how the standard-setting bodies are financed. Which of the following is NOT an IASB principle regarding the nature and amount of funding?
- a) Closed-loop: Financial commitments for funding should be contingent upon particular outcomes.
 - b) Broad-based: It should not rely on one or a few sources.
 - c) Compelling: Constituents should not be allowed to benefit from the standards without contributing to the process of standard setting.
 - d) Country-specific: Funding should be shared by the major economies on a proportionate basis.

Answer: a

Difficulty: Easy

Learning Objective: Discuss some of the challenges and opportunities for accounting.

Section Reference: Challenges and Opportunities for the Accounting Profession

CPA: Financial Reporting

Bloomcode: Knowledge

Feedback: Funding must be open-ended.

AACSB: Analytic

44. Which of the following is an argument in favour of a GAAP body of knowledge that is more prescriptive, or rules-based?

- a) It always emphasizes communicating the best information for users.
- b) The body of knowledge becomes significantly smaller and therefore easier to manage.
- c) It may be easier to defend how to account for a particular item.
- d) There is a tendency for companies to interpret guidelines loosely, and thus account for items inconsistently.

Answer: c

Difficulty: Easy

Learning Objective: Discuss some of the challenges and opportunities for accounting.

Section Reference: Challenges and Opportunities for the Accounting Profession

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

EXERCISES

Ex. 1-45

Explain the advantages of an effective capital allocation process.

Solution 1-45

An effective capital allocation process encourages innovation, promotes productivity, and provides a platform for buying and selling securities and obtaining and granting credit.

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Communication

CPA: Management Accounting

Bloomcode: Knowledge

AACSB: Communication

Ex 1-46 Financial statements in practice and theory

What are the four most frequently provided financial statements? Provide two terminologies used to refer to each statement.

Solution 1-46

1. Statement of financial position/Balance sheet
2. Statement of income/comprehensive income/Income statement/ Profit and loss statement
3. Statement of cash flows/ Cash flow statement
4. Statement of changes in equity/ Statement of retained earnings

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

Ex. 1-47 Stakeholders in the financial reporting environment

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

Solution 1-47

At the centre 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, borrowers, and investors. 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 investors suffered large losses due to the defaulted loans.

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Communication

CPA: Finance

CPA: Strategy & Governance

Bloomcode: Comprehension

AACSB: Communication

Ex. 1-48 Sources of capital and stages of company growth

Briefly describe how the sources of capital a company relies upon for funding might vary according to their stage of growth.

Solution 1-48

As per Illustration 1-2, in the early project/idea stages a company will acquire its initial capital from founders, family, and friends. As they progress to the research and development or prototype stage, private and public venture capital may be introduced, and includes capital provided by angel investors, venture capitalists, and public exchanges such as the TSX Venture Exchange or TSX. Venture capitalists and these public exchanges become the dominant capital sources as greater amounts of capital are required and as a company progresses through commercialization and into stable production.

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Communication

CPA: Finance

CPA: Strategy & Governance

Bloomcode: Knowledge

AACSB: Communication

Ex. 1-49 Objectives of financial reporting

What are the objectives of financial reporting by business enterprises?

Solution 1-49

The objectives of financial reporting are to provide information

1. that is useful to investors, members, contributors, creditors and other users in making their resource allocation decisions and/or assessing management stewardship.
2. to help users in evaluating an entity's economic resources, obligations, and equity/net assets, and the changes to these items.
3. to help users evaluate the economic performance of an entity.

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

Ex 1-50 Traditional users vs. others

Beyond users relying directly on financial information for resource allocation, such as investors and creditors, identify at least two categories of stakeholders included in the broader definition of users who help in the efficient allocation of resources. For each category, indicate what is at stake.

Solution 1-50

Refer to Illustration 1-4.

Stakeholder	What is at Stake
Securities commissions and stock exchanges	Reputation, effective and efficient capital marketplace
Analysts and credit rating agencies	Reputation, profits
Auditors	Reputation, profits (companies are their clients)
Standard setters	Reputation

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Communication

CPA: Financial Reporting

CPA: Strategy & Governance

Bloomcode: Comprehension

AACSB: Communication

Ex. 1-51 Imperfection of the stakeholder ecosystem

The stakeholder ecosystem (depicted in Illustration 1-3) provides checks and balances to ensure that the people with capital—investors and creditors—have good information to use when deciding where best to invest and allocate capital. However, the system does not always work. Explain why this is the case.

Solution 1-51

The stakeholder ecosystem does not always provide perfect information for people with capital because it involves people, and human behaviour is an unpredictable variable. People often act in their own self-interest rather than in the best interest of the capital marketplace, and by extension, the economy.

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Communication

CPA: Financial Reporting

CPA: Strategy & Governance

Bloomcode: Comprehension

AACSB: Communication

Ex. 1-52 Entity vs. proprietary perspective

Explain the difference between the entity perspective and the proprietary perspective.

Solution 1-52

The entity perspective views companies as separate and distinct from their owners, e.g., corporate assets are viewed as assets of the company and not of a specific creditor or shareholder. Investors and creditors have liability or equity claims. On the other hand, the proprietary perspective holds that financial reporting should focus only on the needs of the shareholders, and is not considered appropriate. The entity perspective is adopted as part of the objective of general-purpose financial reporting.

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Communication

CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Communication

Ex. 1-53 User needs

Explain why providing information to users is a challenging task.

Solution 1-53

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. Secondly, users have very different needs. Some users are institutional investors who hold a large percentage of equity shareholdings 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.

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

Ex. 1-54 The decision-usefulness approach to financial reporting

Explain what is meant by the “decision-usefulness” approach to financial reporting. Who will this information be useful to, and why?

Solution 1-54

The decision-usefulness approach to financial reporting dictates that financial statements provide information about the reporting entity that is useful to present and potential equity investors, lenders, and other creditors in making decisions in their capacity as capital providers. It may also be useful to those who are not providers of capital such as analysts, regulators, and competitors.

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

Ex. 1-55 Merits of accrual- vs. cash-basis accounting

Investors are interested in assessing a company's ability to generate net cash inflows, as well as its ability to protect and enhance capital investments. Briefly explain how each of the accrual- and cash-basis methods, respectively, might enhance these objectives.

Solution 1-55

Cash-basis accounting provides better information for assessing the timing and amounts of cash flows, which assist with the first objective. The second objective, concerning long-term performance of the company, may be better served by accrual-based accounting, which generally provides better information about future ability to generate favourable cash flows. It also ties operations to events and the surrounding environment, which are better indicators of performance, and the company's ability to continue operating as a going concern.

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Communication

CPA: Financial Reporting

CPA: Management Accounting

Bloomcode: Comprehension

AACSB: Communication

Ex. 1-56 Information asymmetry

In markets where information asymmetry exists, there can be adverse selection and moral hazard. Explain what these terms mean.

Solution 1-56

Adverse selection refers to *hidden knowledge*, where the capital marketplace may attract the wrong type of company, such as companies who have the most to gain from not disclosing information. Given this situation, companies who do fully disclose all information may choose not to enter the marketplace if they are aware of the presence of adverse selection. Moral hazard refers to *hidden actions*, and occurs as a result of human nature. People or companies may shirk their responsibilities if they think they can get away with it, e.g., not disclose negative information since they know it may be detrimental to their share price. This is a form of management bias.

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Communication

CPA: Financial Reporting

CPA: Strategy & Governance

Bloomcode: Knowledge

AACSB: Communication

Ex. 1-57 Maintaining competitive advantage

In the most efficient and effective marketplace possible, all stakeholders would have equal access to all relevant information. However, a company may feel that complete disclosure may hurt their competitive advantage or position. Offer an example of a circumstance where this may be the case. What do you think the company should do?

Solution 1-57

An example where disclosure may hurt the company's competitive advantage or position would be a legal battle. If the company were in the middle of a lawsuit, the company would want to be careful about how much information was disclosed because it might affect the outcome of the lawsuit. This is an ethical dilemma. The company must weigh the costs and benefits of sharing information. If the financial impact of the lawsuit is expected to be material, they should, at minimum, disclose its existence in the notes to the financial statements. If the amount and timing of any financial impact are sufficiently known and certain, an accrual of these amounts may be necessary.

Difficulty: Hard

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Communication

CPA: Professional & Ethical Behaviour

CPA: Strategy & Governance

Bloomcode: Evaluation

AACSB: Communication

Ex. 1-58 Management bias in financial statement presentation

There are many reasons why management may present biased information in the financial statements. Identify at least three (3) such motivations.

Solution 1-58

Refer to Illustration 1-5. Possible motivations include:

- evaluation of management performance
- compensation structures
- access to capital markets and meeting financial analyst expectations
- contractual obligations

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Communication

CPA: Professional & Ethical Behaviour
CPA: Strategy & Governance
Bloomcode: Comprehension
AACSB: Communication

Ex. 1-59 Financial versus managerial accounting
Distinguish between financial and managerial accounting.

Solution 1-59

Financial accounting (financial reporting) is the process that culminates in the preparation of financial reports that cover all of the enterprise's business activities and that are used by both **internal and external** parties. Users of these financial reports include investors, creditors, and others.

In contrast, **managerial accounting** is the process of identifying, measuring, analyzing, and communicating financial information to internal decision-makers. This information may take varied forms, such as cost-benefit analyses and forecasts that management uses to plan, evaluate, and control an organization's operations.

Difficulty: Easy
Learning Objective: Understand the financial reporting environment.
Section Reference: Financial Statements and Financial Reporting
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Communication

Ex. 1-60 Role of securities commissions and stock exchanges
Explain the role of securities commissions and stock exchanges in financial reporting.

Solution 1-60

The securities commissions and stock exchanges monitor the financial statements of companies whose shares are publicly traded 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.

Difficulty: Easy
Learning Objective: Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.
Section Reference: Standard Setting
CPA: Communication
CPA: Management Accounting
CPA: Strategy & Governance
Bloomcode: Knowledge
AACSB: Communication

Ex. 1-61 Standard setting
Explain the relationship between Canadian GAAP and International Financial Reporting Standards (IFRS).

Solution 1-61

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).

Difficulty: Easy

Learning Objective: Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.

Section Reference: Standard Setting

CPA: Communication

CPA: Management Accounting

CPA: Strategy & Governance

Bloomcode: Knowledge

AACSB: Communication

Ex. 1-62 Purpose of accounting standards

Accounting professions in various countries have tried to develop a set of standards that are generally accepted and universally practised. Explain the motivation for creating such a set of standards.

Solution 1-62

Creating standards facilitates comparability across companies and periods. Without standards, each enterprise would develop its own standards, and readers of financial statement would have to become familiar with every company's particular accounting and reporting practices. It would be almost impossible to prepare statements that could be compared.

Difficulty: Easy

Learning Objective: Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.

Section Reference: Standard Setting

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

Ex. 1-63 ASPE vs. IFRS

Accounting standards for Private Enterprises (ASPE) are geared towards fewer users who have access to additional information about the company. The need for common language and comparability as facilitated by IFRS is less necessary among private enterprises. Explain why, despite this, a private company might choose to voluntarily adopt IFRS.

Solution 1-63

A private company that is looking to go public might find it easier to follow IFRS right from the beginning. Other motivations might include specific requests from users, or ease of adoption if the small enterprise is a subsidiary of a larger company with IFRS reporting already in place.

Difficulty: Easy

Learning Objective: Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.

Section Reference: Standard Setting

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

Ex. 1-64 IFRS Discussion Group

Explain the purpose of the IFRS Discussion Group.

Solution 1-64

The IFRS Discussion Group (IFRS DG) is a sub-committee created by the AcSB mandated to raise awareness of issues arising in Canada as a result of implementing IFRS, and to make recommendations to the AcSB for referral to the International Accounting Standards Board and its subcommittees.

Difficulty: Easy

Learning Objective: Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.

Section Reference: Standard Setting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

Ex. 1-65 Sources of GAAP

International Financial Reporting Standards (IFRS) are the primary source of GAAP for public enterprises 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 that accountants use.

Solution 1-65

Although IFRS outline the specific accounting treatment for a multitude of items, 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. Thus, accountants must use IFRS in conjunction with other sources like professional judgement,

pronouncements of other standard-setting bodies, accounting literature, and accepted industry practices.

Difficulty: Easy

Learning Objective: Explain the meaning of generally accepted accounting principles (GAAP) and the significance of professional judgement in applying GAAP.

Section Reference: Generally Accepted Accounting Principles

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

Ex. 1-66 Sources of GAAP

The Canadian principles-based GAAP does not offer specific standards for every transaction. When specific guidance cannot be found in primary sources such as the Handbook and Accounting guidelines, what process should the accountant follow in their consultation of other sources?

Solution 1-66

If primary sources do not deal with the specific issue, the entity should use accounting policies that are consistent with primary sources. The policies should be developed through use of professional judgement in accordance with the conceptual framework. The accountant might consider pronouncements of other standard setters, accepted industry practices, and other literature, with the goal of producing information that is as relevant and reliable.

Difficulty: Easy

Learning Objective: Explain the meaning of generally accepted accounting principles (GAAP) and the significance of professional judgement in applying GAAP.

Section Reference: Generally Accepted Accounting Principles

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

Ex. 1-67 Professional judgement

Explain the principle of professional judgement. When or why might it be necessary to employ professional judgement, even in a rules-based system?

Solution 1-67

Professional judgement is the process by which professional accountants with significant education and experience apply general principles appropriately as they see fit. This is important in Canada because IFRS and ASPE are based primarily on general principles rather than on specific rules. It may also be useful in a rules-based system, as novel circumstances

and transactions are bound to arise for which a rule does not yet exist. In these scenarios, the professional accountant must make use of professional judgement to decide which treatment/record-keeping approach to a transaction will provide the most relevant, reliable, and timely information to financial statement stakeholders.

Difficulty: Easy

Learning Objective: Explain the meaning of generally accepted accounting principles (GAAP) and the significance of professional judgement in applying GAAP.

Section Reference: Generally Accepted Accounting Principles

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 1-68 SOX and standard setting

After several highly publicized accounting scandals in the U.S. such as Enron, Sunbeam, and WorldCom, all of whom, coincidentally, were clients of the former public accounting firm of Arthur Andersen, the U.S. regulators enacted the Sarbanes-Oxley Act (SOX). Pressure was put on Canada to follow a similar course. Explain what Canada has done to make public companies more accountable.

Solution 1-68

First, the Canadian Public Accountability Board (CPAB) was created to supervise accounting issues similar to those addressed by SOX. These included establishing auditing, quality control, and independence standards and rules.

The Canadian Securities Administrators (CSA) has issued guidelines/rules that require (among other things)

1. company management to take responsibility for the appropriateness and fairness of the financial statements
2. public enterprises to have independent audit committees
3. public accounting firms to be subject to CPAB
4. greater disclosures including ratings from rating agencies, legal proceedings, payments to stock promoters, and details about corporate directors.

Difficulty: Easy

Learning Objective: Discuss some of the challenges and opportunities for accounting.

Section Reference: Challenges and Opportunities for the Accounting Profession

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

Ex. 1-69 Challenges facing financial reporting

In North America, the financial reporting environment is changing at a very rapid pace. Briefly describe four challenges facing the accounting profession today.

Solution 1-69

1. Oversight in the capital marketplace. The Sarbanes-Oxley Act (SOX) instituted the Public Company Accounting Oversight Board (PCAOB), stronger independence rules for auditors, reporting on the effectiveness of the financial reporting internal control system, and disclosure of a code of ethics for senior financial officers.
Canada has followed suit and developed the Canadian Public Accountability Board (CPAB). As well, the Canadian Securities Administrators (CSA) requires company management to take responsibility for the appropriateness and fairness of the financial statements, public companies to have independent audit committees, and public accounting firms to be subject to the CPAB. The CSA also requires much greater disclosures. The overall impact of these financial reforms has been to put more emphasis on government regulation and less on self-regulation.
2. Centrality of ethics. Accountants are central in making the capital marketplace efficient and effective. However, ethical dilemmas are common, often precipitated by management bias. It is not always easy to “do the right thing.” Pressure to “bend the rules,” “play the game,” or “just ignore it” are often there. There is no consensus (yet) among accounting professionals as to what a comprehensive ethical system is, and so it is up to the individual accountant to maintain a high standard of ethics at all times.
3. Standard setting in a political environment. Since standard setting is part of the real world, accounting standards often arise from political action. The stakeholders who lobby the hardest may unduly influence new or revised accounting standards. This is not surprising since many accounting standards have economic consequences. Thus standard setters such as the IASB must consider the needs of all stakeholders when creating or changing standards. The challenge is to find a balance between letting stakeholders have a say while not bowing to undue political pressure.
4. Principles vs. rules. Rules-based, prescriptive systems (such as U.S. GAAP or the Canadian income tax system) have a significantly larger body of knowledge than a principles-based approach such as IFRS and ASPE. However, there is a tendency to interpret the rules literally with a rules-based approach, possibly because it may be easier to defend the accounting for a particular item. A disadvantage of the rules-based approach is that it may not always communicate the best information to the user. The principles-based approaches are based on professional judgement, resulting in carefully reasoned application of the principle to the business facts. Since the body of knowledge is smaller with principles-based approaches, the standard setters must ensure it rests on a cohesive set of principles and conceptual framework, which is sufficiently flexible, and sufficiently detailed to provide good guidance.

Other challenges are the impact of technology and integrated reporting.

Difficulty: Easy

Learning Objective: Discuss some of the challenges and opportunities for accounting.

Section Reference: Challenges and Opportunities for the Accounting Profession

CPA: Communication

CPA: Financial Accounting

CPA: Management Accounting

CPA: Professional & Ethical Behaviour

Bloomcode: Knowledge

AACSB: Communication

Ex. 1-70 Role of executives and management in a post-SOX world

SOX introduced sweeping changes to the institutional structure of the accounting profession. What key provision was introduced relating to the role of management and executive officers, and their relationship to financial reporting? Why?

Solution 1-70

Chief executive officers (CEOs) and chief financial officers (CFOs) are required to certify that the financial statements and company disclosures are appropriate and fairly presented. In many cases, they must forfeit bonuses and profits if there is a restatement of their companies' accounting disclosures. Management must report on the effectiveness of financial reporting internal control systems. Requiring management and executives to make these attestations holds them accountable, and creates a greater sense of ownership over the financial statements. When this is done, management and executives are unable to claim ignorance if intentional misrepresentations or frauds present in the financial reports are uncovered, as many were in the pre-SOX era.

Difficulty: Easy

Learning Objective: Discuss some of the challenges and opportunities for accounting.

Section Reference: Challenges and Opportunities for the Accounting Profession

CPA: Audit & Assurance

CPA: Communication

CPA: Financial Reporting

CPA: Professional & Ethical Behaviour

CPA: Strategy & Governance

Bloomcode: Knowledge

AACSB: Communication

Ex. 1-71 Technology and financial information

Explain how technology impacts the accountants' role as providers of information.

Solution 1-71

Technology impacts the process of identifying, measuring, and communicating useful information to users in profound ways. Information is increasingly abundant and available through technology. Companies are required to file disclosures electronically through

securities commissions. Investors have access to a greater abundance of information as well. This includes earnings calls, analyst briefings, interviews with management and regulators, and much more. The Internet allows disclosure of and access to a much larger group of users while reducing the cost of said communication. As technology advances at a rapid pace, information may even be available in real time. This raises the concern of equal access to information, as it exposes companies to additional risks as they pertain to information security.

Difficulty: Hard

Learning Objective: Discuss some of the challenges and opportunities for accounting.

Section Reference: Challenges and Opportunities for the Accounting Profession

CPA: Audit & Assurance

CPA: Communication

CPA: Financial Reporting

CPA: Strategy & Governance

Bloomcode: Evaluation

AACSB: Technology

Ex. 1-72 Extensible business reporting

What is extensible business reporting language and how is it used?

Solution 1-72

Extensible business reporting language (XBRL) is a system that allows a company to tag its information so that users can more easily extract it for analyzing and other use. The CSA have launched a voluntary filing program, encouraging companies to use XBRL when filing their financial information with securities regulators.

Difficulty: Easy

Learning Objective: Discuss some of the challenges and opportunities for accounting.

Section Reference: Challenges and Opportunities for the Accounting Profession

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Technology

Ex. 1-73 IFRS taxonomy

What is the IFRS taxonomy and how is it used?

Solution 1-73

The IASB has created the IFRS taxonomy, which is a system for classifying things such as financial statement elements and amounts. In 2014, the IASB put together the IFRS

Taxonomy Consultative Group, which provides a technical advisory and review forum to keep abreast of the issues and keep the IFRS taxonomy up to date and relevant.

Difficulty: Easy

Learning Objective: Discuss some of the challenges and opportunities for accounting.

Section Reference: Challenges and Opportunities for the Accounting Profession

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

Ex. 1-74 Principles- versus rules-based approaches

Explain the difference between the principles- versus rules-based approaches regarding GAAP.

Solution 1-74

In a **rules-based** approach—much like the Canadian tax system—there is a rule for most things (even though the rule may be based on a principle). The result is that the body of knowledge in a rules-based approach is significantly larger than that in a principles-based approach.

IFRS and ASPE are more **principles-based**. The body of knowledge is smaller and the idea is that one or more principles form the basis for decision-making in many differing scenarios. In addition, professional judgement is fundamental. There is less emphasis on right and wrong answers. Rather, the financial reporting is a result of carefully reasoned application of the principle to the business facts.

Difficulty: Easy

Learning Objective: Discuss some of the challenges and opportunities for accounting.

Section Reference: Challenges and Opportunities for the Accounting Profession

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

PROBLEMS

P1-75 U.S. GAAP on Canadian GAAP

Explain why U.S. GAAP has and will continue to have a significant impact on GAAP in Canada.

Solution 1-75

U.S. GAAP has and will continue to have a significant impact on GAAP in Canada for three reasons:

Given that Canadian GAAP is based on principles and is fairly open to interpretation, accounting professionals have often (in past) relied on the more prescriptive, specific guidance provided in U.S. GAAP.

1. Many public Canadian companies are also listed on U.S. stock markets and exchanges and to be listed on a U.S. exchange, these companies must follow U.S. GAAP or IFRS. As we move toward international harmonization in accounting standards, the U.S. standards will continue to influence Canadian and international standards due to the significant capital pool of these markets.
2. The United States has not adopted IFRS. In October 2002, the FASB and IASB signed an agreement (the Norwalk Agreement) that formalized their commitment to converge U.S. and international accounting standards. In 2008, the FASB and IASB reaffirmed their commitment to continue to work together, although it is not clear whether this relationship will continue. In addition, the SEC issued a document known as the “Roadmap,” outlining issues regarding the convergence initiative. More recently, the United States has been examining just how moving to IFRS might work from a practical perspective, if at all. It is uncertain as to how the FASB will proceed in terms of IFRS.

Difficulty: Easy

Learning Objective: Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.

Section Reference: Standard Setting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

P1-76 Shortcomings of rules-based approach

Discuss the shortcomings of the rules-based approach regarding GAAP.

Solution 1-76

In a **rules-based** approach there is a tendency for companies to interpret the rules literally and many companies take the view that, if there is no rule for a particular situation, they are free to choose whatever treatment they think is appropriate (within reason). Similarly, many believe that as long as they comply with a rule, even in a narrow sense, they are in accordance with GAAP. Consequently, the rules-based approach does not always emphasize the importance of communicating the **best** information for users. Just because a practice is defensible does not mean it provides the best information. This particular issue is a significant one for the United States as it continues to debate whether to adopt IFRS which is principles-based rather than rules-based.

Difficulty: Easy

Learning Objective: Discuss some of the challenges and opportunities for accounting.

Section Reference: Challenges and Opportunities for the Accounting Profession

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

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CHAPTER 2

CONCEPTUAL FRAMEWORK UNDERLYING FINANCIAL REPORTING

CHAPTER STUDY OBJECTIVES

1. *Indicate the usefulness and describe the main components of a conceptual framework for financial reporting.* A conceptual framework is needed to (1) create standards that build on an established body of concepts and objectives, (2) provide a framework for solving new and emerging practical problems, (3) increase financial statement users' understanding of and confidence in financial reporting, and (4) enhance comparability among different companies' financial statements.

The first level deals with the objective of financial reporting. The second level includes the qualitative characteristics of useful information and elements of financial statements. The third level includes foundational principles and conventions.

2. *Identify the qualitative characteristics of accounting information.* The overriding criterion by which accounting choices can be judged is decision usefulness; that is, the goal is to provide the information that is the most useful for decision making. Fundamental characteristics include relevance and faithful representation. These two characteristics must be present. Enhancing characteristics include comparability, verifiability, timeliness, and understandability. There may be trade-offs.

3. *Define the basic elements of financial statements.* The basic elements of financial statements are (1) assets, (2) liabilities, (3) equity, (4) revenues, (5) expenses, (6) gains, and (7) losses.

4. *Describe the foundational principles of accounting.* (1) Economic entity: The assumption that the activity of a business enterprise can be kept separate and distinct from its owners and any other business unit. (2) Control: The entity has the power to make decisions and reap the benefits or be exposed to the losses (which are variable). (3) Revenue recognition: Revenue is generally recognized when it is (a) earned, (b) measurable, and (c) collectible (realizable). (4) Matching assists in the measurement of income by ensuring that costs (relating to long-lived assets) incurred in earning revenues are booked in the same period as the revenues earned. (5) Periodicity: The assumption that an enterprise's economic activities can be divided into artificial time periods to facilitate timely reporting. (6) Monetary unit: The

assumption that money is the common denominator by which economic activity is conducted, and that the monetary unit gives an appropriate basis for measurement and analysis. (7) Going concern: The assumption that the business enterprise will have a long life. (8) Historical cost principle: Existing GAAP requires that many assets and liabilities be accounted for and reported based on their acquisition price. Many assets are later revalued. (9) Fair value principle: Assets and liabilities are valued at fair value—that is, an exit price—and viewed from a market participant perspective. (10) Full disclosure principle: Accountants follow the general practice of providing information that is important enough to influence an informed user's judgement and decisions.

5. *Explain the factors that contribute to choice and/or bias in financial reporting decisions.*

Choice is the result of many things, including principles-based standards, measurement uncertainty, and increasingly complex business transactions. The conceptual framework is the foundation that GAAP is built on. If there is no primary source of GAAP for a specific decision, then professional judgement must be used, making sure that the accounting policies chosen are consistent with the primary sources of GAAP and the conceptual framework.

Financial engineering is the process of legally structuring a business arrangement or transaction so that it meets the company's financial reporting objective. This is a dangerous practice since it often results in biased information.

Fraudulent financial reporting often results from pressures on individuals or the company. These pressures may come from various sources, including worsening company, industry, or economic conditions; unrealistic internal budgets; and financial statement focal points related to contractual, regulatory, or capital market expectations. Weak internal controls and governance also contribute to fraudulent financial reporting.

6. *Discuss current trends in standard setting for the conceptual framework.* In 2018 the IASB issued a new conceptual framework. It is working on projects relating to disclosure and materiality.

MULTIPLE CHOICE QUESTIONS

Answer	No.	Description
c	1.	Conceptual framework
d	2.	Objectives of financial reporting
d	3.	Conceptual framework
a	4.	Conceptual framework
c	5.	Fundamental qualitative characteristics
b	6.	Relevance
b	7.	Relevance
c	8.	Materiality
c	9.	Understandability
d	10.	Representational faithfulness
a	11.	Criterion for accounting information
c	12.	Enhancing qualitative characteristics
d	13.	Comparability
a	14.	Timeliness
a	15.	Comparability
c	16.	Timeliness
c	17.	Costs of providing useful information
b	18.	Common characteristic of assets and liabilities
b	19.	Asset characteristics
c	20.	Liabilities
c	21.	Equitable obligations
a	22.	Items included in equity under IFRS
d	23.	Definition of gains
b	24.	Other comprehensive income

- c 25. Statements prepared using ASPE
- b 26. Components of comprehensive income
- d 27. Economic entity assumption
- c 28. Timing of revenue recognition
- a 29. Example of full disclosure
- d 30. Economic entity assumption
- c 31. Recognition and measurement
- b 32. Periodicity assumption
- d 33. Going concern assumption
- b 34. Historical cost principle
- b 35. Matching principle
- a 36. Use of allowance for doubtful accounts
- b 37. Historical cost principle
- a 38. Economic entity assumption
- b 39. Matching principle
- d 40. Recording of depreciation
- c 41. Fair value of an asset
- c 42. Full disclosure principle
- b 43. Measurement uncertainty
- b 44. Full disclosure principle
- c 45. Management Discussion and Analysis
- c 46. Inflation
- b 47. Bankruptcy
- a 48. Items included in MD&A
- c 49. Matching
- b 50. Financial reporting
- b 51. Principles-based GAAP
- c 52. Financial engineering
- d 53. Fraudulent financial reporting
- c 54. Accounting policies

EXERCISES

Item	Description
E2-55	Conceptual framework
E2-56	Levels of the conceptual framework
E2-57	Moral hazard
E2-58	Materiality
E2-59	Enhancing qualitative characteristics
E2-60	Accounting terminology – fill in the blanks
E2-61	Fundamental characteristics of useful information
E2-62	Equitable obligations

E2-63	Constructive obligations
E2-64	Comprehensive income
E2-65	Foundational principles
E2-66	Identification of foundational accounting principles
E2-67	Identification of foundational accounting principles and qualitative characteristics
E2-68	Foundational accounting principles and qualitative characteristics – matching
E2-69	Fair value measurement
E2-70	Matching concept
E2-71	Forms of business organization
E2-72	Measurement, existence, and outcome uncertainties
E2-73	Current value measurement bases
E2-74	Going concern assumption
E2-75	Market-based measure versus entity-specific measure
E2-76	Control and the economic entity assumption
E2-77	Principles- vs. rules-based GAAP
E2-78	Financial engineering
E2-79	Fraudulent financial reporting
E2-80	Fraudulent financial reporting and the accountant's role
E2-81	Financial reporting pressures caused by budgets

PROBLEMS

P2-84	Uncertainty trade-off
P2-85	IFRS/ASPE revenue recognition differences

MULTIPLE CHOICE

1. Which of the following is NOT part of the conceptual framework for financial reporting?

- a) elements of financial statements
- b) qualitative characteristics of accounting information
- c) notes to financial statements
- d) foundational principles

Answer: c

Difficulty: Easy

Learning Objective: Indicate the usefulness and describe the main components of a conceptual framework for financial reporting.

Section Reference: Conceptual Framework

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

2. 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 useful 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) to provide the most useful information possible even if the costs exceed the benefits

Answer: d

Difficulty: Easy

Learning Objective: Indicate the usefulness and describe the main components of a conceptual framework for financial reporting.

Section Reference: Conceptual Framework

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

3. Which of the following is NOT a component of a conceptual framework for financial reporting?

- a) accounting's goals and purposes
- b) qualitative characteristics of accounting information
- c) foundational principles
- d) All of the above are components of a conceptual framework.

Answer: d

Difficulty: Easy

Learning Objective: Indicate the usefulness and describe the main components of a conceptual framework for financial reporting.

Section Reference: Conceptual Framework

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

4. Which of the following best describes why a conceptual framework is necessary?

- a) to build all standards and rules upon a common foundation and increase financial statement users' understanding and confidence

- b) to make financial statement preparation an automated process requiring no human intervention
- c) to completely eliminate the potential for companies to exercise professional judgement in preparation of financial information
- d) to decrease the comparability of different companies' financial statements

Answer: a

Difficulty: Easy

Learning Objective: Indicate the usefulness and describe the main components of a conceptual framework for financial reporting.

Section Reference: Conceptual Framework

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

5. Fundamental qualitative characteristics include

- a) relevance and comparability.
- b) representational faithfulness and timeliness.
- c) relevance and representational faithfulness.
- d) verifiability and relevance.

Answer: c

Difficulty: Easy

Learning Objective: Identify the qualitative characteristics of accounting information.

Section Reference: Qualitative Characteristics of Useful Information

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

6. Which of the following does NOT relate to the concept of relevance?

- a) The information must be capable of making a difference in a decision.
- b) Both material and immaterial information is important.
- c) The information has predictive value.
- d) The information has feedback/confirmatory value.

Answer: b

Difficulty: Easy

Learning Objective: Identify the qualitative characteristics of accounting information.

Section Reference: Qualitative Characteristics of Useful Information

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

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.

Answer: b

Difficulty: Easy

Learning Objective: Identify the qualitative characteristics of accounting information.

Section Reference: Qualitative Characteristics of Useful Information

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

8. Materiality refers to

- a) the tangible nature of an item.
- b) representational faithfulness.
- c) the decision-making relevance of a piece of information.
- d) None of these describe materiality.

Answer: c

Difficulty: Easy

Learning Objective: Identify the qualitative characteristics of accounting information.

Section Reference: Qualitative Characteristics of Useful Information

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

9. Which of the following is true about understandability as a qualitative characteristic of financial statements?

- a) The onus to prepare understandable statements and to be able to understand them lies with the preparer.
- b) Where the underlying transactions or economic events are more complex, the user is expected to understand them without the assistance of an advisor.
- c) The onus to prepare understandable statements and to be able to understand them lies with the preparer and the user.

d) Users with no knowledge of business and financial accounting matters are expected to understand the financial statements.

Answer: c

Difficulty: Easy

Learning Objective: Identify the qualitative characteristics of accounting information.

Section Reference: Qualitative Characteristics of Useful Information

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

Bloomcode: Knowledge

AACSB: Communication

10. Representational faithfulness includes

- a) completeness, neutrality, and comparability.
- b) neutrality, completeness, and understandability.
- c) relevance, completeness, and freedom from material error.
- d) neutrality, completeness, and freedom from material error.

Answer: d

Difficulty: Easy

Learning Objective: Identify the qualitative characteristics of accounting information.

Section Reference: Qualitative Characteristics of Useful Information

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

11. 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.

Answer: a

Difficulty: Easy

Learning Objective: Identify the qualitative characteristics of accounting information.

Section Reference: Qualitative Characteristics of Useful Information

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

12. Which statement is correct regarding enhancing qualitative characteristics?
- a) Full discussion of the information presented is a substitute for comparable information.
 - b) Numbers that are easily verifiable with a reasonable degree of accuracy are called soft numbers.
 - c) Information must be available before it loses its ability to influence users' decisions.
 - d) Financial information must be of sufficient quality and clarity that even uninformed readers can understand it.

Answer: c

Difficulty: Easy

Learning Objective: Identify the qualitative characteristics of accounting information.

Section Reference: Qualitative Characteristics of Useful Information

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

13. Comparability allows any financial statement user to
- a) make timely decisions.
 - b) understand all the information presented.
 - c) verify all the data provided.
 - d) identify the real similarities and differences in economic phenomena.

Answer: d

Difficulty: Easy

Learning Objective: Identify the qualitative characteristics of accounting information.

Section Reference: Qualitative Characteristics of Useful Information

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

14. Timeliness is increased by
- a) quarterly reporting.
 - b) comparative financial statements.
 - c) representational faithfulness.
 - d) annual reporting.

Answer: a

Difficulty: Easy

Learning Objective: Identify the qualitative characteristics of accounting information.

Section Reference: Qualitative Characteristics of Useful Information
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

15. Harlow Ltd. operates in both Canada and the United States. The company wants to improve the qualitative characteristics of its financial statements. Which of the following would most likely improve the *comparability* of Harlow'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 Harlow's capital assets should be depreciated
 - d) the use of U.S.-trained accountants

Answer: a

Difficulty: Easy
Learning Objective: Identify the qualitative characteristics of accounting information.
Section Reference: Qualitative Characteristics of Useful Information
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

16. 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) increasing the number of disclosures
 - b) changing the timing of when revenues are recognized
 - c) increasing the frequency of statements from annually to quarterly
 - d) decreasing the useful life of property, plant, and equipment from ten years to five

Answer: c

Difficulty: Easy
Learning Objective: Identify the qualitative characteristics of accounting information.
Section Reference: Qualitative Characteristics of Useful Information
CPA: Financial Reporting
Bloomcode: Comprehension
AACSB: Analytic

17. The costs of providing useful information do NOT include

- a) collecting, processing, and distributing information.
- b) auditing financial statements.
- c) disclosure to competitors.
- d) users' allocation of resources.

Answer: c

Difficulty: Easy

Learning Objective: Identify the qualitative characteristics of accounting information.

Section Reference: Qualitative Characteristics of Useful Information

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

18. The common characteristic of both assets and liabilities is that they both

- a) provide an economic resource.
- b) result from a past transaction or event.
- c) represent a present responsibility.
- d) represent contractual or other rights.

Answer: b

Difficulty: Easy

Learning Objective: Define the basic elements of financial statements.

Section Reference: Elements of Financial Statements

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

19. Which of the following does NOT represent an essential characteristic of an asset?

- a) They represent a present economic resource.
- b) The entity is able to transfer the economic benefit if it so chooses.
- c) The entity has control over the resource.
- d) The resource results from a past transaction or event.

Answer: b

Difficulty: Easy

Learning Objective: Define the basic elements of financial statements.

Section Reference: Elements of Financial Statements

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

20. Which of the following statements regarding liabilities is true?

- a) They must arise through a contractual obligation.
- b) They may be attributable to a future transaction or event.
- c) The duty or responsibility obligates the entity.
- d) The entity often has reasonable discretion to avoid the obligation.

Answer: c

Difficulty: Easy

Learning Objective: Define the basic elements of financial statements.

Section Reference: Elements of Financial Statements

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

21. Equitable obligations arise due to

- a) statutory requirements.
- b) contractual obligations.
- c) moral or ethical considerations.
- d) union agreements.

Answer: c

Difficulty: Easy

Learning Objective: Define the basic elements of financial statements.

Section Reference: Elements of Financial Statements

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Ethics

22. Under IFRS, equity does NOT include

- a) long-term leases.
- b) common and/or preferred shares.
- c) accumulated other comprehensive income.
- d) retained earnings.

Answer: a

Difficulty: Easy

Learning Objective: Define the basic elements of financial statements.

Section Reference: Elements of Financial Statements

CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

23. Gains are defined as

- a) increases in economic resources resulting from an entity's ordinary activities.
- b) decreases in economic resources resulting from an entity's ordinary activities.
- c) the residual interest remaining after liabilities are deducted from assets.
- d) increases in equity resulting from an entity's peripheral or incidental transactions.

Answer: d

Difficulty: Easy
Learning Objective: Define the basic elements of financial statements.
Section Reference: Elements of Financial Statements
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

24. Under IFRS, "other comprehensive income" does NOT include

- a) unrealized holding gains and losses on certain securities.
- b) gains and losses on disposal of property, plant, and equipment.
- c) gains and losses related to certain types of hedges.
- d) certain gains and losses related to foreign exchange transactions.

Answer: b

Difficulty: Easy
Learning Objective: Define the basic elements of financial statements.
Section Reference: Elements of Financial Statements
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

25. Financial statements prepared under ASPE include a

- a) statement of comprehensive income.
- b) statement of cash flows and a statement of changes in shareholders' equity.
- c) balance sheet and a statement of retained earnings.
- d) statement of retained earnings and a statement of comprehensive income.

Answer: c

Difficulty: Easy

Learning Objective: Define the basic elements of financial statements.

Section Reference: Elements of Financial Statements

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

26. 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

Answer: b

Difficulty: Easy

Learning Objective: Define the basic elements of financial statements.

Section Reference: Elements of Financial Statements

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

27. A local businessman owns several different companies. His accountant prepares separate financial statements for each of these businesses. This is an application of the

- a) full disclosure principle.
- b) periodicity assumption.
- c) going concern assumption.
- d) economic entity assumption.

Answer: d

Difficulty: Easy

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

28. Generally, under ASPE, 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.

- c) an exchange has taken place and the earnings process is substantially complete.
- d) the entire amount receivable has been collected from the customer and there remains no further warranty liability.

Answer: c

Difficulty: Easy

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

29. 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 the

- a) full disclosure principle.
- b) periodicity assumption.
- c) going concern assumption.
- d) economic entity assumption.

Answer: a

Difficulty: Easy

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

30. 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.

Answer: d

Difficulty: Easy

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Knowledge
AACSB: Analytic

31. Under ASPE, when deciding whether to recognize a financial statement element (or not), and how to measure it, the accountant should
- a) always use estimates.
 - b) record “hard” numbers and ignore “soft” numbers.
 - c) determine an acceptable level of uncertainty.
 - d) recognize a financial statement element even if it cannot be measured.

Answer: c

Difficulty: Easy
Learning Objective: Describe the foundational principles of accounting.
Section Reference: Foundational Principles
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

32. During the lifetime of an entity, accountants produce financial statements at arbitrary points in time in accordance with the
- a) full disclosure principle.
 - b) periodicity assumption.
 - c) going concern assumption.
 - d) economic entity assumption.

Answer: b

Difficulty: Easy
Learning Objective: Describe the foundational principles of accounting.
Section Reference: Foundational Principles
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

33. 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) fair value principle.
 - d) going concern assumption.

Answer: d

Difficulty: Easy

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

34. Valuing assets at their liquidation values rather than their cost is inconsistent with the

- a) periodicity assumption.
- b) historical cost principle.
- c) matching principle.
- d) economic entity assumption.

Answer: b

Difficulty: Easy

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

35. Which of the following is NOT a good example of the matching principle?

- a) A machine that produces certain goods is depreciated over its useful life. The depreciation expense is matched with the proceeds from the sale of those goods.
- b) The entire amount of a two-year insurance premium is expensed in the first year.
- c) An uncollectible receivable is written off in the year that the sale was made.
- d) Recognition of revenue for which associated expenses cannot yet be determined is delayed until such determination can be made.

Answer: b

Difficulty: Easy

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

36. Use of an allowance for doubtful accounts is an application of the

- a) matching principle.
- b) revenue recognition principle.
- c) historical cost principle.
- d) full disclosure principle.

Answer: a

Difficulty: Easy

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

37. Which of the following statements does NOT apply to the historical cost principle?

- a) Historical cost represents a value at a point in time.
- b) The principle does not apply to financial instruments.
- c) Historical cost results from a reciprocal or two-way exchange.
- d) Over time, historical cost becomes irrelevant in terms of predictive value.

Answer: b

Difficulty: Easy

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

38. Preparation of consolidated financial statements when a parent-subsidary relationship exists is an example of

- a) the economic entity assumption.
- b) the matching principle.
- c) comparability.
- d) reliability.

Answer: a

Difficulty: Easy

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Comprehension
AACSB: Analytic

39. The matching principle 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) measuring expenses correctly.

Answer: b

Difficulty: Easy
Learning Objective: Describe the foundational principles of accounting.
Section Reference: Foundational Principles
CPA: Financial Reporting
Bloomcode: Comprehension
AACSB: Analytic

40. Which of the following serves as the justification for the periodic recording of depreciation expense?
- a) association of efforts (expense) with accomplishments (revenue)
 - b) minimization of income tax liability
 - c) immediate recognition of an expense
 - d) systematic and rational allocation of cost over the periods benefited

Answer: d

Difficulty: Easy
Learning Objective: Describe the foundational principles of accounting.
Section Reference: Foundational Principles
CPA: Financial Reporting
Bloomcode: Comprehension
AACSB: Analytic

41. Fair value (of an asset) is
- a) an entry price.
 - b) an entity-specific measure.
 - c) an exit price.
 - d) not used when following IFRS.

Answer: c

Difficulty: Easy

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

42. 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 contingencies.
- d) requires that the financial statements be consistent and comparable.

Answer: c

Difficulty: Easy

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

43. Under ASPE, 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 but disclose the measurement uncertainty in the notes to the financial statements.
- d) record the maximum amount in the financial statements.

Answer: b

Difficulty: Easy

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

44. The operations of a resource company's oil sands operations results in environmental damage. While the extent of the damage cannot be determined at this time, 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.

Answer: b

Difficulty: Easy

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

45. Management Discussion and Analysis (MD&A) is

- a) notes on meetings between management and auditors.
- b) an internal document not released to shareholders.
- c) supplementary information included in the annual report.
- d) supplementary information included in the notes to the financial statements.

Answer: c

Difficulty: Easy

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

46. Under GAAP, inflation has been historically ignored due to the

- a) economic entity assumption.
- b) going concern assumption.
- c) monetary unit assumption.
- d) periodicity assumption.

Answer: c

Difficulty: Easy

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

47. Which basic assumption may NOT be followed when a firm in bankruptcy reports financial results?

- a) economic entity assumption
- b) going concern assumption
- c) periodicity assumption
- d) monetary unit assumption

Answer: b

Difficulty: Easy

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

48. Management Discussion and Analysis (MD&A) does NOT include

- a) notes to the financial statements.
- b) key performance drivers.
- c) the company's vision and strategy.
- d) the company's capabilities (capital and other resources).

Answer: a

Difficulty: Easy

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

49. The practice of matching

- a) dictates that efforts (expenditures) be matched with associated cash flow.
- b) requires arbitrary allocation of an asset's contribution to a revenue stream.
- c) illustrates the cause and effect relationship between money spent to earn revenues and the revenues themselves.

d) is required by GAAP to approximate an asset's contribution to an entity's periodic cash flow.

Answer: c

Difficulty: Easy

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

50. Financial reporting is

- a) independent of the environment in which it operates.
- b) the result of carefully applied professional judgement.
- c) influenced by the decisions of individuals who act in the interest of stakeholders at the expense of themselves.
- d) completely free of bias.

Answer: b

Difficulty: Easy

Learning Objective: Explain the factors that contribute to choice and/or bias in financial reporting decisions.

Section Reference: Financial Reporting Issues

CPA: Financial Reporting

CPA: Strategy & Governance

Bloomcode: Knowledge

AACSB: Analytic

51. Principles-based GAAP is sometimes criticized for being

- a) too inflexible.
- b) too flexible.
- c) too inconsistent.
- d) too difficult for the reader to understand.

Answer: b

Difficulty: Easy

Learning Objective: Explain the factors that contribute to choice and/or bias in financial reporting decisions.

Section Reference: Financial Reporting Issues

CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

52. Which of the following situations does NOT demonstrate an attempt at financial engineering?
- a) creating complex legal arrangements and financial instruments
 - b) structuring debt financing so that it meets the GAAP definition of equity rather than debt
 - c) accounting for bona fide business transactions in a transparent manner
 - d) aggressively interpreting GAAP so that the impact on critical ratios is minimized

Answer: c

Difficulty: Easy
Learning Objective: Explain the factors that contribute to choice and/or bias in financial reporting decisions.
Section Reference: Financial Reporting Issues
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

53. 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) vigilant management
 - d) an increased focus on tying bonuses to short-term company performance

Answer: d

Difficulty: Easy
Learning Objective: Explain the factors that contribute to choice and/or bias in financial reporting decisions.
Section Reference: Financial Reporting Issues
CPA: Financial Reporting
Bloomcode: Comprehension
AACSB: Analytic

54. In the absence of specific GAAP guidance, an entity should adopt accounting policies that are
- i. consistent with specific GAAP guidance.

- ii. consistent with the most conservative reporting choices.
 - iii. collaboratively developed with the assistance of all business units.
 - iv. developed through exercising professional judgement and applying the conceptual framework.
- a) i, ii, and iii
 - b) i and iii
 - c) i and iv
 - d) ii and iv

Answer: c

Difficulty: Easy

Learning Objective: Explain the factors that contribute to choice and/or bias in financial reporting decisions.

Section Reference: Financial Reporting Issues

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

EXERCISES

Ex. 2-55 Conceptual framework

Briefly describe the objectives of a soundly developed conceptual framework.

Solution 2-55

A soundly developed conceptual framework should

1. increase financial statement users' understanding of and confidence in financial reporting,
2. enhance comparability among companies' financial statements,
3. allow new and emerging practical problems to be solved more quickly.

Difficulty: Easy

Learning Objective: Indicate the usefulness and describe the main components of a conceptual framework for financial reporting.

Section Reference: Conceptual Framework

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

Ex. 2-56 Levels of the conceptual framework

Provide a brief overview of the levels of a conceptual framework.

Solution 2-56

First Level: The “why” – The conceptual framework’s building blocks. Objectives identifying accounting’s goals and purposes.

Second Level: Bridge between levels 1 and 3 -- Qualitative characteristics that make accounting information useful and elements of the financial statements (assets, liabilities, equity, revenues, expenses, gains, and losses)

Third Level: The “how” – Foundational principles used in establishing and applying accounting standards.

A graphic similar to Illustration 2.1 may also be presented.

Difficulty: Easy

Learning Objective: Indicate the usefulness and describe the main components of a conceptual framework for financial reporting.

Section Reference: Conceptual Framework

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

Ex. 2-57 Moral hazard

In Chapter 1, the issue of information asymmetry, and the concept of moral hazard were introduced. Explain why the moral hazard issue is worse where some users (such as accountants and bankers) have expert knowledge.

Solution 2-57

The moral hazard issue is worse where certain stakeholders such as accountants and bankers have expert knowledge that the rest of the capital marketplace does not because they may use their expertise to act in their own self-interest to the detriment of other capital marketplace participants such as investors.

Difficulty: Easy

Learning Objective: Indicate the usefulness and describe the main components of a conceptual framework for financial reporting.

Section Reference: Conceptual Framework

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 2-58 Materiality

The concept of materiality is extremely important to the process of financial statement preparation and audit. Briefly explain the benchmarking approach to arriving at a materiality figure. What other factors might be considered in deciding whether an item is material?

Solution 2-58

Current auditing standards (CAS 320.A7) consider 5% of pre-tax income from continuing operations for manufacturing companies and 1% of revenues for not-for-profit entities to be material. This is not definitive and is a fairly simplistic view of materiality. The item's impact on financial statement ratios and management compensation also needs to be considered. Materiality is also a function of qualitative factors such as illegal acts, failure to comply with regulations, or inadequate/inappropriate description of an accounting policy. The materiality constraint must be sensibly applied and also consider the cost/benefit to the company in providing details of events and transactions relating to their operations.

Difficulty: Easy

Learning Objective: Identify the qualitative characteristics of accounting information.

Section Reference: Qualitative Characteristics of Useful Information

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 2-59 Enhancing qualitative characteristics

Although fundamental qualitative characteristics of relevance and reliability are considered most important, financial statement preparers also place value upon certain enhancing qualitative characteristics. Briefly describe each of these characteristics and their contribution to providing decision-useful accounting information.

Solution 2-59

Enhancing qualitative characteristics include *comparability*, *verifiability*, *timeliness*, and *understandability*.

Comparability enables users to identify real similarities and differences in economic phenomena because they have not been obscured by accounting methods that cannot be compared.

Verifiability exists when knowledgeable, independent users can achieve similar results or reach consensus regarding the accounting for a particular transaction.

Timeliness means information is available to decision-makers before it loses its ability to influence their decisions.

Understandability means financial information is of sufficient quality and clarity that reasonable informed users will see its significance.

Difficulty: Easy

Learning Objective: Identify the qualitative characteristics of accounting information.

Section Reference: Qualitative Characteristics of Useful Information

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 2-60 Accounting terminology – 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 qualitative characteristics that make accounting information useful for decision making.
2. Enhancing qualitative characteristics are _____, _____, _____ and _____.
3. Liabilities have three essential characteristics:
1. They represent a _____, 2. the entity has a _____, and 3. _____.
4. While consolidated financial statements are prepared from the perspective of the _____, taxes are paid from the perspective of the _____.
5. Collectibility is one of the three conditions of the revenue recognition principle. Assuming the other two conditions are met, revenue should only be recognized if collectibility 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 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.

Solution 2-60

1. coherent, relevance, representational faithfulness
2. comparability, verifiability, timeliness, understandability
3. present duty or obligation, present enforceable obligation, the liability results from a past transaction or event
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

Difficulty: Easy

Learning Objective: Identify the qualitative characteristics of accounting information.

Section Reference: Qualitative Characteristics of Useful Information

Learning Objective: Define the basic elements of financial statements.

Section Reference: Elements of Financial Statements

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

Ex. 2-61 Fundamental characteristics of useful information

What steps should be taken to ensure that both fundamental characteristics of useful information, relevance and representational faithfulness, are present?

Solution 2-61

In order to ensure that both fundamental characteristics of useful information (relevance and representational faithfulness) are present, the following steps should be taken:

1. **Identify the economic event or transaction.** For instance, assume that an investment in shares of a publicly traded company has increased in value. This is an economic event.
2. **Identify the type of information about that transaction or event that would be relevant and can be faithfully represented.** The type of information that would be relevant might be the fair value of the investment.
3. **Assess whether the information is available and can be faithfully represented.** Since the shares are publicly traded, fair value is available and could easily be presented faithfully in the financial statements.

Difficulty: Easy

Learning Objective: Identify the qualitative characteristics of accounting information.

Section Reference: Qualitative Characteristics of Useful Information.

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

Ex. 2-62 Equitable obligations

Due to the current poor economic conditions, Inferno Corp., a medium-size manufacturer in Burnaby, is downsizing its shipping department and has to let go two of the employees, Chevron and Shell. Both are excellent workers and have been with the company for several years. The department's supervisor, Jo-Ann Roberts, goes to the company CEO to see if there is another alternative for these employees (other than termination of their employment). Jo-Ann suggests that Chevron could be retrained to learn how to operate a forklift and Shell would like to learn how to be a first aid attendant. Since Inferno always needs employees with these skills, the CEO agrees to try this. Inferno's workforce is not unionized. What type of obligation is this? Discuss.

Solution 2-62

This would be an equitable obligation, which does not arise from a contractual obligation, but rather from moral or ethical considerations. Theoretically (since there is no union contract with attendant language regarding layoffs and terminations), the company has no obligation to Chevron and Shell and could let them go without any further ado. However, it appears that both Ms. Roberts and the CEO feel a moral obligation to help the employees by retraining them. This will have future benefits for Inferno. For example, the company will not lose good workers; it will benefit from their new skills; and it will improve morale among other workers who may feel threatened by potential future job losses.

Difficulty: Medium

Learning Objective: Define the basic elements of financial statements.

Section Reference: Elements of Financial Statements

CPA: Communication

CPA: Strategy & Governance

Bloomcode: Analysis

AACSB: Communication

Ex. 2-63 Constructive obligations

It was recently found that a fleet of vehicles produced by Agrarium Automotive Corp. possess a manufacturing defect relating to emissions compliance. In the past, Agrarium has issued recalls to owners of such vehicles, and paid for the associated repair cost. Agrarium has announced that they will continue to stand behind their products. Owners of the vehicle thus expect that Agrarium will replace or repair their vehicles. What type of obligation is this? Discuss.

Solution 2-63

This would be a constructive obligation, which arises from the contract between Agrarium and its vehicle owners as well as the policy to stand behind its products. There are moral and ethical considerations associated with the defect itself; however, the obligation in and of itself is constructive.

Difficulty: Medium

Learning Objective: Define the basic elements of financial statements.

Section Reference: Elements of Financial Statements

CPA: Communication

CPA: Strategy & Governance

Bloomcode: Analysis

AACSB: Communication

Ex. 2-64 Comprehensive income

Describe the income concept of comprehensive income and what is included in this notion of income under IFRS? What is included in it under ASPE?

Solution 2-64

Under IFRS, comprehensive income includes net income and other comprehensive income (all other changes in equity except for owners' investments and distributions). Other comprehensive income is made up of revenues, expenses, gains, and losses that, in accordance with primary sources of GAAP, are recognized in comprehensive income, but excluded from net income. For example:

- unrealized holding gains and losses on certain securities
- changes in revaluation surplus when using the revaluation method to account for capital assets
- certain gains and losses related to the translation of foreign operations, and cash flow hedges
- certain gains and losses related to remeasurement of defined benefit plans and liabilities measured at fair value

The concepts of comprehensive income and other comprehensive income do not exist under ASPE. Items would either be booked through net income or straight to shareholders' equity.

Difficulty: Easy

Learning Objective: Define the basic elements of financial statements.

Section Reference: Elements of Financial Statements

CPA: Communication

CPA: Strategy & Governance

Bloomcode: Knowledge

AACSB: Communication

Ex. 2-65 Foundational principles

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

Solution 2-65

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 economic entity assumption, control, revenue recognition, and matching principles.

Measurement relates to the "conversion" of information into numbers. It includes the periodicity, monetary unit, and going concern assumptions, and the historical cost and fair value principles.

Presentation/disclosure relates to 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.

Difficulty: Easy

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Audit & Assurance

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

Ex. 2-66 Identification of foundational accounting principles

State the accounting principle or assumption that is most applicable in the following situations:

1. A company prepares consolidated financial statements for a subsidiary that 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 collectibility is an issue.
4. Disclosure of the liability from a lawsuit in the financial statements
5. Preparation of monthly financial statements
6. Using the Canadian dollar in financial statements
7. An energy company includes detailed information about its reserves in its notes to the financial statements.

Solution 2-66

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

Difficulty: Easy

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 2-67 Identification of foundational accounting principles and qualitative characteristics
Presented below are a number of accounting procedures and practices followed by January Corp. For each of these items, list the assumption, principle, or qualitative characteristic that is NOT being followed.

1. Because the company's income is low this year, January switched from accelerated depreciation to straight-line depreciation.
2. The president of January believes it is foolish to report financial information on a yearly basis. She believes that financial information should be disclosed only when significant new information is available related to the company's operations.
3. January decides to establish a large loss and related liability this year because of the possibility that it may lose a pending lawsuit. The possibility of loss is considered remote by the corporation's lawyers.
4. One of the corporation's executives purchased a new home computer for personal use with company money, charging Miscellaneous Expense.
5. The corporation has not established an Allowance for Doubtful Accounts, even though there are a significant number of their accounts that are either slow paying or may not pay their debts in full.

Solution 2-67

1. Representational Faithfulness/ Neutrality
2. Periodicity assumption
3. Matching principle
4. Economic entity assumption
5. Matching principle

Difficulty: Easy

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 2-68 Foundational accounting principles and qualitative characteristics – matching
Listed below are several foundational accounting principles and qualitative characteristics.
Match the letter of each with the appropriate phrase describing its application. Note that
each item may be used more than once or not at all.

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

- ____ 1. Using the Canadian dollar in the financial statements
- ____ 2. The earning process is completed and realized or realizable.
- ____ 3. Accounting information reflects the economic substance of the event or transaction.
- ____ 4. Quarterly financial reports
- ____ 5. The use of accruals and deferrals in adjusting the accounts
- ____ 6. Useful standard measuring unit for business transactions
- ____ 7. Including explanatory notes as part of the financial statements
- ____ 8. The affairs of the business are distinguished from those of its owners.
- ____ 9. A business enterprise is 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. Presentation of timely information with predictive and feedback value

Solution 2-68

- 1. c
- 2. f
- 3. l
- 4. d
- 5. g
- 6. c
- 7. h

8. a

9. b

10. e

11. k

12. i

Difficulty: Easy

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

Ex. 2-69 Fair value measurement

The ongoing trend toward using fair value has both its supporters and its critics. Briefly explain arguments in favour of and against the use of fair value.

Solution 2-69

Arguments in favour:

Fair values are current and therefore more relevant. The cost at which an asset is carried (using the cost at which it was acquired, say, 20 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.

Difficulty: Easy

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 2-70 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 theory behind a) revenue recognition and b) expense recognition.

Solution 2-70

a) The basis of revenue recognition includes 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 says that revenue is recognized when performance is achieved (earned) and measurability and collectibility are reasonably assured (realized/realizable).

b) The basis of expense recognition includes "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 says 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.

Difficulty: Easy

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 2-71 Forms of business organization

Identify at least two (2) common forms of business organization. For each business structure name an associated pro and con.

Solution 2-71

	Brief Description	Pros	Cons
Proprietorship	Small business owned and run by one person (sole proprietor)	– Simple to set up and maintain records – Does not have to file separate tax return	– Not a separate legal entity; lawsuits would be directed against the proprietor – Personal assets may be required to pay off business debts
Partnership	Business usually owned and/or run by more than one person (the partners)	– At the basic level, simple to set up and maintain records – Does not have to file separate income tax returns (may need to for GST/HST)	– Not a separate legal entity; lawsuits would be directed against the partners – Personal assets may be required to pay off business debts
Corporation	Business is incorporated as a separate legal entity	– Limited liability protection – Any obligations are obligations of the corporation and not the owners	– More complex to set up and maintain records – Separate tax returns must be completed and filed – Covered by the Canada Business Corporations Act or provincial corporations act

Difficulty: Easy

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 2-72 Measurement, existence, and outcome uncertainties

Explain the difference between measurement uncertainty, existence uncertainty, and outcome uncertainty.

Solution 2-72

When a company cannot objectively identify a value (for instance, the value of a share that is not publicly traded) and therefore they must estimate the value, the resulting imprecision is called **measurement uncertainty**.

Existence uncertainty refers to the question as to whether something exists or not.

Outcome uncertainty is the uncertainty surrounding future inflows and outflows for assets and liabilities.

Difficulty: Easy

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

Ex. 2-73 Current value measurement bases

Identify three current value measurement bases in the IFRS conceptual framework.

Solution 2-73

Three current value measurement bases identified in the framework include:

1. **Fair value**,
2. **Value in use** for assets and **fulfilment value** for liabilities and
3. **Current cost**.

Difficulty: Easy

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

Ex. 2-74 Going concern assumption

The going concern assumption applies in most, but not all, business situations. When would it not apply?

Solution 2-74

The only time when the assumption would not apply is when there is intent to liquidate the company's net assets and cease operations or cease trading in the company's shares or when the company has no realistic alternative but to liquidate or cease operations.

Difficulty: Easy

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Knowledge

Ex. 2-75 Market-based measure versus entity-specific measure

Fair value is a market-based measure, as opposed to an entity-specific measure. Explain the difference between an entity-specific value and a market-based value.

Solution 2-75

An entity-specific value represents how the company might value the item in question. This is often called value in use and reflects the present value of the future cash flows the entity expects to receive from use of the asset. A market-based value seeks to determine value by looking at how market participants would value the item in question. It does not look at value from the perspective of the entity itself and as such it does not consider company-specific synergies.

Difficulty: Easy

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 2-76 Control and the economic entity assumption

Consolidated financial statements are prepared from the perspective of the economic entity. Determination of which business units, or subsidiaries, are to be included in the entity is rooted in the definition of control. Describe how this concept is interpreted under IFRS and ASPE, respectively. Discuss the significance of this difference in interpretation.

Solution 2-76

IFRS 10 notes that the investor has control over an investee when it has the following:

1. power over the investee;
2. exposure, or rights, to variable returns from its involvement with the investee; and
3. the ability to use its power over the investee to affect the amount of the investors' returns.

Under ASPE, the standards are similar where the company owns voting shares in another company (consistent with the traditional interpretation of control as >50% voting common shares). In some situations, such as those involving sales of financial instruments to certain trusts or other legal entities, ASPE standards are significantly different. ASPE focuses on whether the entity is demonstrably distinct from the company. In assessing this, the company looks at:

- whether the entity in question can be unilaterally dissolved by the company, and
- whether others have more than 10% ownership interest.

This distinction is important because it determines which entities are included as part of the economic entity for financial reporting purposes. This will have an impact on the entity's appearance to stakeholders.

Difficulty: Easy

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 2-77 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 2-77

Advantages of a principles-based approach:

1. Decisions are based on the conceptual framework – so they should be consistent.

2. Flexibility – allows for making decisions about new or unusual transactions based on principles.
3. Allows accountants to use their professional expertise and professional judgement.

Disadvantages of a principles-based approach:

1. Flexibility may result in reduced comparability between different firms.
2. Flexibility may be abused and bias may creep into decisions.

Difficulty: Easy

Learning Objective: Explain the factors that contribute to choice and/or bias in financial reporting decisions.

Section Reference: Financial Reporting Issues

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 2-78 Financial engineering

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

Solution 2-78

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.

Difficulty: Easy

Learning Objective: Explain the factors that contribute to choice and/or bias in financial reporting decisions.

Section Reference: Financial Reporting Issues

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 2-79 Fraudulent financial reporting

Identify several factors that contribute to fraudulent financial reporting.

Solution 2-79

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 downturn

Difficulty: Easy

Learning Objective: Explain the factors that contribute to choice and/or bias in financial reporting decisions.

Section Reference: Financial Reporting Issues

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 2-80 Fraudulent financial reporting and the accountant's role

Explain what the accountant's responsibility is in preparation of a company's financial records.

Solution 2-80

The accountant's role is to capture business and economic events and transactions as they occur and communicate them to interested parties. They should not use the financial statements to portray something that is not there. Good financial reporting should be a result of reasoned and supported analysis that is grounded in a conceptual framework. It should not be influenced by external pressures such as those identified in Exercise 2-76.

Difficulty: Easy

Learning Objective: Explain the factors that contribute to choice and/or bias in financial reporting decisions.

Section Reference: Financial Reporting Issues

CPA: Audit & Assurance

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 2-81 Financial reporting pressures caused by budgets

Explain why budgets might exert negative influence into accounting decisions. Offer some examples to illustrate where this might be the case.

Solution 2-81

Budgets put tremendous pressure on company management since bonuses and even jobs might depend on meeting budget targets. For example, if a manager's year-end bonus

depends upon reaching a certain sales target, he might create some artificial sales near year-end to inflate the sales figure.

Difficulty: Easy

Learning Objective: Explain the factors that contribute to choice and/or bias in financial reporting decisions.

Section Reference: Financial Reporting Issues

CPA: Audit & Assurance

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

PROBLEMS

Pr. 82 New 1 Uncertainty trade-off

Explain the trade-off related to uncertainty.

Solution 2-82

Too much uncertainty (existence, outcome, or measurement) may make it inappropriate to recognize a financial statement element because it undermines the usefulness of the financial statements. Estimates with high measurement uncertainty provide information that is less relevant for decision making than those with low measurement uncertainty. However, if the element is not recognized at all in the financial statements, then some relevant information has not been included and the statements are incomplete. A compromise is to measure and recognize the elements in the body of the financial statements and to disclose the measurement uncertainty and its significance in the notes to the financial statements.

Difficulty: Easy

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

Pr. 83 IFRS/ASPE revenue recognition differences

Distinguish between the IFRS balance sheet approach and the ASPE income statement approach to revenue recognition.

Solution 2-83

Revenue has generally been recognized when the following three conditions are met, which is an income statement approach followed under ASPE:

1. risks and rewards have passed and/or the earnings process is substantially complete (significant acts have been performed and there is no continuing involvement);
2. the revenue is measurable; and
3. the revenue is collectible (realized or realizable).

The new IFRS 15 standard (*Revenue from Contracts with Customers*) is a balance sheet approach where five-steps are followed in determining when revenue is recognized:

1. Identify the contract with the customer.
2. Identify the performance obligations in the contract (promises to transfer goods and/or services that are distinct).
3. Determine the transaction price.
4. Allocate the transaction price to each performance obligation.
5. Recognize revenue when each performance obligation is satisfied.

This new IFRS approach recognizes that a transaction has occurred when the entity enters into a contract where it has rights and performance obligations under the contract which is in contrast to the ASPE approach, which focuses more on the earnings process.

Difficulty: Easy

Learning Objective: Describe the foundational principles of accounting.

Section Reference: Foundational Principles

CPA: Financial Reporting

Bloomcode: Knowledge
AACSB: Analytic

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CHAPTER 3

THE ACCOUNTING INFORMATION SYSTEM & MEASUREMENT ISSUES

CHAPTER LEARNING OBJECTIVES

1. Use valuation techniques to measure financial statement elements. IFRS and ASPE incorporate a mixed-attribute measurement model including measurements that are cost-based (such as historical cost), those that are based on current value (such as fair value), and many hybrid measures that have attributes of both cost-based and current value measurements. Valuation techniques are used to help with measurement of financial statement elements. Common examples include market models and income models. Income models are widely used and include discounted cash flow methods and present value concepts. When using models, you must determine what inputs should be used. Common inputs include discount rates and cash flow estimates. The quality of these inputs affects the quality of the final measurement. Accountants often use probabilities to help deal with risk and uncertainty. Given the amount of judgement that goes into measuring financial statement elements, disclosures are very important.

2. Use IFRS 13 to measure fair value. IFRS 13 establishes a fairly detailed body of knowledge relating to measurement of fair value. Fair value measurement under IFRS 13 is a market-based approach that incorporates the specific attributes of the asset/liability being measured, the valuation premise (how the asset/liability is to be used), the principal market, and the valuation technique. Since market prices are not always available, valuation models are used to measure the value. Inputs to these models are either observable in the market or not. Observable inputs are most useful since they are more objective. The fair value hierarchy establishes three levels of inputs, with level 1 being the highest and best type of input (based on observable market prices). Because level 3 inputs are more subjective, additional disclosures are required.

3. Understand and apply present value concepts. Present value concepts are used to acknowledge the time value of money. There are various techniques and tools to calculate present value, including formulas, tables, financial calculators, and spreadsheets. Inputs to the calculation include interest, payments, number of periods, and if the calculation involves an annuity, information about whether it is an ordinary annuity or an annuity due. Present value concepts are frequently used in measuring financial statement elements.

4. Identify differences in accounting between ASPE and IFRS, and what changes are expected in the near future. The main difference is that IFRS contains specific guidance in IFRS 13 regarding fair value measurements. Under ASPE, guidance is spread throughout the body of knowledge and is less detailed.

MULTIPLE CHOICE QUESTION

Answer	No.	Description
d	1	Inputs to income model
b	2	Traditional discounted cash flow approach
d	3	Expected cash flow approach
c	4	Financial measurement categories
b	5	Hybrid measurement
c	6	Current value measurement
a	7	Discounted cash flow approach
a	8	Calculate present value
b	9	Impairment loss
d	10	Fair value of a bond
b	11	Valuation premise
c	12	Highest and best use concept
a	13	Cost model
d	14	Level 1 inputs
a	15	Fair value measurement under IFRS 13
d	16	Fair value measurement under IFRS 13
b	17	Simple interest
d	18	Compound interest
a	19	Interest-on-interest
c	20	Calculate rate of interest
a	21	Calculate quarterly interest
b	22	Calculate present value
a	23	Calculate present value
a	24	Differences in accounting between ASPE and IFRS

EXERCISES

Item	Description
E3-25	Calculate the present value of an annuity due
E3-26	Calculate the present value of an ordinary annuity
E3-27	Valuation of entity-specific assets
E3-28	Measurement of financial statement elements
E3-29	Transaction journal entries
E3-30	Adjusting entries
E3-31	Calculate market price of a bond
E3-32	Present value of an annuity due

PROBLEMS

Item	Description
P3-33	Simple and compound interest
P3-34	Calculate bond price

MULTIPLE CHOICE QUESTION

1. Inputs to income models include which of the following?
- a) using a risk-free and risk-adjusted interest rate
 - b) adjusting cash flows and the discount rate in the same calculation
 - c) actual cash flows
 - d) time value of money

Answer: d

Difficulty: Easy

Learning Objective: Use valuation techniques to measure financial statement elements.

Section Reference: Measuring Financial Statement Elements

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

2. Under the traditional discounted cash flow approach,
- a) the model is best used when cash flows are uncertain.
 - b) the stream of contracted cash flows is discounted.
 - c) the risk-free discount rate is used.
 - d) the method is best used when cash flows are variable.

Answer: b

Difficulty: Easy

Learning Objective: Use valuation techniques to measure financial statement elements.

Section Reference: Measuring Financial Statement Elements

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

3. Under the expected cash flow approach,
- a) the model is best used where the element being measured does not have variable cash flows.
 - b) the projected cash flows reflect the certainty in terms of amount and timing.

- c) the discount rate is adjusted to accommodate the riskiness of the cash flows.
- d) the cash flow uncertainty is dealt with by using probabilities.

Answer: d

Difficulty: Easy

Learning Objective: Use valuation techniques to measure financial statement elements.

Section Reference: Measuring Financial Statement Elements

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

4. Which of the following is not a category to measure financial statement elements?

- a) cost-based measures.
- b) hybrid measures.
- c) cash flow measures.
- d) current value measures.

Answer: c

Difficulty: Easy

Learning Objective: Use valuation techniques to measure financial statement elements.

Section Reference: Measuring Financial Statement Elements

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

5. Which of the following is an example of an item that would be measured under the hybrid measurement categorization?

- a) investment properties.
- b) inventory measured at the lower of cost and net realizable value.
- c) biological assets.
- d) financial instruments carried at cost.

Answer: b

Difficulty: Easy

Learning Objective: Use valuation techniques to measure financial statement elements.

Section Reference: Measuring Financial Statement Elements

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

6. Which of the following is an example of an item that would be measured under the current value measurement categorization?

- a) inventory using various cost flow assumptions.
- b) inventory measured at the lower of cost and net realizable value.
- c) biological assets.
- d) financial instruments carried at cost.

Answer: c

Difficulty: Easy

Learning Objective: Use valuation techniques to measure financial statement elements.

Section Reference: Measuring Financial Statement Elements

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

7. Which of the following is true regarding the traditional discounted cash flow approach?

- a) The discount rate is adjusted to accommodate the riskiness of the cash flows.
- b) The cash flows have been adjusted to accommodate their riskiness.
- c) This model is best used where cash flows are fairly uncertain.
- d) Both a) and c) are correct.

Answer: a

Difficulty: Easy

Learning Objective: Use valuation techniques to measure financial statement elements.

Section Reference: Measuring Financial Statement Elements

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

Use the following data for questions 8–9.

8. Frontier Landscaping owns some equipment that is used in their operations. Management estimates that the equipment will last another three years and will generate the following future cash flows at the end of each year.

Year 1	Year 2	Year 3
\$4,000	\$6,000	\$7,000

Calculate the present value of each of these future cash flows given a 4% discount rate.

- a) \$15,617
- b) \$9,394
- c) \$18,135
- d) \$35,165

Answer: a

Difficulty: Medium

Learning Objective: Use valuation techniques to measure financial statement elements.

Section Reference: Measuring Financial Statement Elements

CPA: Finance

CPA: Management Accounting

Bloomcode: Application

AACSB: Analytic

Feedback: $(\$4,000 \times .96154) + (\$6,000 \times .92456) + (\$7,000 \times .88900) = \$15,617$

9. Frontier Landscaping owns some equipment that is used in their operations. Management estimates that the equipment will last another three years and will generate the following future cash flows at the end of each year.

Year 1	Year 2	Year 3
\$4,000	\$6,000	\$7,000

Assuming Frontier Landscaping's equipment has a carrying value of \$16,000, how much of an impairment loss must Frontier record?

- a) none as there is no impairment.
- b) \$383
- c) \$6,606
- d) \$2,518

Answer: b

Difficulty: Medium

Learning Objective: Use valuation techniques to measure financial statement elements.

Section Reference: Measuring Financial Statement Elements

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$16,000 - [(\$4,000 \times .96154) + (\$6,000 \times .92456) + (\$7,000 \times .88900)] = \$383$

10. Billow Company has issued a 3% bond that is payable in 5 years and has a face value of \$100,000. The risk-adjusted market rate is 4%. Calculate the fair value of the bond.

- a) \$82,193
- b) \$13,355
- c) \$68,838
- d) \$95,548

Answer: d

Difficulty: Medium

Learning Objective: Use valuation techniques to measure financial statement elements.

Section Reference: Measuring Financial Statement Elements

CPA: Finance

CPA: Management Accounting

Bloomcode: Application

AACSB: Analytic

Feedback: $(\$100,000 \times .82193) + (\$100,000 \times .03 \times 4.45182) = \$95,548$

11. Valuation premise does not refer to

- a) the perceived value of the asset/liability.
- b) the actual use of the asset/liability.
- c) the highest and best use valuation in the market.
- d) how the asset/liability is to be used.

Answer: b

Difficulty: Easy

Learning Objective: Use IFRS 13 to measure fair value.

Section Reference: Measuring Fair Value Using IFRS 13

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

12. The highest and best use concept values the asset based on the highest value that the market would place on the asset, considering all possible uses that are

- a) physically possible.
- b) legally permissible.
- c) financially feasible.
- d) economically intolerable.

Answer: c

Difficulty: Easy

Learning Objective: Use IFRS 13 to measure fair value.

Section Reference: Measuring Fair Value Using IFRS 13

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

13. The cost model attempts to reflect the amount that would be required to
- a) replace the asset's service capacity.
 - b) value older financial assets where there is no longer a market for the asset.
 - c) value the asset.
 - d) value older non-financial assets where there is a market for the asset.

Answer: a

Difficulty: Easy

Learning Objective: Use IFRS 13 to measure fair value.

Section Reference: Measuring Fair Value Using IFRS 13

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

14. Level 1 inputs
- a) are the lowest-quality inputs but provide the best-quality fair value.
 - b) are used when level 3 inputs are not available.
 - c) are generally not observable in various markets.
 - d) are more objective.

Answer: d

Difficulty: Easy

Learning Objective: Use IFRS 13 to measure fair value.

Section Reference: Measuring Fair Value Using IFRS 13

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

15. A fair value measure under IFRS 13 is based on which view of fair value?
- a) market participant view
 - b) shareholder view
 - c) fair value view
 - d) unbiased view

Answer: a

Difficulty: Easy

Learning Objective: Use IFRS 13 to measure fair value.

Section Reference: Measuring Fair Value Using IFRS 13

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

16. In order to measure fair value under IFRS13, an entity must determine
- a) the item being measured, and how the item could or would be used.
 - b) the market the item would be (or is) bought and sold in.
 - c) which fair value model is being used to value the item.
 - d) all of the above

Answer: d

Difficulty: Easy

Learning Objective: Use IFRS 13 to measure fair value.

Section Reference: Measuring Fair Value Using IFRS 13

CPA: Financial Reporting

CPA: Finance

CPA: Management Accounting

Bloomcode: Knowledge

AACSB: Analytic

Use the following data for questions 17–19.

17. Branson Company deposited \$5,800 in an account paying 2.5% annual interest. How much simple interest would Branson earn in 3 years?
- a) \$5,945
 - b) \$435
 - c) \$145
 - d) \$446

Answer: b

Difficulty: Medium

Learning Objective: Understand and apply present value concepts.

Section Reference: Present Value Concepts

CPA: Finance

Bloomcode: Application

AACSB: Analytic

Feedback: $\$5,800 \times .025 \times 3 = \$435$

18. Branson Company deposited \$5,800 in an account paying 2.5% annual interest. How much compound interest would Branson earn in 3 years?

- a) \$6,235
- b) \$435
- c) \$145
- d) \$446

Answer: d

Difficulty: Medium

Learning Objective: Understand and apply present value concepts.

Section Reference: Present Value Concepts

CPA: Finance

Bloomcode: Application

AACSB: Analytic

Feedback: $(\$5,800 \times 1.07689) - \$5,800 = \$446$

19. Branson Company deposited \$5,800 in an account paying 2.5% annual interest. How much interest-on-interest would Branson earn in 3 years?

- a) \$11
- b) \$33
- c) \$5.50
- d) \$22

Answer: a

Difficulty: Medium

Learning Objective: Understand and apply present value concepts.

Section Reference: Present Value Concepts

CPA: Finance

Bloomcode: Application

AACSB: Analytic

Feedback: $(\$5,800 \times 1.07689) - (\$5,800 \times .025 \times 3) - \$5,800 = \$11$

20. Fiddler Company has a loan balance of \$853.02 and must make equal payments of \$100 at the end of each of the next 10 months. What is the monthly rate of interest that Fiddler Company is paying?

- a) 2%
- b) 2.5%

- c) 3%
- d) 4%

Answer: c

Difficulty: Medium

Learning Objective: Understand and apply present value concepts.

Section Reference: Present Value Concepts

CPA: Finance

Bloomcode: Application

Feedback: $\$853.02 / \$100 = 8.5302$ which is PV factor of an ordinary annuity at 3% for 10 periods.

21. Helvetica Corporation is interested in leasing a piece of machinery that has a fair value of \$150,000. The market rate for financing is 8% and Helvetica plans to lease the machinery for the next five years. Calculate the quarterly lease payments.

- a) \$ 9,174
- b) \$15,278
- c) \$31,824
- d) \$37,569

Answer: a

Difficulty: Medium

Learning Objective: Understand and apply present value concepts.

Section Reference: Present Value Concepts

CPA: Financial Reporting

CPA: Finance

Bloomcode: Application

AACSB: Analytic

Feedback: PV of an ordinary annuity = $\$150,000 / 16.35143 = \$9,174$ given $i = 2\%$, $n = 20$ periods.

22. Barkley Company will receive \$400,000 in a future year. If the future receipt is discounted at an interest rate of 8%, its present value is \$252,068. In how many years is the \$400,000 received?

- a) 5 years
- b) 6 years
- c) 7 years
- d) 8 years

Answer: b

Difficulty: Medium

Learning Objective: Understand and apply present value concepts.

Section Reference: Present Value Concepts

CPA: Finance

CPA: Management Accounting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$252,068 \div \$400,000 = 0.63017$; 0.63017 is PV factor for 6 years at 8%

23. Pearson Corporation makes an investment today (January 1, 2020). They will receive \$9,000 every December 31 for the next six years (2020–2025). If Pearson wants to earn 12% on the investment, what is the most they should invest on January 1, 2020?

- a) \$37,003
- b) \$41,443
- c) \$73,036
- d) \$81,801

Answer: a

Difficulty: Medium

Learning Objective: Understand and apply present value concepts.

Section Reference: Present Value Concepts

CPA: Finance

CPA: Management Accounting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$9,000 \times 4.11141 = \$37,003$

24. The main difference in the accounting for measurement issues between IFRS and ASPE is that

- a) IFRS has a well-developed framework for measuring fair values (IFRS13), whereas ASPE does not.
- b) there is no difference between accounting for measurement issues between these standards.
- c) guidance under ASPE is concentrated in a single area of the ASPE body of knowledge.
- d) IFRS requires explicit disclosure of fair value amounts, whereas these disclosures under ASPE are optional.

Answer: a

Difficulty: Easy

Learning Objective: Identify differences in accounting between ASPE and IFRS, and what changes are expected in the near future.

Section Reference: IFRS/ASPE Comparison

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

EXERCISES

Ex. 3-25

Raleigh Inc. is considering leasing a piece of equipment with a fair value of \$108,000 for three years. The current market interest rate for financing the equipment is 5% compounded semi-annually. Calculate the semi-annual lease payment assuming that the payment is made at the beginning of the period (round to the nearest dollar).

Solution 3-25

Present value of an annuity due of \$108,000 for six periods at 2.5% ($\$108,000 / 5.64583$) = \$19,129.

Difficulty: Medium

Learning Objective: Understand and apply present value concepts.

Section Reference: Present Value Concepts

CPA: Finance

CPA: Management Accounting

Bloomcode: Application

AACSB: Analytic

Ex. 3-26

Raleigh Inc. is considering leasing a piece of equipment with a fair value of \$108,000 for three years. The current market interest rate for financing the equipment is 5% compounded semi-annually. Calculate the semi-annual lease payment assuming that the payment is made at the end of the period (round to the nearest dollar).

Solution 3-26

Present value of an ordinary annuity of \$108,000 for six periods at 2.5% ($\$108,000 / 5.50813$) = \$19,607.

Difficulty: Medium

Learning Objective: Understand and apply present value concepts.

Section Reference: Present Value Concepts

CPA: Finance

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 3-27 Expected Cash Flow Approach

Assume that Picnic Paper Co. has several minor lawsuits outstanding. To determine the amount of liability to recognize on the statement of financial position, Picnic decides to use expected cash flow techniques. Based on discussions with their lawyers, Picnic has developed the following cash flow estimates, and related probabilities:

Year	Cash Flow Estimate	Probability Assessment
2020	\$2,300	30%
	\$4,500	45%
	\$8,200	25%
2021	\$3,200	20%
	\$5,400	50%
	\$7,100	30%

Instructions

Based on these estimates, and assuming a risk-free rate of 5%, what is the present value of expected cash flows that Picnic should record on their statement of financial position for 2020?

Solution 3-27

<u>Year</u>	<u>Cash Flow Estimate</u>	<u>Probability Assessment</u>	<u>Expected Cash Flow</u>
2020	\$2,300	30%	\$690
	\$4,500	45%	\$2,025
	\$8,200	25%	<u>\$2,050</u>
			\$4,765
2021	\$3,200	20%	\$640
	\$5,400	50%	\$2,700
	\$7,100	30%	<u>\$2,130</u>
			\$5,470

<u>Year</u>	<u>Expected Cash Flow</u>	<u>PV Factor i-5%</u>	<u>Present Value</u>
2020	\$4,765	0.95238	\$4,538.09
2021	\$5,470	0.90703	\$4,961.45

Total **\$9,499.54**

Difficulty: Medium

Learning Objective: Use valuation techniques to measure financial statement elements.

Section Reference: Measuring Financial Statement Elements

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 3-28 Your client, Bench Company, has a few minor lawsuits outstanding. Your main contact, Michael Wood, has heard that, though their amount is unknown, these lawsuits must be recorded on the financial statements. Explain briefly for Mr. Wood, the cash flow approach you would take to determining the amount to record on Bench Company's financial statements.

Solution 3-28

The stream of expected cash flows related to Bench Company's expected lawsuits will be paid out at a future time. To account for the time value of money, these cash flows are discounted to the present, using the discount rate reflecting the value of those dollars at present day. Two main cash flow approaches should be considered:

Traditional Approach

The stream of cash flows is discounted, and a discount rate used to accommodate the riskiness of the cash flows.

Expected Cash Flow Approach

Use the risk-free interest rate and adjust for cash flow uncertainty with probability weighting.

Since the traditional approach is best used when cash flows are fairly certain, the expected cash flow approach is recommended to Mr. Wood in this situation, since the amount and timing of Bench Company's lawsuit payouts is relatively uncertain.

Difficulty: Medium

Learning Objective: Use valuation techniques to measure financial statement elements.

Section Reference: Measuring Financial Statement Elements

CPA: Financial Reporting

CPA: Communication

Bloomcode: Application

AACSB: Communication

Ex. 3-29 Valuation under IFRS 13

Hood Company owns specialized equipment that was purchased in an acquisition of Riding Company. The equipment has a book value of \$1,800,000, but according to IFRS, it is assessed for impairment on an annual basis. To perform this impairment test, Hood must estimate the fair value of the equipment. It has developed the following cash flow estimates related to the equipment based on internal information. Each cash flow estimate reflects Hood's estimate of annual cash flows over the next 7 years. The equipment is assumed to have no residual value after the 7 years. (Assume the cash flows occur at the end of each year.)

<u>Year</u>	<u>Cash Flow Estimate</u>
1–3	\$240,000
4–6	365,000
7	425,000

Hood determines, using their own assumptions, that the appropriate discount rate for this estimation is 6%. To the nearest dollar, what is the estimated fair value of the equipment?

Solution 3-29

$$\begin{aligned}
 &(\$240,000 \times 2.67301) + (\$365,000 \times 2.67301 \times .83962) + \$425,000 \times .66506 \\
 &= \$641,522.40 + \$819,174.12 + \$282,650.50 \\
 &= \$1,743,347
 \end{aligned}$$

Difficulty: Medium

Learning Objective: Use IFRS 13 to measure fair value.

Section Reference: Measuring Fair Value Using IFRS 13

CPA: Financial Reporting

CPA: Finance

Bloomcode: Application

AACSB: Analytic

Ex. 3-30 Inputs under IFRS 13

There are three levels of inputs under IFRS 13. What type of inputs are used by Hood Company in exercise 3-85? As a result, what classification would be assigned to the specialized equipment?

Solution 3-30

Hood used unobservable internal company data in the valuation of their IFRS 13 valuation of specialized equipment acquired upon acquisition of Riding Company. Unobservable inputs such as a company's own data or assumptions are considered Level 3 inputs, which are the most subjective of all three in the hierarchy, and, hence require greater disclosures to give financial statement users greater information about the related uncertainty. Because Level 3 inputs are in use, the asset would be classified as a Level 3 asset.

Difficulty: Hard

Learning Objective: Use IFRS 13 to measure fair value.

Section Reference: Measuring Fair Value Using IFRS 13

CPA: Financial Reporting

CPA: Communication

Bloomcode: Evaluation

AACSB: Analytic

Ex. 3-31 Calculate market price of a bond

On January 1, 2020 Lance Co. issued five-year bonds with a face value of \$700,000 and a stated interest rate of 12% payable semi-annually on July 1 and January 1. The bonds were sold to yield 10%.

Calculate the issue price of the bonds.

Solution 3-31

Present value of \$700,000 discounted for 10 periods at 5% ($\$700,000 \times .61391$) =	\$429,737
Present value of \$42,000 for 10 periods at 5% ($\$42,000 \times 7.72173$) =	<u>324,313</u>
Issue price of the bonds	<u>\$754,050</u>

Difficulty: Medium

Learning Objective: Understand and apply present value concepts.

Section Reference: Present Value Concepts

CPA: Finance

CPA: Management Accounting

Bloomcode: Application

AACSB: Analytic

Ex. 3-32 Present value of an annuity due

How much must be invested now to receive \$30,000 for ten years if the first \$30,000 is received today and the rate is 8%?

Solution 3-32

Present value of an annuity due of \$30,000 for ten periods at 8% ($\$30,000 \times 7.24689$) = \$217,407.

Difficulty: Medium

Learning Objective: Understand and apply present value concepts.

Section Reference: Present Value Concepts

CPA: Finance

CPA: Management Accounting

Bloomcode: Application

AACSB: Analytic

PROBLEMS

P3-33

Flip Flop has just inherited \$10,000 from a long lost relative and wants to invest it for the next 5 years.

- Calculate Flip Flop's interest to be received and accumulated year end balances for each year assuming 4% annual simple interest.
- Calculate Flip Flop's interest to be received and accumulated year end balances for each year assuming 4% compound interest.

Solution 3-33

- Annual interest = $\$10,000 \times .04 = \$400$ per year

Year	Beginning Amount	Simple Interest	Accumulated Year End Balance
1	\$10,000	\$400	\$10,400
2	10,400	400	10,800
3	10,800	400	11,200
4	11,200	400	11,600
5	11,600	400	12,000

- Annual interest is earned on the principal and interest.

Year	Beginning Amount	Compound Interest	Accumulated Year End Balance
1	\$10,000	$\$10,000 \times .04 = 400$	\$10,400
2	10,400	$10,400 \times .04 = 416$	10,816
3	10,816	$10,816 \times .04 = 433$	11,249
4	11,249	$11,249 \times .04 = 450$	11,699
5	11,699	$11,699 \times .04 = 468$	12,167

Difficulty: Medium

Learning Objective: Understand and apply present value concepts.

Section Reference: Present Value Concepts

CPA: Finance

Bloomcode: Application

AACSB: Analytic

P3-34

Blast from the Past issued 10-year bonds with a coupon rate of 3% paid semi-annually and a face value of \$500,000. The market interest rate is 5%.

- a) Calculate the present value of the bonds using PV tables assuming payments are made at the end of the period (round answer to the nearest dollar).
- b) Calculate the present value of the bonds using PV tables assuming payments are made at the beginning of the period (round answer to the nearest dollar).

Solution 3-34

- a) Present value of the face value amount of \$500,000 for 20 periods at 2.5% ($\$500,000 \times .61027$) = \$305,135.

Present value of an ordinary annuity of \$7,500 ($\$500,000 \times 1.5\%$) for 20 periods at 2.5% ($\$7,500 \times 15.58916$) = \$116,919.

Total Present Value = \$305,135 + \$116,919 = \$422,054.

- b) Present value of the face value amount of \$500,000 for 20 periods at 2.5% ($\$500,000 \times .61027$) = \$305,135.

Present value of an annuity due of \$7,500 ($\$500,000 \times 1.5\%$) for 20 periods at 2.5% ($\$7,500 \times 15.97889$) = \$119,842.

Total Present Value = \$305,135 + \$119,842 = \$424,977.

Difficulty: Medium

Learning Objective: Understand and apply present value concepts.

Section Reference: Present Value Concepts

CPA: Finance

CPA: Management Accounting

Bloomcode: Application

AACSB: Analytic

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CHAPTER 4

REPORTING FINANCIAL PERFORMANCE

CHAPTER STUDY OBJECTIVES

- 1. *Understand how firms create value, manage performance, and communicate useful information to users.*** A business is based on a basic model of obtaining financing, investing in assets, and using those assets to generate profits. Different industries have different business models. Even within an industry, different businesses may have different strategies for generating revenues. Some businesses and industries are riskier than others. Companies must decide how and whether to manage these risks. Managing risks costs money, which reduces profits. Capital markets demand greater returns for riskier businesses. Users use information about performance to evaluate past performance and profitability and to provide a basis for predicting future performance. They also use the information to help assess risk and uncertainty regarding future cash flows.
- 2. *Understand the concept of and be able to assess the quality of earnings/information.*** The concept of quality of earnings is used by analysts and investors to assess how well the reported income reflects the underlying business and future potential. When assessing quality of earnings, users must consider all information about a company. High-quality earnings have various attributes, as noted in Illustration 4.4. Where the information is biased, this degrades the quality.
- 3. *Understand the differing perspectives on how to measure income.*** There are various ways to measure income, including operating income, net income, and comprehensive income. IFRS recognizes the concept of comprehensive income but this is not recognized under ASPE. Other comprehensive income consists of a set list of items identified under IFRS essentially dealing with certain unrealized gains/ losses. Under IFRS, some of these items are recycled (reclassified) to net income and some are not.
- 4. *Measure and report results of discontinued operations.*** The gain or loss on disposal of a business component involves the sum of: (1) the income or loss from operations to the financial statement date, and (2) the gain or loss on the disposal of the business component. These items are reported net of tax among the irregular items in the income statement. Related assets are identified on the balance sheet where material. Under IFRS, non-current assets are reclassified to current assets.

5. Measure income and prepare the income statement and the statement of comprehensive income using various formats. There are many ways to present the income statement and the statement of comprehensive income. GAAP lays out certain minimum requirements, but beyond that, a company has some leeway to present the information as it wishes. The goal is to ensure that the statements present information about performance in a transparent manner, including presenting items such that the users can see which are ordinary and which are peripheral activities. IFRS allows the statement of comprehensive income to be presented in a combined statement or two separate statements.

By convention, companies use what is known as a single-step method or a multiple-step method (or a variation of the two).

IFRS requires entities to provide information about either the nature or function of expenses. When information is presented using function, additional disclosures should be made regarding the breakdown of the nature of expenses because the latter has good cash flow predictive value. The entity should choose the method that best reflects the nature of the business and industry.

6. Prepare the statement of retained earnings and the statement of changes in equity. The retained earnings statement should disclose net income (loss), dividends, prior period adjustments, and transfers to and from retained earnings (appropriations). This statement is required under ASPE.

The statement of changes in equity is a required statement under IFRS and takes the place of the statement of changes in retained earnings. It shows all changes in all equity accounts including accumulated other comprehensive income.

7. Understand how disclosures and analysis help users of financial statements assess performance. Disclosures include notes and supplementary information. They provide background and explanatory information needed to understand the business. Investors and analysts use quality of earnings analysis to help determine a company's value.

8. Identify differences in accounting between IFRS and ASPE and potential changes. The chart in Illustration 4.20 outlines the major differences. The IASB was in the research project stages regarding financial performance reporting.

9. Explain the differences between the cash basis of accounting and the accrual basis of accounting. Accrual basis accounting provides information about cash inflows and outflows associated with earnings activities as soon as these cash flows can be estimated with an

acceptable degree of certainty. The cash basis focuses on when cash is received or disbursed, and therefore it is not the best predictor of future cash flows if the company has irregular cash flow patterns.

MULTIPLE CHOICE

Answer	No.	Description
b	1.	Business model activities
c	2.	Business model activities and the income statement
b	3.	Risk/return trade-off
a	4.	Representational faithfulness
b	5.	Financial risk management
c	6.	Value creation
d	7.	Usefulness of the income statement
d	8.	Usefulness of the income statement
c	9.	Segregating income
b	10.	Concept of soft numbers
d	11.	Earnings management
b	12.	Limitations of the income statement
d	13.	Quality of earnings
b	14.	High-quality earnings
b	15.	Net income definition
a	16.	IFRS view of income
c	17.	Other comprehensive income
a	18.	All-inclusive income
c	19.	Comprehensive income inclusions
a	20.	Accumulated other comprehensive income
c	21.	Calculation of earnings per share
d	22.	Calculation of net income using retained earnings
a	23.	Calculation of total purchases
d	24.	Calculation of cost of goods sold
c	25.	Calculation of accounts payable
c	26.	Reporting discontinued operations

- d 27. Determination of a discontinued operation
- b 28. Classification of assets held for sale
- c 29. Assets held for sale
- a 30. Recognizing assets that have been written down
- b 31. Calculation of income from discontinued operations
- c 32. EPS disclosures on income statement
- c 33. IFRS requirement for expense presentation
- d 34. Expenses presented by function
- a 35. Presentation of discontinued operations on income statement
- b 36. Unusual gains and losses
- d 37. Separate presentation under IFRS
- b 38. Single-step income statement
- a 39. Income statement presentation
- c 40. IFRS requirement for expense presentation
- d 41. Expenses presented by function
- b 42. Intraperiod tax allocation
- d 43. Intraperiod tax allocation
- b 44. Earnings per share data
- c 45. Presentation of expenses by function
- d 46. Calculation of selling expenses
- a 47. Calculation of general and administrative expenses
- a 48. Calculation of selling expenses
- b 49. Calculation of general and administrative expenses
- d 50. Calculation of income from continuing operations
- a 51. Calculation of net income
- a 52. Determination of infrequent losses
- d 53. Calculation of cost of goods sold
- c 54. Retained earnings statement
- c 55. Effect of accounting errors
- c 56. Retained earnings statement
- a 57. Losses excluded from income statement
- b 58. Change in accounting principle
- d 59. Change in accounting principle
- a 60. Correction of an error
- b 61. Statement of shareholders' equity
- d 62. Change in accounting principle
- b 63. Adjustments to retained earnings
- a 64. Calculate adjusted retained earnings
- c 65. Effect of accounting errors
- a 66. Effect of accounting errors
- d 67. Effect of accounting errors
- a 68. Effect of accounting errors

- d 69. Effect of accounting errors on current assets
- d 70. Events affecting income from continuing operations
- b 71. Events affecting retained earnings
- c 72. Calculation of retained earnings balance
- b *73. Calculate service revenue
- c 74. Notes to financial statements
- d 75. Assessing quality of earnings
- b 76. Assessing quality of earnings
- d 77. Differences between ASPE and IFRS
- c 78. Presentation of expenses under APSE
- a 79. Presentation of held-for-sale assets
- b *80. Accrual basis of accounting
- c *81. Modified cash basis
- b *82. Strict cash basis
- b *83. Accrual vs. cash basis
- a *84. Calculation of cash basis revenue
- c *85. Conversion of cash to accrual basis

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

EXERCISES

Item	Description
E4-86	Value creation
E4-87	Representational faithfulness
E4-88	Income statement performance assessment
E4-89	Income statement information about future cash flows
E4-90	Statement of income terminology
E4-91	Low-cost/high-volume strategy versus cost differentiation strategy
E4-92	Income statement limitations
E4-93	Characteristics of high-quality earnings
E4-94	Earnings management
E4-95	Earnings management
E4-96	Calculation of net income from the change in shareholders' equity
E4-97	Calculation of net income from the change in shareholders' equity
E4-98	Comprehensive income
E4-99	An all-inclusive approach
E4-100	Comprehensive income
E4-101	Definitions
E4-102	Comprehensive income terminology
E4-103	Recycled items
E4-104	Discontinued operations

E4-105	Discontinued operations
E4-106	Income statement classifications
E4-107	Classification of income statement and retained earnings statement items
E4-108	Nature versus function of expense presentation
E4-109	Understandability/disclosure trade-off
E4-110	Calculation of net income
E4-111	Terminology
E4-112	Statement of changes in equity
E4-113	Statement of retained earnings
E4-114	Comprehensive income
E4-115	Non-GAAP measures
E4-116	The OSC and non-GAAP measures
E4-117	Analyzing financial health and quality of earnings
*E4-118	Cash basis
*E4-119	Accrual basis
*E4-120	Cash basis
E4-121	Changes in accounting principles

PROBLEMS

Item	Description
P4-122	Discontinued operations
P4-123	Multiple-step income statement
P4-124	Income statement, including corrections
P4-125	Multiple-step income statement
P4-126	Multiple-step income statement
P4-127	Income statement adjustments
P4-128	Income statement and retained earnings statement
P4-129	Single-step income statement
*P4-130	Cash to accrual accounting
P4-131	Danger of using non-GAAP earnings

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

MULTIPLE CHOICE

1. The business model may be broken down into three activities:

- a) investing, operating, allocating.
- b) investing, operating, financing.
- c) financing, operating, and comprehensive income.
- d) balance sheet, income statement, cash flow statement.

Answer: b

Difficulty: Easy

Learning Objective: Understand how firms create value, manage performance, and communicate useful information to users.

Section Reference: Business Models and Industries

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

2. The income statement captures an entity's

- a) financing activities.
- b) investing activities.
- c) operating activities.
- d) interrelationship between activities.

Answer: c

Difficulty: Easy

Learning Objective: Understand how firms create value, manage performance, and communicate useful information to users.

Section Reference: Business Models and Industries

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

3. The "risk/return" trade-off means

- a) using various techniques to manage risks.
- b) the market demands a greater return when there is greater risk.
- c) not investing in a risky business.
- d) monitoring risks.

Answer: b

Difficulty: Easy

Learning Objective: Understand how firms create value, manage performance, and communicate useful information to users.

Section Reference: Business Models and Industries

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

4. The concept of representational faithfulness requires 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 management.
- d) identify all risks that the entity faces.

Answer: a

Difficulty: Easy

Learning Objective: Understand how firms create value, manage performance, and communicate useful information to users.

Section Reference: Business Models and Industries

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

5. The first step in the financial risk management process is

- a) buying insurance.
- b) identifying risks.
- c) managing risks.
- d) monitoring risks.

Answer: b

Difficulty: Easy

Learning Objective: Understand how firms create value, manage performance, and communicate useful information to users.

Section Reference: Business Models and Industries

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

6. Value creation refers to

- a) generating the highest profits possible given available resources.
- b) choosing the optimal business model for a given industry.
- c) finding an optimal balance between managing risks and taking the right opportunities.
- d) how a company creates value for its employees.

Answer: c

Difficulty: Easy

Learning Objective: Understand how firms create value, manage performance, and communicate useful information to users.

Section Reference: Business Models and Industries

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

7. Information in the income statement does NOT help users to

- a) evaluate the past performance of the enterprise.
- b) provide a basis for predicting future performance.
- c) help assess the risk of not achieving future cash flows.
- d) calculate the exact amount of future dividends.

Answer: d

Difficulty: Easy

Learning Objective: Understand how firms create value, manage performance, and communicate useful information to users.

Section Reference: Business Models and Industries

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

8. A useful statement of income
- a) has feedback value.
 - b) has predictive value.
 - c) helps stakeholders understand the business.
 - d) all of the above

Answer: d

Difficulty: Easy

Learning Objective:

Section Reference: Business Models and Industries

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

9. Segregating a company's recurring operating income from nonrecurring income sources is useful because
- a) recurring income is constantly changing.
 - b) nonrecurring income is subject to greater management bias and uncertainty.
 - c) results from continuing operations have greater significance for predicting future performance.
 - d) nonrecurring income is irrelevant to stakeholders.

Answer: c

Difficulty: Easy

Learning Objective: Understand how firms create value, manage performance, and communicate useful information to users.

Section Reference: Business Models and Industries

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

10. The concept of soft numbers reflects the fact that
- a) financial statement numbers may be manipulated.
 - b) sometimes significant measurement uncertainty exists.
 - c) sometimes significant errors exist.
 - d) earnings numbers may not be sustainable.

Answer: b

Difficulty: Easy

Learning Objective: Understand the concept of and be able to assess the quality of earnings/information.

Section Reference: Quality of Earnings/Information

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

11. 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.

Answer: d

Difficulty: Easy

Learning Objective: Understand the concept of and be able to assess the quality of earnings/information.

Section Reference: Quality of Earnings/Information

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

12. 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 the use of estimates.
- d) income numbers are affected by the accounting methods used.

Answer: b

Difficulty: Easy

Learning Objective: Understand the concept of and be able to assess the quality of earnings/information.

Section Reference: Quality of Earnings/Information

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

13. Which of the following is INCORRECT regarding “quality of earnings”?

- a) Quality of earnings refers to how solid the earnings numbers are.
- b) Analysts use quality of earnings to assess how well the reported income reflects the underlying business and future potential.
- c) If earnings quality is high, numbers are accepted as is.
- d) If earnings quality is low, numbers are accepted as is.

Answer: d

Difficulty: Easy

Learning Objective: Understand the concept of and be able to assess the quality of earnings/information.

Section Reference: Quality of Earnings/Information

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

14. Which of the following statements regarding high-quality earnings is NOT true?

- a) The shares of companies with high-quality earnings are valued higher in capital markets.
- b) High-quality earnings make verifiable promises about future performance.
- c) High-quality earnings provide higher-quality information.

d) High-quality earnings have a lower likelihood of potential misstatement.

Answer: b

Difficulty: Easy

Learning Objective: Understand the concept of and be able to assess the quality of earnings/information.

Section Reference: Quality of Earnings/Information

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

15. Net income represents

a) revenues and gains less expenses and losses from continuing operations only.

b) revenues and gains less expenses and losses from both continuing and discontinued operations.

c) net income plus/minus other comprehensive income.

d) ongoing revenues and expenses before gains, losses, and discontinued operations.

Answer: b

Difficulty: Easy

Learning Objective: Understand the differing perspectives on how to measure income.

Section Reference: Measurement of Income

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

16. The view of income that IFRS generally supports is referred to as the

a) all-inclusive approach.

b) current operating performance approach.

c) other comprehensive income approach.

d) operating income approach.

Answer: a

Difficulty: Easy

Learning Objective: Understand the differing perspectives on how to measure income.

Section Reference: Measurement of Income

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

17. At year end, other comprehensive income is closed out to

a) retained earnings.

b) share capital.

c) accumulated other comprehensive income.

d) net income.

Answer: c

Difficulty: Easy

Learning Objective: Understand the differing perspectives on how to measure income.

Section Reference: Measurement of Income

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

18. All-inclusive income includes all of the following EXCEPT

- a) investments by owners.
- b) losses on disposal of assets.
- c) dividend revenue.
- d) gains on the expropriation of property by the government.

Answer: a

Difficulty: Easy

Learning Objective: Understand the differing perspectives on how to measure income.

Section Reference: Measurement of Income

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

19. 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.

Answer: c

Difficulty: Easy

Learning Objective: Understand the differing perspectives on how to measure income.

Section Reference: Measurement of Income

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

20. Accumulated other comprehensive income would be reported in

- a) shareholders' equity.
- b) retained earnings.
- c) net income.
- d) net income from continuing operations.

Answer: a

Difficulty: Easy

Learning Objective: Understand the differing perspectives on how to measure income.

Section Reference: Measurement of Income

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

21. The calculation of earnings per share is generally based on which income figure?

- a) Other comprehensive income
- b) Income from discontinued operations
- c) Net income
- d) All-inclusive income

Answer: c

Difficulty: Easy

Learning Objective: Understand the differing perspectives on how to measure income.

Section Reference: Measurement of Income

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

22. Papaya Inc. has 100,000 common shares outstanding and has a policy of paying a \$1.30 annual dividend for each of these shares. Papaya has an income tax rate of 35%, and its retained earnings statement for 2020 reported a closing balance of \$1,452,000. Assuming an opening retained earnings balance of zero, dividend payments according to its usual policy, and no other adjustments, Papaya's 2020 net income was

- a) \$1,536,500.
- b) \$2,364,846.
- c) \$1,452,000.
- d) \$1,582,000.

Answer: d

Difficulty: Medium

Learning Objective: Understand the differing perspectives on how to measure income.

Section Reference: Measurement of Income

CPA: Financial Reporting

Bloomcode: Application

Feedback: $\$1,452,000 + (\$1.30 \times 100,000) = \$1,582,000$

AACSB: Analytic

23. The following information is available for Pear Limited for 2020:

Accounts payable, beginning	\$14,000
Cash payments on account during year.....	54,000
Purchase discounts taken during year on 2020 purchases	1,200
Accounts payable, ending.....	7,000

Assuming the company records purchases at gross amounts, the total purchases for 2020 would be

- a) \$48,200.
- b) \$61,000.
- c) \$55,200.

d) \$59,800.

Answer: a

Difficulty: Medium

Learning Objective: Understand the differing perspectives on how to measure income.

Section Reference: Measurement of Income

CPA: Financial Reporting

Bloomcode: Application

Feedback: $\$54,000 + \$1,200 - \$14,000 + \$7,000 = \$48,200$

AACSB: Analytic

24. The following information is available for Excelsior Corp for 2020:

Payment for goods during year	\$104,000
Accounts payable, beginning	14,000
Inventory, beginning.....	28,000
Accounts payable, ending.....	12,600
Inventory, ending	16,200

Cost of goods sold for 2020 is

a) \$102,600.

b) \$132,000.

c) \$105,400.

d) \$114,400.

Answer: d

Difficulty: Medium

Learning Objective: Understand the differing perspectives on how to measure income.

Section Reference: Measurement of Income

CPA: Financial Reporting

Bloomcode: Application

Feedback: $\$104,000 - \$14,000 + \$12,600 = \$102,600$ (purchases)

$\$28,000 + \$102,600 - \$16,200 = \$114,400$

AACSB: Analytic

25. The following information is available for Royal Corp. for 2020:

Accounts payable, beginning	\$14,000
Cash payments on account during year.....	7,000
Purchase discounts taken during year on 2020 purchases.....	1,200
Purchases	10,000

Assuming that all purchases are made on account, accounts payable at the end of the year are

a) \$17,000

b) \$22,800

c) \$15,800

d) \$24,000

Answer: c

Difficulty: Medium

Learning Objective: Understand the differing perspectives on how to measure income.

Section Reference: Measurement of Income

CPA: Financial Reporting

Bloomcode: Application

Feedback: $\$14,000 - \$7,000 + \$10,000 - \$1,200 = \$15,800$

AACSB: Analytic

26. 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, and 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.

Answer: c

Difficulty: Easy

Learning Objective: Measure and report results of discontinued operations.

Section Reference: Discontinued Operations

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

27. For purposes of discontinued operations, the key elements in determining that a separate segment exists are that the component is

- a) a separate business and a separate legal entity.
- b) a separate legal entity and generates its own net cash flows.
- c) in a separate geographic region and can be sold.
- d) a separate business and generates its own cash flow.

Answer: d

Difficulty: Hard

Learning Objective: Measure and report results of discontinued operations.

Section Reference: Discontinued Operations

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

28. If an asset is to be classified as held for sale, which of the following conditions does NOT apply?

- a) The sale has been authorized by the company's management.
- b) Changes to the sale plan are likely.
- c) It is probable that the asset will be sold within one year.
- d) There is an active program to find a buyer.

Answer: b

Difficulty: Hard

Learning Objective: Measure and report results of discontinued operations.

Section Reference: Discontinued Operations

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

29. When an asset is held for sale

- a) it must relate to a discontinued operation.
- b) the entity must continue to record depreciation for the asset.
- c) the asset is remeasured to the lower of carrying (book) value and fair value less costs to sell.
- d) the asset is remeasured to the lower of fair value and carrying (book) value.

Answer: c

Difficulty: Hard

Learning Objective: Measure and report results of discontinued operations.

Section Reference: Discontinued Operations

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

30. If the value of an asset that has been written down later increases, to what extent may the related gain be recognized?

- a) up to the amount of the original loss
- b) no remeasurements may be recognized
- c) none of the gain may be recognized
- d) up to the fair market value of the asset

Answer: a

Difficulty: Hard

Learning Objective: Measure and report results of discontinued operations.

Section Reference: Discontinued Operations

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

31. Sesame Corp.'s adjusted trial balance at December 31, 2020 included the following:

	<u>Debit</u>	<u>Credit</u>
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

Loss of warehouse due to flood.....	15,000	
Loss from operation of discontinued division	24,000	
Bad debt expense.....	<u>5,000</u>	
Totals.....	<u>\$162,000</u>	<u>\$176,000</u>

Sesame uses the perpetual system, and their income tax rate is 30%. On Sesame's multiple-step income statement for 2020, income from discontinued operations is

- a) \$10,500.
- b) \$16,800.
- c) \$24,000.
- d) \$24,500.

Answer: b

Difficulty: Medium

Learning Objective: Measure and report results of discontinued operations.

Section Reference: Discontinued Operations

CPA: Financial Reporting

Bloomcode: Application

Feedback: $\$24,000 \times (1 - 0.3) = \$16,800$

AACSB: Analytic

32. 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 unusual item.
- b) Results of operations of a discontinued segment should be disclosed in other comprehensive income.
- c) Earnings per share from both continuing operations and for the discontinued segment should be disclosed either 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.

Answer: c

Difficulty: Hard

Learning Objective: Measure and report results of discontinued operations.

Section Reference: Discontinued Operations

Learning Objective: Measure income and prepare the income statement and the statement of comprehensive income using various formats.

Section Reference: The Statement of Income and the Statement of Comprehensive Income

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

33. During 2020, Honeydew Corp disposed of Blackberry Division, a major segment of its business. Honeydew realized a gain of \$1,500,000, net of taxes, on the sale of Blackberry's assets. During 2020, Blackberry's operating losses, net of taxes, were \$1,800,000. How should these facts be reported in Honeydew's income statement for 2020?

<u>Total Amount to be included in</u>	
Income from	Results of

	<u>Continuing Operations</u>	<u>Discontinued Operations</u>
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

Answer: c

Difficulty: Medium

Learning Objective: Measure and report results of discontinued operations.

Section Reference: Discontinued Operations

CPA: Financial Reporting

Bloomcode: Application

Feedback: $\$1,800,000 - \$1,500,000 = \$300,000$ loss

AACSB: Analytic

34. On January 1, 2020, Bellair Ltd. decided to discontinue its plastics making division. The division, considered a reportable segment, was sold on June 1, 2020. Division assets with a carrying value of \$812,500 were sold for \$625,000. Operating income from January 1 to May 31 for the division was \$62,500. Ignoring taxes, what amount should be reported on Bellair's income statement for the year ended December 31, 2020, under the caption "discontinued operations"?

- a) \$250,000 gain
- b) \$187,500 loss
- c) \$62,500 gain
- d) \$125,000 loss

Answer: d

Difficulty: Medium

Learning Objective: Measure and report results of discontinued operations.

Section Reference: Discontinued Operations

CPA: Financial Reporting

Bloomcode: Application

Feedback: $\$812,500 - \$625,000 - \$62,500 = \$125,000$ loss

AACSB: Analytic

35. During 2020, Door Inc. decided to dispose of Bell Division, considered a separate reportable segment. Door estimates it can sell Bell at a loss of \$30,000, which it does on May 1, 2020. Bell's operating income from January 1 to April 30 was \$23,000. Ignoring taxes, and assuming statements are prepared under ASPE, the discontinued operations section of Door's income statement for the year ended December 31, 2020 should report

- a) the \$23,000 operating income and the \$30,000 loss in the discontinued operations section of the income statement.
- b) the \$23,000 operating income in the body of the income statement and the \$30,000 loss in the discontinued operations section of the income statement.
- c) the \$23,000 operating income and the \$30,000 loss in the body of the income statement.
- d) only the income from Door's other divisions. Since it no longer owns Bell at December 31, Door does not need to report anything relating to Bell's operations during the year.

Answer: a

Difficulty: Medium

Learning Objective: Measure and report results of discontinued operations.

Section Reference: Discontinued Operations

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

36. Unusual gains and losses are items on the income statement that

- a) are typical of everyday activities but do not occur frequently.
- b) are not typical of everyday activities or do not occur frequently.
- c) include write down of inventories and write off of bad debts.
- d) are not usually disclosed separately.

Answer: b

Difficulty: Easy

Learning Objective: Measure income and prepare the income statement and the statement of comprehensive income using various formats.

Section Reference: The Statement of Income and the Statement of Comprehensive Income

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

37. Under IFRS, which of the following is NOT required to be presented separately in the statements of income/comprehensive income?

- a) revenues
- b) discontinued operations
- c) tax expense
- d) depreciation/amortization

Answer: d

Difficulty: Hard

Learning Objective: Measure income and prepare the income statement and the statement of comprehensive income using various formats.

Section Reference: The Statement of Income and the Statement of Comprehensive Income

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

38. The single-step income statement emphasizes

- a) the gross profit figure.
- b) total revenues and total expenses.
- c) discontinued operations and accounting changes.
- d) the various components of income from continuing operations.

Answer: b

Difficulty: Easy

Learning Objective: Measure income and prepare the income statement and the statement of comprehensive income using various formats.

Section Reference: The Statement of Income and the Statement of Comprehensive Income

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

39. 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 multiple-step income statement
- d) including gains and losses from discontinued operations

Answer: a

Difficulty: Hard

Learning Objective: Measure income and prepare the income statement and the statement of comprehensive income using various formats.

Section Reference: The Statement of Income and the Statement of Comprehensive Income

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

40. IFRS requires that expenses be presented in the income statement

- a) by amount or in alphabetical order.
- b) by geographical area or by the single-step method.
- c) by nature or by function.
- d) by current or non-current.

Answer: c

Difficulty: Easy

Learning Objective: Measure income and prepare the income statement and the statement of comprehensive income using various formats.

Section Reference: The Statement of Income and the Statement of Comprehensive Income

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

41. When expenses are presented by function in the income statement,

- a) they should be presented by type of expense (e.g., depreciation, purchases, salaries).
- b) they should be reported as part of other comprehensive income.
- c) their cash flow predictive value is increased.
- d) more professional judgment is required to allocate expenses between functions.

Answer: d

Difficulty: Easy

Learning Objective: Measure income and prepare the income statement and the statement of comprehensive income using various formats.

Section Reference: The Statement of Income and the Statement of Comprehensive Income

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

42. Intraperiod tax allocation

- a) allocates tax balances between fiscal years.
- b) allocates tax balances within a fiscal period.
- c) is used for income from continuing operations but not for income from discontinued operations.
- d) is used for other comprehensive income but not for income from discontinued operations.

Answer: b

Difficulty: Easy

Learning Objective: Measure income and prepare the income statement and the statement of comprehensive income using various formats.

Section Reference: The Statement of Income and the Statement of Comprehensive Income

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

43. Intraperiod tax allocation

- a) arises because certain revenue and expense items appear in the income statement either before or after they are included in the tax return.
- b) is required for the cumulative effect of changes in accounting principles but not for discontinued operations.
- c) allocates income tax expense evenly over a number of accounting periods.
- d) relates income tax expense to the items that affect the amount of tax.

Answer: d

Difficulty: Hard

Learning Objective: Measure income and prepare the income statement and the statement of comprehensive income using various formats.

Section Reference: The Statement of Income and the Statement of Comprehensive Income

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

44. Regarding earnings per share (EPS) data

- a) both public and private corporations are required to report EPS on the face of the income statement.
- b) although public corporations are required to report EPS, private corporations are not.
- c) EPS related to comprehensive income is required.
- d) financial analysts do not attach much importance to EPS data.

Answer: b

Difficulty: Easy

Learning Objective: Measure income and prepare the income statement and the statement of comprehensive income using various formats.

Section Reference: The Statement of Income and the Statement of Comprehensive Income

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

45. Regarding presentation of expenses by nature versus function, function refers to

- a) the type of expense, such as depreciation, purchases, or employee benefits.
- b) whether the expense actively contributed to the generation of income.
- c) the business activity to which the expense relates.
- d) the name of the cost centre responsible for the expense.

Answer: c

Difficulty: Easy

Learning Objective: Measure income and prepare the income statement and the statement of comprehensive income using various formats.

Section Reference: The Statement of Income and the Statement of Comprehensive Income

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

Use the following information for questions 46-47

Oskar Corp. reports operating expenses in two categories: (1) selling and (2) general and administrative. The adjusted trial balance at December 31, 2020, 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.

46. How much of the expenses listed above should be included in Oskar's selling expenses for 2020?

- a) \$260,000
- b) \$335,000
- c) \$340,000
- d) \$415,000

Answer: d

Difficulty: Medium

Learning Objective: Measure income and prepare the income statement and the statement of comprehensive income using various formats.

Section Reference: The Statement of Income and the Statement of Comprehensive Income

CPA: Financial Reporting

Bloomcode: Application

Feedback: $\$150,000 + \$75,000 + \$110,000 + (\$160,000/2) = \$415,000$

AACSB: Analytic

47. How much of the expenses listed above should be included in Oskar's general and administrative expenses for 2020?

- a) \$380,000
- b) \$410,000
- c) \$440,000
- d) \$470,000

Answer: a

Difficulty: Medium

Learning Objective: Measure income and prepare the income statement and the statement of comprehensive income using various formats.

Section Reference: The Statement of Income and the Statement of Comprehensive Income

CPA: Financial Reporting

Bloomcode: Application

Feedback: $\$120,000 + \$180,000 + (\$160,000/2) = \$380,000$

AACSB: Analytic

48. Groucho Corp. reports operating expenses in two categories: (1) selling and (2) general and administrative. The adjusted trial balance at December 31, 2020, included the following 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	170,000

One-half of the rented premises is occupied by the sales department. Groucho's total selling expenses for 2020 are

- a) \$520,000.
- b) \$440,000.
- c) \$410,000.
- d) \$350,000.

Answer: a

Difficulty: Medium

Learning Objective: Measure income and prepare the income statement and the statement of comprehensive income using various formats.

Section Reference: The Statement of Income and the Statement of Comprehensive Income

CPA: Financial Reporting

Bloomcode: Application

Feedback: $\$160,000 + \$80,000 + (\$220,000/2) + \$170,000 = \$520,000$

AACSB: Analytic

49. The following items were among those reported on Harry's Ltd.'s income statement for the year ended December 31, 2020:

Legal and audit fees	\$200,000
Rent for office space	470,000
Interest on inventory loan	496,000
Loss on abandoned equipment used in operations.....	82,000

The office space is used equally by Harry's sales and accounting departments. What amount should be classified as general and administrative expenses in Harry's multiple-step income statement for 2020?

a) \$235,000

b) \$435,000

c) \$670,000

d) \$931,000

Answer: b

Difficulty: Medium

Learning Objective: Measure income and prepare the income statement and the statement of comprehensive income using various formats.

Section Reference: The Statement of Income and the Statement of Comprehensive Income

CPA: Financial Reporting

Bloomcode: Application

Feedback: $\$200,000 + (\$470,000/2) = \$435,000$

AACSB: Analytic

Use the following information for questions 50-51.

Sesame Corp.'s adjusted trial balance at December 31, 2020, included the following:

	<u>Debit</u>	<u>Credit</u>
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
Loss of warehouse due to flood.....	15,000	
Loss from operation of discontinued division	24,000	
Bad debt expense.....	5,000	
Totals	<u>\$162,000</u>	<u>\$176,000</u>

Sesame uses the perpetual system, and their income tax rate is 30%.

50. On Sesame's multiple-step income statement for 2020, income from continuing operations is

- a) \$17,500.
- b) \$52,800.
- c) \$24,500.
- d) \$26,600.

Answer: d

Difficulty: Medium

Learning Objective: Measure income and prepare the income statement and the statement of comprehensive income using various formats.

Section Reference: The Statement of Income and the Statement of Comprehensive Income

CPA: Financial Reporting

Bloomcode: Application

Feedback: $\$170,000 + \$6,000 - \$70,000 - \$28,000 - \$11,000 - \$9,000 - \$15,000 - \$5,000 = \$38,000$; $38,000 \times (1 - 0.3) = \$26,600$

AACSB: Analytic

51. On Sesame's multiple-step income statement for 2020, net income is

- a) \$9,800.
- b) \$15,000.
- c) \$16,800.
- d) \$24,000.

Answer: a

Difficulty: Medium

Learning Objective: Measure income and prepare the income statement and the statement of comprehensive income using various formats.

Section Reference: The Statement of Income and the Statement of Comprehensive Income

CPA: Financial Reporting

Bloomcode: Application

Feedback: $(\$176,000 - \$162,000) \times (1 - 0.3) = \$9,800$

AACSB: Analytic

52. Meg Inc. incurred the following infrequent losses during 2020:

A \$135,000 write down of equipment leased to others (net of tax)

A \$60,000 adjustment of accruals on long-term contracts (net of tax)

A \$90,000 write off of obsolete inventory (net of tax)

Of those losses, what amount should be included in Meg's 2020 income from continuing operations?

- a) \$285,000
- b) \$225,000
- c) \$195,000
- d) \$150,000

Answer: a

Difficulty: Medium

Learning Objective: Measure income and prepare the income statement and the statement of comprehensive income using various formats.

Section Reference: The Statement of Income and the Statement of Comprehensive Income

CPA: Financial Reporting

Bloomcode: Application

Feedback: $\$135,000 + \$60,000 + \$90,000 = \$285,000$

AACSB: Analytic

53. The following information is available for Quiny Inc. for 2020:

Disbursements for purchases	\$715,000
Increase in trade accounts payable	63,800
Decrease in merchandise inventory	30,800

Cost of goods sold for 2020 was

a) \$715,000.

b) \$778,800.

c) \$770,000.

d) \$809,600.

Answer: d

Difficulty: Medium

Learning Objective: Measure income and prepare the income statement and the statement of comprehensive income using various formats.

Section Reference: The Statement of Income and the Statement of Comprehensive Income

CPA: Financial Reporting

Bloomcode: Application

Feedback: $\$715,000 + \$63,800 + \$30,800 = \$809,600$

AACSB: Analytic

54. Honeysuckle Inc. reported the following information for 2020:

Sales revenue	\$780,000
Cost of goods sold	525,000
Operating expenses	82,500
Gain on the sale of equipment.....	105,000
Cash dividends received on investment securities.....	4,500

For 2020, on a multiple-step income statement, Honeysuckle would report other income of

a) \$277,500.

b) \$109,500.

c) \$105,000.

d) \$4,500.

Answer: b

Difficulty: Medium

Learning Objective: Measure income and prepare the income statement and the statement of comprehensive income using various formats.

Section Reference: The Statement of Income and the Statement of Comprehensive Income

CPA: Financial Reporting

Bloomcode: Application

Feedback: Other income = $\$105,000 + \$4,500 = \$109,500$

AACSB: Analytic

55. Rudolph Corporation reports the following information:

Net income	\$900,000
Dividends on common shares	\$252,000
Dividends on preferred shares.....	\$ 90,000
Weighted average common shares outstanding.....	300,000

Rudolph should report earnings per share of

- a) \$1.86.
- b) \$2.16.
- c) \$2.70.
- d) \$3.00.

Answer: c

Difficulty: Medium

Learning Objective: Measure income and prepare the income statement and the statement of comprehensive income using various formats.

Section Reference: The Statement of Income and the Statement of Comprehensive Income

CPA: Financial Reporting

Bloomcode: Application

Feedback: $(\$900,000 - \$90,000) \div 300,000 = \$2.70$

AACSB: Analytic

56. 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

Answer: c

Difficulty: Easy

Learning Objective: Prepare the statement of retained earnings and the statement of changes in equity.

Section Reference: The Statement of Retained Earnings and the Statement of Changes in Equity

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

57. Which one of the following types of losses is excluded from the determination of net income in the income statement?

- a) material losses resulting from correction of errors related to prior periods
- b) material losses resulting from sale of assets not originally acquired for resale
- c) material losses resulting from write off of intangibles
- d) material losses resulting from sale of investments

Answer: a

Difficulty: Easy

Learning Objective: Prepare the statement of retained earnings and the statement of changes in equity.

Section Reference: The Statement of Retained Earnings and the Statement of Changes in Equity

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

58. Which of the following is a change in accounting principle?

- a) a change in the estimated service life of machinery
- b) a change from FIFO to weighted average for inventory costing
- c) a change in the estimated allowance for bad debts
- d) a change in estimated future warranty expense

Answer: b

Difficulty: Easy

Learning Objective: Prepare the statement of retained earnings and the statement of changes in equity.

Section Reference: The Statement of Retained Earnings and the Statement of Changes in Equity

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

59. When reporting a change in accounting principle, required disclosure(s) on the income statement include

- 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 be disclosed immediately after discontinued operations.
- d) a change in accounting principle is not reported on the income statement.

Answer: d

Difficulty: Easy

Learning Objective: Prepare the statement of retained earnings and the statement of changes in equity.

Section Reference: The Statement of Retained Earnings and the Statement of Changes in Equity

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

60. Unsure Inc. made a very large arithmetical error in the preparation of its year-end financial statements by incorrect placement of a decimal point in the calculation of depreciation. The error caused the net income to be reported at almost double the correct amount. When Unsure discovered the error in the following year, correction of the error should be treated as a(n)

- a) adjustment to beginning retained earnings, net of tax.
- b) increase in depreciation expense for the year in which the error is discovered.
- c) gain for the year in which the error was made.
- d) 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.

Answer: a

Difficulty: Easy

Learning Objective: Prepare the statement of retained earnings and the statement of changes in equity.

Section Reference: The Statement of Retained Earnings and the Statement of Changes in Equity

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

61. The statement of changes in shareholders' equity
- a) is a required statement under ASPE.
 - b) is a required statement under IFRS.
 - c) is a required statement under both IFRS and ASPE.
 - d) is an optional statement under both IFRS and ASPE.

Answer: b

Difficulty: Easy

Learning Objective: Prepare the statement of retained earnings and the statement of changes in equity.

Section Reference: The Statement of Retained Earnings and the Statement of Changes in Equity

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

62. Changes in accounting principle are allowed where
- a) they are required by a primary source of GAAP.
 - b) they result in reliable and more relevant information.
 - c) the company reports less favourable results under the new policy.
 - d) both a and b are correct.

Answer: d

Difficulty: Easy

Learning Objective: Prepare the statement of retained earnings and the statement of changes in equity.

Section Reference: The Statement of Retained Earnings and the Statement of Changes in Equity

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

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

	<u>Change in Estimated Lives of Depreciable Assets</u>	<u>Change from Unaccepted Principle to Accepted Principle</u>
a)	Yes	Yes
b)	No	Yes
c)	Yes	No
d)	No	No

Answer: b

Difficulty: Easy

Learning Objective: Prepare the statement of retained earnings and the statement of changes in equity.

Section Reference: The Statement of Retained Earnings and the Statement of Changes in Equity
 CPA: Financial Reporting
 Bloomcode: Knowledge
 AACSB: Analytic

64. Portland Corporation reports the following information:

Correction of understatement of depreciation expense in prior years, net of tax	\$ 1,376,000
Dividends declared	1,024,000
Net income	3,200,000
Retained earnings, January 1, 2020, as reported	6,400,000

Portland should report retained earnings at January 1, 2020, as adjusted at

- a) \$5,024,000.
- b) \$7,200,000.
- c) \$8,576,000.
- d) \$9,952,000.

Answer: a

Difficulty: Medium

Learning Objective: Prepare the statement of retained earnings and the statement of changes in equity.

Section Reference: The Statement of Retained Earnings and the Statement of Changes in Equity

CPA: Financial Reporting

Bloomcode: Application

Feedback: \$6,400,000 – \$1,376,000 = \$5,024,000

AACSB: Analytic

Use the following information for questions 65-66.

The 2019 and 2020 financial statements of Banana Inc. contained the following errors:

	<u>2019</u>	<u>2020</u>
Ending inventory	\$10,000 overstated	\$16,000 understated
Insurance expense	4,800 understated	2,600 overstated

65. Assuming that none of the errors were detected or corrected, by what amount will 2019 income before taxes be overstated or understated?

- a) \$5,200 understated
- b) \$5,200 overstated
- c) \$14,800 overstated
- d) \$14,800 understated

Answer: c

Difficulty: Medium

Learning Objective: Prepare the statement of retained earnings and the statement of changes in equity.

Section Reference: The Statement of Retained Earnings and the Statement of Changes in Equity

CPA: Financial Reporting

Bloomcode: Application

Feedback: \$10,000 + \$4,800 = \$14,800 overstated

AACSB: Analytic

66. Assuming that none of the errors were detected or corrected, by what amount will 2020 income before taxes be overstated or understated?

- a) \$28,600 understated
- b) \$23,800 understated
- c) \$13,400 understated
- d) \$13,400 overstated

Answer: a

Difficulty: Medium

Learning Objective: Prepare the statement of retained earnings and the statement of changes in equity.

Section Reference: The Statement of Retained Earnings and the Statement of Changes in Equity

CPA: Financial Reporting

Bloomcode: Application

Feedback: $\$10,000 + \$16,000 + \$2,600 = \$28,600$ understated

AACSB: Analytic

Use the following information for questions 67-69. Ignore taxes.

Peach Inc.'s financial statements for the years 2019 and 2020 contained errors as follows:

	<u>2019</u>	<u>2020</u>
Ending Inventory	\$ 3,000 understated	\$ 5,000 overstated
Depreciation Expense	5,500 overstated	3,500 overstated

67. Assuming that the errors made in 2019 were corrected, but that the errors made in 2020 were not detected, by what amount will 2020 income before taxes be overstated or understated?

- a) \$5,000 overstated
- b) \$8,500 overstated
- c) \$1,500 understated
- d) \$1,500 overstated

Answer: d

Difficulty: Medium

Learning Objective: Prepare the statement of retained earnings and the statement of changes in equity.

Section Reference: The Statement of Retained Earnings and the Statement of Changes in Equity

CPA: Financial Reporting

Bloomcode: Application

Feedback: $\$5,000 - \$3,500 = \$1,500$ overstated

AACSB: Analytic

68. Assuming that none of the errors were detected or corrected, by what amount will retained earnings at December 31, 2020 be overstated or understated?

- a) \$4,000 understated
- b) \$5,000 overstated
- c) \$8,500 understated
- d) \$11,500 understated

Answer: a

Difficulty: Medium

Learning Objective: Prepare the statement of retained earnings and the statement of changes in equity.

Section Reference: The Statement of Retained Earnings and the Statement of Changes in Equity

CPA: Financial Reporting

Bloomcode: Application

Feedback: $\$5500 + \$3,500 - \$5,000 = \$4,000$ understated

AACSB: Analytic

69. Assuming that none of the errors were detected or corrected, and that no additional errors were made in 2019, by what amount will current assets at December 31, 2020 be overstated or understated?

- a) \$2,000 overstated
- b) \$10,000 understated
- c) \$10,000 overstated
- d) \$5,000 overstated

Answer: d

Difficulty: Medium

Learning Objective: Prepare the statement of retained earnings and the statement of changes in equity.

Section Reference: The Statement of Retained Earnings and the Statement of Changes in Equity

CPA: Financial Reporting

Bloomcode: Application

Feedback: \$5,000 overstated

AACSB: Analytic

Use the following information for questions 70-71,

For Pear Limited, events and transactions during 2018-2020 included the following. The tax rate for all items is 30%.

1. Depreciation for 2019 was found to be understated by \$30,000.
2. A 2020 strike by the employees of a supplier resulted in a loss of \$20,000.
3. The inventory at December 31, 2018 was overstated by \$40,000.
4. A 2020 flood destroyed a building that had a book value of \$400,000. Floods are very uncommon in that area.

70. The effect of these events and transactions on 2020 income from continuing operations net of tax would be

- a) \$14,000.
- b) \$35,000.
- c) \$63,000.
- d) \$294,000.

Answer: d

Difficulty: Medium

Learning Objective: Prepare the statement of retained earnings and the statement of changes in equity.

Section Reference: The Statement of Retained Earnings and the Statement of Changes in Equity

CPA: Financial Reporting

Bloomcode: Application

Feedback: $(\$20,000 + \$400,000) \times (1 - 0.3) = \$294,000$

AACSB: Analytic

71. The effect of these events and transactions on the balance of retained earnings at January 1, 2020 would be
- a) \$14,000.
 - b) \$21,000.
 - c) \$294,000.
 - d) \$343,000.

Answer: b

Difficulty: Medium

Learning Objective: Prepare the statement of retained earnings and the statement of changes in equity.

Section Reference: The Statement of Retained Earnings and the Statement of Changes in Equity

CPA: Financial Reporting

Bloomcode: Application

Feedback: $\$30,000 \times (1 - 0.3) = \$21,000$

AACSB: Analytic

72. The following information was extracted from the accounts of Tomato Corporation at December 31, 2020:

	<u>CR (DR)</u>
Total reported income since incorporation.....	\$1,540,000
Total cash dividends paid	(550,000)
Cumulative effect of changes in accounting principle	(154,000)
Total stock dividends distributed	(330,000)
Correction of an error, recorded January 1, 2020.....	84,700

What should be the balance of retained earnings at December 31, 2020?

- a) \$465,300
- b) \$550,000
- c) \$590,700
- d) \$506,000

Answer: c

Difficulty: Medium

Learning Objective: Prepare the statement of retained earnings and the statement of changes in equity.

Section Reference: The Statement of Retained Earnings and the Statement of Changes in Equity

CPA: Financial Reporting

Bloomcode: Application

Feedback: $\$1,540,000 - \$550,000 - \$154,000 - \$330,000 + \$84,700 = \$590,700$

AACSB: Analytic

73. In 2020, Junction Corporation has cash receipts from customers of \$270,000 and cash payments for operating expenses of \$168,000. At January 1, 2020, accounts receivable were \$30,000; at December 31, 2020 they were \$34,400. Total service revenue is

- a) \$270,000.
- b) \$274,400.
- c) \$106,400.
- d) \$265,600.

Answer: b

Difficulty: Medium

Learning Objective: Explain the differences between the cash basis of accounting and the accrual basis of accounting.

Section Reference: Cash Basis versus Accrual Basis Earnings (Appendix 4A)

CPA: Financial Reporting

Bloomcode: Application

Feedback: $\$270,000 - \$30,000 + \$34,400 = \$274,400$

AACSB: Analytic

74. Which of the following is(are) NOT recommended to be included in notes to the financial statements?

- a) accounting policies
- b) information about the capital structure of the company
- c) individual salaries of top management
- d) sources of estimation uncertainty

Answer: c

Difficulty: Easy

Learning Objective: Understand how disclosures and analysis help users of financial statements assess performance.

Section Reference: Disclosure and Analysis

CPA: Financial Reporting

CPA: Strategy & Governance

Bloomcode: Knowledge

AACSB: Analytic

75. To assess the quality of earnings, financial statement users should look at

- a) the income statement only.
- b) the statement of cash flows.
- c) the level of business risk.
- d) the whole set of financial statements, including the notes, as well as environmental factors.

Answer: d

Difficulty: Easy

Learning Objective: Understand how disclosures and analysis help users of financial statements assess performance.

Section Reference: Disclosure and Analysis

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

76. When looking to the statement of financial position for an assessment of earnings quality, stakeholders should pay particular attention to

- a) a proportionately high cash balance, as this signifies high-quality earnings.
- b) how the company is financed and what the revenue-generating assets are.
- c) a proportionately low liability balance, as this signifies high-quality earnings.
- d) The statement of financial position is not a reflection of earnings quality.

Answer: b

Difficulty: Easy

Learning Objective: Understand how disclosures and analysis help users of financial statements assess performance.

Section Reference: Disclosure and Analysis

CPA: Financial Reporting

CPA: Finance

Bloomcode: Knowledge

AACSB: Analytic

77. Which of the following is INCORRECT regarding differences between IFRS and ASPE?

- a) Both IFRS and ASPE mandate a list of required items that must be presented.
- b) IFRS requires that held-for-sale assets be reclassified as current assets.
- c) Comprehensive income is not recognized under ASPE.
- d) Both IFRS and ASPE require presentation of both basic and diluted EPS.

Answer: d

Difficulty: Easy

Learning Objective: Identify differences in accounting between IFRS and ASPE and potential changes.

Section Reference: IFRS/ASPE Comparison

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

78. Regarding classification of expenses by nature versus function, under ASPE, an entity is required to

- a) present an analysis of expenses based on their nature.
- b) present their expenses according to their nature.
- c) present expenses in a manner that is most transparent.
- d) present their expenses according to their function.

Answer: c

Difficulty: Easy

Learning Objective: Identify differences in accounting between IFRS and ASPE and potential changes.

Section Reference: IFRS/ASPE Comparison

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

79. Regarding presentation of discontinued operations, under IFRS, on the balance sheet, an entity must classify held-for-sale assets as

- a) current assets.
- b) current or non-current, depending on their nature.
- c) available for sale assets.
- d) Assets held for sale do not appear on the balance sheet.

Answer: a

Difficulty: Easy

Learning Objective: Identify differences in accounting between IFRS and ASPE and potential changes.

Section Reference: IFRS/ASPE Comparison

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

80. The accrual basis of accounting

- a) must be used by all taxpayers.
- b) recognizes revenue when earned and expenses when incurred.
- c) does not record depreciation.
- d) records depreciation but expenses all inventory purchases.

Answer: b

Difficulty: Easy

Learning Objective: Explain the differences between the cash basis of accounting and the accrual basis of accounting.

Section Reference: Application of the Cash and Accrual Bases of Accounting (Appendix 4A)

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

81. The modified cash basis

- a) is frequently used by manufacturing firms.
- b) does not usually record inventory.
- c) capitalizes and depreciates property, plant, and equipment.
- d) is derived from the accrual basis of accounting.

Answer: c

Difficulty: Easy

Learning Objective: Explain the differences between the cash basis of accounting and the accrual basis of accounting.

Section Reference: Application of the Cash and Accrual Bases of Accounting (Appendix 4A)

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

82. The strict cash basis of accounting

- a) records revenue when earned.
- b) does not conform with GAAP.
- c) records expenses when incurred.
- d) none of the above

Answer: b

Difficulty: Easy

Learning Objective: Explain the differences between the cash basis of accounting and the accrual basis of accounting.

Section Reference: Application of the Cash and Accrual Bases of Accounting (Appendix 4A)

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

83. 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 <u>Receivable</u>	Accrued <u>Expenses Payable</u>
a)	No	No
b)	No	Yes
c)	Yes	No
d)	Yes	Yes

Answer: b

Difficulty: Medium

Learning Objective: Explain the differences between the cash basis of accounting and the accrual basis of accounting.

Section Reference: Application of the Cash and Accrual Bases of Accounting (Appendix 4A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

84. For the year ended June 30, 2020, Harry Corp. reported revenue of \$900,000 in its accrual basis income statement. Additional information was as follows:

Accounts receivable June 30, 2019	\$200,000
Accounts receivable June 30, 2020	490,000
Uncollectible accounts written off during the fiscal year	20,000

Under the cash basis, Harry should report revenue of

- a) \$590,000.
- b) \$610,000.
- c) \$630,000.
- d) \$1,190,000.

Answer: a

Difficulty: Medium

Learning Objective: Explain the differences between the cash basis of accounting and the accrual basis of accounting.

Section Reference: Cash Basis versus Accrual Basis Earnings (Appendix 4A)

CPA: Financial Reporting

Bloomcode: Application

Feedback: $\$900,000 + \$200,000 - \$490,000 - \$20,000 = \$590,000$

AACSB: Analytic

85. Gerald Bone, M.D., keeps his accounting records on the cash basis. During 2020, Dr. Bone collected \$150,000 from his patients. At December 31, 2019, Dr. Bone had accounts receivable of \$45,000. At December 31, 2020, 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 2020?

- a) \$145,000
- b) \$140,000
- c) \$135,000
- d) \$105,000

Answer: c

Difficulty: Medium

Learning Objective: Explain the differences between the cash basis of accounting and the accrual basis of accounting.

Section Reference: Application of the Cash and Accrual Bases of Accounting (Appendix 4A)

CPA: Financial Reporting

Bloomcode: Application

Feedback: $\$150,000 - \$45,000 + \$35,000 - \$5,000 = \$135,000$

AACSB: Analytic

Exercises

Ex. 4-86 Value creation

Describe the concept of value creation. Does the value creation process look the same for all companies? Explain.

Solution 4-86

Value creation refers to the act of finding an optimal balance between managing risks and taking the right opportunities such that the firm's net assets and potential are maximized. Well-run companies develop strategies that will allow them to react to the best opportunities in order to maximize shareholder value and maintain risks at an acceptable level.

This process will look different for every company as it depends on many variables. These might include their industry, the opportunities available to them, the assets they have to realize those opportunities, and their risk tolerance (acceptable level of risks). It also depends on shareholder demands and expectations. Some companies are expected to grow steadily and maintain stability, while others are expected to be more volatile.

Difficulty: Easy

Learning Objective: Understand how firms create value, manage performance, and communicate useful information to users.

Section Reference: Performance

CPA: Communication

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Comprehension

AACSB: Communication

Ex. 4.87 Representational faithfulness

Consider the concept of representational faithfulness. Explain why an understanding of the business and industry is essential to performing an audit, and how this relates to the fundamental characteristic of representational faithfulness.

Solution 4-87

The financial statement auditor's responsibility is to determine whether the financial statements present fairly the financial position and performances of the entity. This fair presentation is known as representational faithfulness, which requires financial statements to reflect the economic reality of running a business, including how it creates and sustains value. Knowledge of a business, its strategy, and its industry creates expectations of financial statement figures and ratios. For example, a company following a low-cost strategy will have small sales margins, while one that emphasizes product differentiation will have larger sales margins. The auditor (as well as other financial statement users) could check that figures are consistent with the strategy as an initial, high-level indicator of representational faithfulness.

Difficulty: Easy

Learning Objective: Understand how firms create value, manage performance, and communicate useful information to users.

Section Reference: Performance

CPA: Communication
CPA: Financial Reporting
CPA: Strategy and Governance
Bloomcode: Comprehension
AACSB: Communication

Ex. 4-88 Income statement performance assessment

Explain how the income statement can be used to evaluate an enterprise's past performance and profitability. What other information might be useful for performance and profitability evaluation?

Solution 4-88

By examining revenues, expenses, gains, and losses, users can see how the company (and management) performed, and compare the company's performance with that of its competitors. Balance sheet information is also useful in assessing profitability, such as by calculating return on assets. Users can also examine information (such as press releases) released by the company, and by analysts and regulators, to form a better assessment of a company's performance.

Difficulty: Easy

Learning Objective: Understand how firms create value, manage performance, and communicate useful information to users.

Section Reference: Performance

CPA: Communication
CPA: Financial Reporting
CPA: Strategy and Governance
Bloomcode: Comprehension
AACSB: Communication

Ex. 4-89 Income statement information about future cash flows

How might stakeholders use the income statement to help assess a company's expected cash inflows?

Solution 4-89

The relationship among various components of income highlights the relationships among them and can be used to predict future performance, including cash flows. For example, for a company with healthy collections, recurring operating income should be a rough estimation of cash flow from operating activities. These results from continuing operations can be used to predict future performance.

Difficulty: Easy

Learning Objective: Understand how firms create value, manage performance, and communicate useful information to users.

Section Reference: Performance

CPA: Communication

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Comprehension

AACSB: Communication

Ex. 4-90 Statement of income terminology

The statement of income/earnings has many names. Distinguish among the income statement, statement of profit or loss and statement of comprehensive income, and the statement of financial performance.

Solution

Under ASPE, the **income statement** is commonly used, but under IFRS, the statement is expanded to include other comprehensive income and may be shown as two separate statements (referred to as the **statement of profit or loss** and **statement of comprehensive income**) or as a combined statement newly named **statement of financial performance**.

Difficulty: Easy

Learning Objective: Understand how firms create value, manage performance, and communicate useful information to users.

Section Reference: Performance

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

Ex. 4-91 Low-cost/high-volume strategy versus cost differentiation strategy

Explain the difference between a low-cost/high-volume strategy and a cost differentiation strategy.

Solution

A **low-cost/high-volume strategy** occurs when a company prices its goods lower to attract more customers and get higher volumes of sales. A **cost differentiation strategy** occurs when a company is able to attract higher prices because it sells more unique and higher-end products.

Difficulty: Easy

Learning Objective: Understand how firms create value, manage performance, and communicate useful information to users.

Section Reference: Performance

CPA: Communication

CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Communication

Ex. 4-92 Income statement limitations

Briefly discuss the limitations of the income statement.

Solution 4-92

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. Financial recording bias can exist and degrade the quality of the financial statements.

Difficulty: Easy

Learning Objective: Understand the concept of and be able to assess the quality of earnings/information.

Section Reference: Quality of Earnings/Information

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

Ex. 4-93 Characteristics of high-quality earnings

Describe the characteristics of high-quality earnings.

Solution 4-93

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.

Difficulty: Easy

Learning Objective: Understand the concept of and be able to assess the quality of earnings/information.

Section Reference: Quality of Earnings/Information

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

Ex. 4-94 Earnings management

Explain the concept of earnings management. Why is it of concern to investors and financial statement users? Do you think this practice should be allowed?

Solution 4-94

Earnings management is the process of targeting certain earnings levels or desired earnings trends, and working backwards to ensure these targets are met. This can involve accounting policy selection, use of estimates, and transaction execution, often to increase income in the current year (however, depending on reporting motivations, earnings may also be manipulated downward in the current year). As long as there is full disclosure, the market should be able to see through attempts to mask economic reality. Despite this, investors and financial statement users are concerned that information presented is too promotional and lacks the transparency required to adhere to the principle of representational faithfulness—there is still a great deal of information asymmetry, or, information known by management and unavailable to external stakeholders. In short, companies do not always disclose all important information and markets do not always operate efficiently.

Difficulty: Easy

Learning Objective: Understand the concept of and be able to assess the quality of earnings/information.

Section Reference: Quality of Earnings/Information

CPA: Communication

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Comprehension

AACSB: Communication

Ex. 4-95 Earnings management

Consider the practice of earnings management. Describe a scenario where a company might have an incentive to report lower earnings. Describe some earnings management approaches they might take to achieve this objective.

Solution 4-95

A company might decrease current earnings in order to increase future income (“taking a bath”). However, certain companies might more consistently report lower earnings to reduce their tax burden, maintain a level of profitability required to qualify for grants, or funding, or, to minimize pressure from shareholders to pay out dividends or other returns.

Some ways a company could decrease current earnings include:

- establish reserves using aggressive assumptions to estimate items such as sales returns, loan losses, and warranty returns
- delay recognition of large sales to the following fiscal year
- accelerate recognition of larger expense items
- establish aggressive estimates regarding the useful lives of assets to maximize the depreciation expense

Difficulty: Easy

Learning Objective: Understand the concept of and be able to assess the quality of earnings/information.

Section Reference: Quality of Earnings/Information

CPA: Communication

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Comprehension

AACSB: Communication

Ex. 4-96 Calculation of net income from the change in shareholders' equity

Presented below is selected information pertaining to Pullman Enterprises Ltd. for last year:

Assets, January 1.....	\$240,000
Assets, December 31	320,000
Liabilities, January 1	120,000
Common shares, December 31.....	60,000
Retained earnings, December 31	20,000
Common shares issued during the year.....	2,000
Dividends declared during the year	32,000

Instructions

Calculate the net income for last year.

Solution 4-96

	<u>January 1</u>	<u>December 31</u>
Assets.....	\$240,000	\$320,000
Liabilities	<u>120,000</u>	<u>240,000</u>
Shareholders' equity.....	<u>\$ 120,000</u>	<u>\$80,000</u> *

Calculation of net income:

Shareholders' equity, Dec 31	\$ 80,000
Less shareholders' equity, Jan 1	<u>(120,000)</u>
Decrease	(40,000)
Add back dividend declared	32,000
Less common shares issued	<u>(2,000)</u>
Net income (loss)	<u>\$ (10,000)</u>

*\$60,000 + \$20,000

Difficulty: Medium

Learning Objective: Understand the differing perspectives on how to measure income.

Section Reference: Measurement of Income

CPA: Financial Reporting
 Bloomcode: Application
 AACSB: Analytic

Ex. 4-97 Calculation of net income from the change in shareholders' equity

Presented below are changes in all account balances of Heys Inc. during last year, except for retained earnings.

	Increase (Decrease)		Increase (Decrease)
Cash	\$22,000	Accounts payable	\$28,000
Accounts receivable (net)	(9,000)	Bonds payable.....	(14,000)
Inventory	48,000	Common shares	72,000
Plant Assets (net).....	24,000		

The only entries in retained earnings were for net income and a dividend declaration of \$12,000.

Instructions

Calculate the net income for last year.

Solution 4-97

Calculation of net income:

Change in assets (\$94,000 – \$9,000)	\$85,000	Increase
Change in liabilities (\$28,000 – \$14,000)	<u>14,000</u>	Increase
Change in shareholders' equity.....	71,000	Increase
Add back dividend declared	12,000	
Less common shares.....	<u>(72,000)</u>	
Net income	<u>\$ 8,000</u>	

Difficulty: Medium

Learning Objective: Understand the differing perspectives on how to measure income.

Section Reference: Measurement of Income

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 4-98 Comprehensive income

Tarzana Corporation completed its first year of operations on December 31, 2020. Results and other information for the year included the following:

Sales.....	\$810,000
Cost of goods sold	320,000
Operating expenses	94,000

Unrealized holding gain from investments (accounted for
under the fair value through comprehensive income model) 31,000

Instructions

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

Solution 4-98

TARZANA CORPORATION
Statement of Income and Comprehensive Income
For the Year Ended December 31, 2020

Sales	\$810,000
Cost of goods sold	<u>320,000</u>
Gross profit	490,000
Operating expenses	<u>94,000</u>
Net income	396,000
Other comprehensive income	
Unrealized holding gain – OCI	<u>31,000</u>
Comprehensive income	<u>\$427,000</u>

Difficulty: Medium

Learning Objective: Understand the differing perspectives on how to measure income.

Section Reference: Measurement of Income

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 4-99 An all-inclusive approach

The notion of comprehensive earnings is sometimes referred to as the “all-inclusive” approach to measuring income. Explain what is meant by “all-inclusive.” How does this differ from the traditional notion of income? Why do you think that emerging standards such as IFRS support this view of income?

Solution 4-99

The “all-inclusive” approach is an income measurement approach that indicates most items, including irregular ones, are reported in net income. In contrast, more traditional views of net income exclude irregular items from net income, under the argument that they are not representative of continuing operations. Emerging standards such as IFRS, however, are strong proponents of fair value reporting as representational faithfulness and thus take preference to inclusion of ALL operations (even irregular or discontinued ones) on the income statement to provide stakeholders with a complete view of business operations. There is still

some resistance to this view, as oft-used performance measures such as earnings per share still employ the traditional net income figure.

Difficulty: Easy

Learning Objective: Understand the differing perspectives on how to measure income.

Section Reference: Measurement of Income

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

Ex. 4-100 Comprehensive income

Oiseau Inc. reported the following for 2020:

Net sales	\$ 1,470,000
Cost of goods sold	850,000
Selling and admin expenses	210,000
Loss on disposal of equipment.....	(12,000)
Unrealized gain OCI.....	14,000

Instructions

Prepare a statement of comprehensive income. Ignore income tax and EPS. Assume Oiseau follows IFRS.

Solution 4-100

OISEAU INC.
Statement of Comprehensive Income
For the Year Ended December 31, 2020

Net sales	\$1,470,000
Cost of goods sold	<u>850,000</u>
Gross profit	620,000
Operating expenses	
Selling and administrative expenses	210,000
Loss on disposal of equipment.....	<u>12,000</u>
Net income.....	398,000
Other comprehensive income	
Items that may be reclassified subsequently to net income or loss:	
Unrealized gain on fair-value OCI investments.....	<u>14,000</u>
Comprehensive income	<u><u>\$412,000</u></u>

Difficulty: Medium

Learning Objective: Understand the differing perspectives on how to measure income.

Section Reference: Measurement of Income

Learning Objective: Measure income and prepare the income statement and the statement of comprehensive income using various formats.

Section Reference: The Statement of Income and the Statement of Comprehensive Income

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 4-101 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. How are earnings per share calculated?
8. State two examples of adjustments to 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. What plans does the IASB have?

Solution 4-101

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 an entity's ordinary revenue-generating activities.
2. Expenses are decreases 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 continuing 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.
7. The calculation of earnings per share is: net income minus preferred dividends divided by the weighted average number of common shares outstanding.
8. Adjustments to prior years' retained earnings include correction of an error in the financial statements of a prior period and retroactively applied changes in accounting principles. The adjustments should be charged or credited to the opening balance of retained earnings.
9. The IASB has been working on its Primary Financial Statements Project and plans to issue a Discussion Paper or Exposure Draft in 2019. The IASB is also working on a disclosure project in the research project stage.

Difficulty: Medium

Learning Objective: Understand the differing perspectives on how to measure income.

Section Reference: Measurement of Income

Learning Objective: Measure and report results of discontinued operations.

Section Reference: Discontinued Operations

Learning Objective: Measure income and prepare the income statement and the statement of comprehensive income using various formats.

Section Reference: The Statement of Income and the Statement of Comprehensive Income

Learning Objective: Prepare the statement of retained earnings and the statement of changes in equity.

Section Reference: The Statement of Retained Earnings and the Statement of Changes in Equity

Learning Objective: Identify differences in accounting between IFRS and ASPE and potential changes.

Section Reference: IFRS/ASPE Comparison

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 4-102 Comprehensive income terminology

Explain the difference(s) between other comprehensive income, comprehensive income, and accumulated other comprehensive income.

Solution

Other comprehensive income (OCI) is made up of certain specific gains or losses including unrealized gains and losses on certain securities, certain foreign exchange gains or losses, and other gains and losses as defined by IFRS. Some items are “recycled” or reclassified which means that they are recognized first in OCI and then reclassified later to net income.

Comprehensive income is net income plus/minus other comprehensive income/loss.

Other comprehensive income is closed out to a balance sheet account that is often referred to as **Accumulated Other Comprehensive Income**, which acts as a type of retained earnings account. Accumulated Other Comprehensive Income is an equity account on the balance sheet.

Difficulty: Easy

Learning Objective: Understand the differing perspectives on how to measure income.

Section Reference: Measurement of Income

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 4-103 Recycled items

Under IFRS, some items included in other comprehensive income are “recycled” or reclassified which means that they are recognized first in OCI and then reclassified later to net income. Identify which of the following items should be recycled/reclassified and which should not by using the letter “Y” for yes and the letter “N” for no.

- _____ 1. Changes in revaluation surplus under the revaluation method for property, plant, and equipment.
- _____ 2. Gains and losses on remeasurement of defined benefit pension plans.
- _____ 3. Gains and losses arising from translating the financial statements of certain foreign operations.
- _____ 4. Gains and losses for certain hedges.
- _____ 5. Gains and losses on remeasuring FV-OCI Investments-debt instruments.
- _____ 6. Gains and losses on remeasuring FV-OCI Investments-equity instruments.
- _____ 7. Changes in fair value of certain liabilities measured at fair value through profit or loss relating to the liability’s credit risk under IFRS 9.
- _____

Solution

- N 1. Changes in revaluation surplus under the revaluation method for property, plant, and equipment.
- N 2. Gains and losses on remeasurement of defined benefit pension plans.

- Y 3. Gains and losses arising from translating the financial statements of certain foreign operations.
- Y 4. Gains and losses for certain hedges.
- Y 5. Gains and losses on remeasuring FV-OCI Investments-debt instruments.
- N 6. Gains and losses on remeasuring FV-OCI Investments-equity instruments.
- N 7. Changes in fair value of certain liabilities measured at fair value through profit or loss relating to the liability's credit risk under IFRS 9.

Difficulty: Easy

Learning Objective: Understand the differing perspectives on how to measure income.

Section Reference: Measurement of Income

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

Ex. 4-104 Discontinued operations

Hibou Ltd., a private company based in Vancouver, decided to sell its Industrial 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 2020, the plan was finalized and approved by the board of directors. The sale is anticipated to be completed by June 30, 2021.

Other information:

1. Hibou's 2020 after-tax net income (excluding the results from the Industrial Design Division) was \$450,000.
2. During the year, the division reported an after-tax loss of \$120,000 (revenues: \$30,000, expenses: \$150,000).
3. Management estimates that after-tax legal and audit fees of \$32,000 as well as severance payments of \$66,000 will be required to finalize the disposal plan. A portion of these costs is expected to be offset by the after-tax proceeds of \$61,000 from the sale of the division's assets.

Instructions

Assuming the Industrial Design Division qualifies for treatment as a discontinued operation, prepare a partial income statement for Hibou for 2020. The statement should begin with income from continuing operations and include an appropriate footnote pertaining to the disposal of the Industrial Design Division.

Solution 4-104

Partial income statement:

HIBOU LTD.
Partial Income Statement
For the Year Ended December 31, 2020

Net income from continuing operations.....		\$450,000
Discontinued operations*		
Loss from operation of discontinued		
Industrial Design Division (net of tax)	\$120,000	
Loss from disposal of		
Industrial Design Division (net of tax)	<u>37,000</u>	<u>157,000</u>
Net income		<u>\$293,000</u>

* Footnote:

On December 31, due to continued losses, the board of directors unanimously approved management's plan to dispose of the Industrial Design Division. The sale is anticipated to be completed by June 30, 2021.

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

Revenues	\$ 30,000
Expenses.....	150,000
Net loss	\$(120,000)

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

Proceeds from sale of assets	\$61,000
Less legal and audit fees	32,000
Less severance payments to staff.....	<u>66,000</u>
	<u>\$37,000</u>

Difficulty: Medium

Learning Objective: Measure and report results of discontinued operations.

Section Reference: Discontinued Operations

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

Ex. 4-105 Discontinued operations

Motivated Inc.'s manufacturing division lost \$140,000 (net of tax) for the year ended December 31, 2020. Motivated estimates that it can sell the division at a loss of \$190,000 (net of tax). The division qualifies for treatment as a discontinued operation.

Instructions

a) Explain how the discontinued operation would be measured and presented on the income statement and balance sheet under ASPE.

b) Explain how your answer to part (a) would be different if Motivated prepared financial statements in accordance with IFRS.

Solution 4-105

The \$140,000 (net of tax) loss from operation of the discontinued division, and the \$190,000 (net of tax) loss on impairment of net assets of the discontinued division should be shown in the discontinued operations section of the income statement for the year ended December 31, 2020. The discontinued operations section follows income from continuing operations. Under ASPE, the assets and liabilities related to the discontinued manufacturing division should be segregated on the balance sheet according to their nature (e.g., current assets related to the discontinued manufacturing division should be presented as current assets held for sale/related to discontinued operations, and non-current assets related to the discontinued manufacturing division should be presented as non-current assets held for sale/related to discontinued operations).

b) Under IFRS, the \$140,000 (net of tax) loss from operation of the discontinued division, and the \$190,000 (net of tax) loss on impairment of net assets of the discontinued division should be also be shown in the discontinued operations section of the income statement for the year ended December 31, 2020. However, on the balance sheet, all assets and liabilities related to the discontinued manufacturing division should be presented as held for sale, and classified as current assets and current liabilities, respectively.

Difficulty: Medium

Learning Objective: Measure and report results of discontinued operations.

Section Reference: Discontinued Operations

CPA: Communication

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 4-106 Income statement classifications

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

- a) Advertising
- b) Depreciation of head office building
- 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 fire loss
- h) Purchase discounts

- i) Sales discounts
- j) Officers' salaries
- k) Freight-out
- l) Sinking fund income

Solution 4-106

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

Difficulty: Medium

Learning Objective: Measure income and prepare the income statement and the statement of comprehensive income using various formats.

Section Reference: The Statement of Income and the Statement of Comprehensive Income

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 4-107 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 years' retained earnings

- _____ 1. The bad debt rate was increased from 1% to 2% of sales, thus increasing bad debt expense.
- _____ 2. Obsolete inventory was written off. This was a material amount, and the first loss of this type in the company's history.
- _____ 3. An uninsured earthquake loss was incurred. This was the first loss of this type in the company's history.
- _____ 4. Recognition of revenue earned last year, inadvertently omitted from last year's income statement.
- _____ 5. The company sold one of its warehouses at a loss.
- _____ 6. Settlement of a court case involving the 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 that were taken over by a dictator unsympathetic to Canadian business interests.
- _____ 8. The company failed to record depreciation in the previous year.
- _____ 9. Discontinuance of all production in Canada. The manufacturing operations were relocated to Honduras.
- _____ 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 4-107

- 1. a

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

Difficulty: Medium

Learning Objective: Measure income and prepare the income statement and the statement of comprehensive income using various formats.

Section Reference: The Statement of Income and the Statement of Comprehensive Income

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 4-108 Nature versus function of expense presentation

IFRS requires a business to present an analysis of expenses based on either “nature” or “function.” Explain what this means.

Solution 4-108

Nature refers to the type of expense, such as purchases, depreciation, employee benefits, or distribution costs.

Function refers to the business function or activity, such as production or cost of sales, or selling and administrative (head office). Thus expenses would be grouped by these activities. Presenting expenses by nature is usually quite straightforward as no allocation of costs is required between functions. On the other hand, presenting expenses by function requires more judgement, as many costs would be allocated between functions, such as payroll, depreciation, and occupancy costs. However, it does give more insight into the various phases of the business.

Difficulty: Easy

Learning Objective: Measure income and prepare the income statement and the statement of comprehensive income using various formats.

Section Reference: The Statement of Income and the Statement of Comprehensive Income

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

Ex. 4-109 Understandability/disclosure trade-off

Explain briefly the trade-off between understandability and full disclosure. Would statements provided to external users have more or less detail than internal management reports? Why?

Solution 4-109

Usually, financial statements provided to external users have less detail than internal management reports. For external users, expenses might be grouped by nature instead of function, and could be presented in a condensed income statement format with supplementary schedules to support the totals. This helps reduce the statement to one of convenient size, reducing information overload, while availing more detailed information to readers who want to study all reported data on operations. Even then, the data available to readers is not as robust as that available to management because it serves different decision purposes. Further, the cost of presenting accurate granular detail to external users may exceed its usefulness. A company should try to publish information that optimizes this cost-benefit relationship while preserving the underlying principle of representational faithfulness.

Difficulty: Easy

Learning Objective: Measure income and prepare the income statement and the statement of comprehensive income using various formats.

Section Reference: The Statement of Income and the Statement of Comprehensive Income

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

Ex 4-110 Calculation of net income

Heron Ltd. had the following information for 2020:

Assets, January 1	\$250,000
Assets, December 31	230,000
Liabilities, January 1	150,000
Common shares, December 31.....	80,000
Retained earnings, December 31	41,000

Common shares sold during the year	10,000
Dividends declared during the year	13,000

Compute the net income for the year.

Solution 4-110

	<u>Jan 1</u>	<u>Dec 31</u>
Assets	\$250,000	
Liabilities	<u>150,000</u>	
Shareholders' equity	<u>\$100,000</u>	<u>\$121,000*</u>

Computation of net income:

Shareholders' equity December 31	\$121,000
Shareholders' equity January 1	<u>100,000</u>
Increase	21,000
Add: Dividends declared	13,000
Less: Common shares sold	<u>(10,000)</u>
Net income	<u>\$ 24,000</u>

*\$80,000 + \$41,000

Difficulty: Medium

Learning Objective: Measure income and prepare the income statement and the statement of comprehensive income using various formats.

Section Reference: The Statement of Income and the Statement of Comprehensive Income

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 4-111 Terminology

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

- Net income minus preferred dividends divided by the weighted average of common shares outstanding. _____
- A correction of an error is reported as a(n) _____
- An income statement that includes only two groupings (revenues and expenses) _____
- The income statement category for a disposal of a segment of a business. _____

5. Relating tax expense to specific items on the income statement.
-

Solution 4-111

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

Difficulty: Easy

Learning Objective: Measure income and prepare the income statement and the statement of comprehensive income using various formats.

Section Reference: The Statement of Income and the Statement of Comprehensive Income

Learning Objective: Prepare the statement of retained earnings and the statement of changes in equity.

Section Reference: The Statement of Retained Earnings and the Statement of Changes in Equity

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

Ex. 4-112 Statement of changes in equity

Tote Ltd. reported the following balances at January 1, 2020:

Common shares	\$370,000
Retained earnings	70,000
Accumulated other comprehensive income.....	71,000

During the year Tote earned net income of \$310,000 and generated other comprehensive income of \$64,000.

Instructions

Prepare a statement of shareholders' equity for the year ended December 31, 2020.

Solution 4-112

TOTE LTD.
Statement of Shareholders' Equity

For the Year Ended December 31, 2020

	Total	Common Shares	Comprehensive Income	Retained Earnings	Accumulated Other Comprehensive Income
Beginning balance	\$511,000	\$370,000		\$ 70,000	\$71,000
Net income	310,000		\$310,000	<u>310,000</u>	
Other comprehensive income	<u>64,000</u>		<u>64,000</u>		<u>64,000</u>
Comprehensive income			<u>\$374,000</u>		
Ending balance	<u>\$885,000</u>	<u>\$370,000</u>		<u>\$380,000</u>	<u>\$135,000</u>

Difficulty: Medium

Learning Objective: Prepare the statement of retained earnings and the statement of changes in equity.

Section Reference: The Statement of Retained Earnings and the Statement of Changes in Equity

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 4-113 Statement of retained earnings

Mondial Corporation prepares financial statements in accordance with ASPE. At January 1, 2020, the company had retained earnings of \$420,000. In 2020, net income was \$1,737,000, and cash dividends of \$360,000 were declared and paid.

Prepare a 2020 statement of retained earnings for Mondial Corporation.

Solution 4-113

MONDIAL CORPORATION
Statement of Retained Earnings
For the Year Ended December 31, 2020

Balance, January 1	\$ 420,000
Add: Net income	<u>1,737,000</u>
	2,157,000
Less: Dividends	<u>360,000</u>
Balance, December 31	<u>\$1,797,000</u>

Difficulty: Medium

Learning Objective: Prepare the statement of retained earnings and the statement of changes in equity.

Section Reference: The Statement of Retained Earnings and the Statement of Changes in Equity

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 4-114 Comprehensive income

Sunshine Corporation had the following balances at December 31, 2020 (in thousands): preferred shares \$3,012; common shares \$4,718; contributed surplus \$1,750; retained earnings \$16,791; and accumulated other comprehensive income \$514.

During the year ended December 31, 2020, the company earned net income of \$3,613,000, sold common shares of \$30,000, and paid out dividends of \$14,000 and \$5,000 to preferred and common shareholders, respectively.

Prepare a statement of changes in equity for the year ended December 31, 2020, as well as the shareholders' equity section of the Sunshine Corporation balance sheet as at December 31, 2020.

Solution 4-114

SUNSHINE CORPORATION
Statement of Changes in Equity
For the Year Ended December 31, 2020 (all amounts in thousands)

	Total	Comp. Income	Preferred Shares	Common Shares	Contr. Surplus	Retained Earnings	Acc. Other Comp. Inc.
Beginning Balance	\$26,785		\$3,012	\$4,718	\$1,750	\$16,791	\$514
Comprehensive Income:							
Net income	3,613	\$3,613				3,613	
Dividends to shareholders:							
Preferred	(14)					(14)	
Common	(5)					(5)	
Issue of common shares	<u>30</u>			<u>30</u>			
Ending Balance	<u>\$30,409</u>		<u>\$3,012</u>	<u>\$4,748</u>	<u>\$1,750</u>	<u>\$20,385</u>	<u>\$514</u>

SUNSHINE CORPORATION
Balance Sheet (Partial)
December 31, 2020 (all amounts in thousands)

Share capital:	
Preferred shares	\$ 3,012
Common shares	<u>4,748</u>
Total share capital	7,760
Contributed surplus	<u>1,750</u>
Total paid-in capital	9,510
Retained earnings	20,385

Accumulated other comprehensive income.....	<u>514</u>
Total shareholders' equity.....	<u>\$30,409</u>

Difficulty: Medium

Learning Objective: Prepare the statement of retained earnings and the statement of changes in equity.

Section Reference: The Statement of Retained Earnings and the Statement of Changes in Equity

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 4-115 Non-GAAP measures

Companies often try to help users assess the results of operations and their financial position by providing modified GAAP information such as non-GAAP earnings. Describe what is meant by non-GAAP earnings, and explain the danger in providing these numbers.

Solution 4-115

Non-GAAP earnings start with GAAP net income and add back or deduct nonrecurring or non-operating items to arrive at an adjusted net income number. When clearly disclosed and explained, it can add value to the decision-making process. The danger is that, in the absence of standards to ensure the calculation is consistently prepared and comparable between companies, stakeholders may be misguided in their assessment of company performance.

Difficulty: Easy

Learning Objective: Understand how disclosures and analysis help users of financial statements assess performance.

Section Reference: Disclosure and Analysis

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

Ex. 4-116 The OSC and non-GAAP measures

In an effort to curb to potential confusion created by non-GAAP earnings discussed in Exercise 4-111, the OSC has issued a staff notice on these disclosures. Briefly explain what this notice states issuers should do. Why do you think the OSC is particularly interested in streamlining these disclosures?

Solution 4-116

The OSC's staff notice on non-GAAP financial measures states that an issuer should do the following:

1. State explicitly the non-GAAP measure does not have standardized meaning and is thus unlikely to be comparable.

2. Present with equal or greater prominence the corresponding GAAP measure.
3. Explain why the non-GAAP measure provides useful information to investors, and any purposes for which management uses these measures.
4. Provide a clear quantitative reconciliation from the non-GAAP measure to the GAAP measure. Reference this reconciliation if the non-GAAP measure appears in the document first.
5. Explain any changes in composition of the non-GAAP measure when compared with previously disclosed measures.

The OSC polices a wide variety of securities and financial instruments issued by various corporations, and has an oversight role to play in ensuring that the information provided to investors is transparent and consistent with the principle of representational faithfulness. As such, they have a vested interest in comparability and understandability of information for all stakeholders. In response to potential sources of ambiguity such as non-GAAP disclosures, the OSC thus chooses to provide guidelines that will streamline these disclosures as much as possible.

Where securities are not publicly listed, but a company still follows GAAP, non-GAAP disclosures would be less of a concern, since stakeholders would likely have access to additional information about the company.

Difficulty: Easy

Learning Objective: Understand how disclosures and analysis help users of financial statements assess performance.

Section Reference: Disclosure and Analysis

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

Ex. 4-117 Analyzing financial health and quality of earnings

List some items that you should be looking for when analyzing the health and quality of earnings of a company.

Solution 4-117

1. Accounting policies
2. Notes to financial statements
3. Measurement uncertainty
4. Financial statements as a whole
5. Income statement: percentage of net income from continuing operations

6. Statement of financial position (balance sheet): how is the company financed? revenue-generating assets?
7. Cash flow statement: compare cash from operations to net income
8. Environmental factors (industry, economy), and competition

Difficulty: Easy

Learning Objective: Understand how disclosures and analysis help users of financial statements assess performance.

Section Reference: Disclosure and Analysis

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

***Ex. 4-118** Cash basis

Argent Inc. reported the following information for their 2020 fiscal year:

Revenue on the income statement	\$114,000
Accounts receivable, Jan 1	3,200
Accounts receivable, Dec 31	6,120
Unearned revenue, Jan 1	1,200
Unearned revenue, Dec 31	1,840

Instructions

Calculate the revenue for the year on a cash basis.

Solution 4-118

$\$114,000 + \$3,200 - \$6,120 - \$1,200 + \$1,840 = \$111,720.$

Difficulty: Medium

Learning Objective: Explain the differences between the cash basis of accounting and the accrual basis of accounting.

Section Reference: Application of the Cash and Accrual Bases of Accounting (Appendix 4A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 4-119 Accrual basis

Discover Inc. reported the following information for their 2020 fiscal year:

Cash receipts from sales	\$114,000
Accounts receivable, Jan 1	4,500

Accounts receivable, Dec 31	7,400
Unearned revenue, Jan 1	1,500
Unearned revenue, Dec 31.....	1,200

Instructions

Calculate the revenue for the year on an accrual basis.

Solution 4-119

$$\$114,000 - \$4,500 + \$7,400 + \$1,500 - \$1,200 = \$117,200$$

Difficulty: Medium

Learning Objective: Explain the differences between the cash basis of accounting and the accrual basis of accounting.

Section Reference: Application of the Cash and Accrual Bases of Accounting (Appendix 4A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 4-120 Cash Basis

Explain the theoretical weaknesses of the cash basis approach. Isn't cash management the most important part of a business?

Solution 4-120

Today's economy is based more on credit than cash. The accrual basis recognizes all aspects of credit. Accrual basis accounting provides the cash information that investors, creditors, and other decision makers seek about an enterprises future cash flows by reporting this information as soon as those cash flows can be reasonable estimated to an acceptable degree of certainty. Accrual-based accounting aids in predicting future cash flows by reporting transactions and other events with cash consequences at the time the transactions and events occur, rather than when cash is received and paid.

Difficulty: Easy

Learning Objective: Explain the differences between the cash basis of accounting and the accrual basis of accounting.

Section Reference: Application of the Cash and Accrual Bases of Accounting (Appendix 4A)

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

Ex. 4-121 Changes in accounting principles

Describe how changes in accounting principles are applied and affect the financial statements.

Solution 4-121

Changes in accounting principle are generally recognized through **retrospective restatement**, which involves determining the effect of the policy change on the income of prior periods that are affected. The financial statements for all prior periods that are presented for comparative purposes should be restated except when the effect cannot be determined reasonably. If all comparative years are not disclosed, a cumulative amount would instead be calculated and adjusted through the opening retained earnings amount.

Difficulty: Easy

Learning Objective: Prepare the statement of retained earnings and the statement of changes in equity.

Section Reference: The Statement of Retained Earnings and the Statement of Changes in Equity.

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

PROBLEMS

Pr. 4-122 Discontinued operations

Bagel Corporation operates several stores in British Columbia (Vancouver, Victoria, Kamloops, Penticton, and Prince George). The restructuring of its organization on November 20, 2020, has led to the decision to sell its Prince George store. In preparing financial statements at December 31, 2020, the following information was made available:

1. The Prince George operation incurred a loss of \$283,500 for the 2020 calendar year, including \$225,000 for the period January 1 to November 20, 2020.
2. Estimated costs to sell are \$300,000.
3. At December 31, 2020, the fair value of the Prince George assets is estimated at \$7 million and the carrying (book) value is \$7.3 million.
4. The combined provincial and federal income tax rate is 30%.
5. It is estimated that the operation will lose an additional \$250,000 before it is sold.

Instructions

- a) The Prince George operation qualifies for reporting as a discontinued operation. What amount should be reported in the discontinued operations section of Bagel's 2020 income statement?
- b) In early 2021, the Prince George operation is sold for \$8.5 million, with actual costs to sell of \$400,000. Additional disposal costs related to the sale are \$500,000. The operation lost an additional \$150,000 before it was sold. What amount should be reported in the discontinued operations section of Bagel's 2021 income statement?

Solution 4-122

a)	
Loss from operations for 2020, before tax	\$(283,500)
Reduction in carrying value of assets estimated to be fair value less costs to sell	
(\$7,300,000 – [\$7,000,000 – \$300,000])	(600,000)
Estimated pre-tax loss	(883,500)
Recovery of 30% tax of above amount.....	(265,050)
Loss on discontinued operations	<u>\$(618,450)</u>

b)	
Sale price	\$8,500,000

Minus assets sold at fair value	(6,700,000)
Additional costs to sell (\$400,000 – \$300,000)	(100,000)
Less additional loss from operations	(150,000)
Additional disposal costs	<u>(500,000)</u>
Estimated pre-tax amount	1,050,000
Applicable income tax at 30%	<u>(315,000)</u>
Gain on discontinued operations	<u>\$ 735,000</u>

Difficulty: Medium

Learning Objective: Measure and report results of discontinued operations.

Section Reference: Discontinued Operations

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 4-123 Multiple-step income statement

Presented below is information that relates to Muffin Limited for 2020:

Collections of credit sales	\$1,100,000
Retained earnings, January 1, 2020	800,000
Sales	1,900,000
Selling and administrative expenses	290,000
Casualty loss (pre-tax)	350,000
Cash dividends declared on common shares	34,000
Cost of goods sold	1,100,000
Loss resulting from calculation error on depreciation charge in 2018 (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 Muffin common shares	60,000

Additional information:

1. Early in 2020, Muffin changed depreciation methods for its plant assets from the double-declining-balance to the straight-line method. The affected assets were purchased at the beginning of 2015 for \$200,000, had no residual value, and had useful lives of 10 years. Depreciation expense of \$20,000 is included in the selling and administrative expenses of \$290,000.
2. On September 1, 2020, Muffin 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. Muffin bases its bad debts expense upon a percentage of sales. In 2018 and 2019, the percentage was 0.5 %. In 2020, the percentage was changed to 1%.

Instructions

In good form, prepare a multiple-step income statement for 2020. Assume a 20% income tax rate and that 20,000 common shares were outstanding during the year.

Solution 4-123

MUFFIN LIMITED
Income Statement
For the Year Ended December 31, 2020

Sales.....		\$1,900,000	
Cost of goods sold		<u>1,100,000</u>	
Gross profit		800,000	
Selling and administrative expenses.....		<u>290,000</u>	
Operating income		510,000	
Other revenues and gains			
Other revenues.....	\$180,000		
Gain from transactions in foreign currency	<u>220,000</u>	<u>400,000</u>	
			910,000
Other expenses and losses			
Other expenses.....	120,000		
Early extinguishment of debt	340,000		
Casualty loss.....	<u>350,000</u>	<u>810,000</u>	
Income from continuing operations before tax.....		100,000	
Income tax		<u>20,000</u>	
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)	<u>440,000</u>	<u>56,000</u>	
Net income			<u>\$ 136,000</u>
Earnings per share:			
Income from continuing operations	\$4.00		
Discontinued operations	<u>2.80</u>		
Net income	<u>\$6.80</u>		

Difficulty: Medium

Learning Objective: Measure and report results of discontinued operations.

Section Reference: Discontinued Operations

Learning Objective: Measure income and prepare the income statement and the statement of comprehensive income using various formats.

Section Reference: The Statement of Income and the Statement of Comprehensive Income

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 4-124 Income statement, including corrections

During calendar 2020, Scone Corporation reported income from continuing operations of \$800,000 (after taxes). In addition, the following information, which has not yet been considered or included in the above figure, has been revealed:

1. On December 31, 2020, Scone adopted the average cost method of inventory valuation. The company had previously used the FIFO method. The change decreases income for 2020 by \$50,000 (pre-tax) and the cumulative effect of the change on prior years' income was a \$60,000 (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. (Depreciation has been correctly recorded.)
3. Scone decided to discontinue its stereo division in 2020. During the current year, the loss on the disposal of this segment was \$150,000 (before applicable taxes).

Instructions

Present in good form the income statement of Scone Corporation for 2020 starting with "income from continuing operations." Assume that Scone's tax rate is 20% and that 100,000 common shares were outstanding during the year.

Solution 4-124

SCONE CORPORATION
Partial Income Statement
For the Year Ended December 31, 2020

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	<u>(120,000)</u>
Net income	<u>\$672,000</u>

Earnings per share	
Income from continuing operations	\$7.92
Discontinued operations, net of tax	<u>(1.20)</u>
Net income	<u>\$6.72</u>

*Income from continuing operations (unadjusted)	\$800,000
Gain on sale of machinery (after tax)	32,000
Current effect of change in accounting principle (after tax)	<u>(40,000)</u>
Adjusted income from continuing operations	<u>\$792,000</u>

Difficulty: Medium

Learning Objective: Measure income and prepare the income statement and the statement of comprehensive income using various formats.

Section Reference: The Statement of Income and the Statement of Comprehensive Income

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 4-125 Multiple-step income statement

Presented below is information related to Pastry Inc.

Retained earnings, December 31, 2019.....	\$ 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 shares	33,600
Cost of goods sold	820,000
Gain resulting from calculation error on depreciation charge in 2019 (pre-tax)	520,000
Other revenue	60,000
Other expenses.....	50,000

Instructions

In good form, prepare a multiple-step income statement for the year 2020. Assume a 20% tax rate and that 50,000 common shares were outstanding during the year. Pastry is a private corporation following ASPE.

Solution 4-125

PASTRY INC.
Income Statement
For the Year Ended December 31, 2020

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

Difficulty: Medium

Learning Objective: Measure income and prepare the income statement and the statement of comprehensive income using various formats.

Section Reference: The Statement of Income and the Statement of Comprehensive Income

CPA: Financial Reporting
 Bloomcode: Application
 AACSB: Analytic

Pr. 4-126 Multiple-step income statement

Shown below is an income statement for 2020 that was prepared by a junior accountant at Fritter Corporation.

FRITTER CORPORATION
Income Statement
December 31, 2020

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

Instructions

In good form, prepare a multiple-step income statement for 2020 for Fritter Corporation that is presented in accordance with generally accepted accounting principles (including format and terminology). Fritter Corporation has 50,000 common shares outstanding and has a 20% income tax rate on all tax-related items. As a private corporation, Fritter does not disclose earnings per share information.

Solution 4-126

FRITTER CORPORATION
Income Statement
For the Year Ended December 31, 2020

Sales.....		\$975,000
Cost of goods sold		<u>408,500</u>
Gross profit		566,500
Selling expenses.....	\$155,000	
Administrative expenses.....	<u>215,000</u>	<u>370,000</u>
Income from operations		196,500
Other revenue – Investment revenue.....		<u>19,500</u>
		216,000
Other expenses – Interest expense.....		13,000
Fire loss.....		<u>80,000</u>
Income from continuing operations before taxes		123,000

Income taxes	<u>24,600</u>
Income from continuing operations	98,400
Discontinued operations:	
Loss from discontinued operations, net of applicable income tax of \$6,000	<u>24,000</u>
Net income	<u>\$ 74,400</u>

Difficulty: Medium

Learning Objective: Measure income and prepare the income statement and the statement of comprehensive income using various formats.

Section Reference: The Statement of Income and the Statement of Comprehensive Income

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 4-127 Income statement adjustments

You have been hired by the CFO of Turnover Corporation, a public company. As the new senior accountant, you have been asked to help with the preparation of the 2020 income statement.

For 2020, Turnover reported pre-tax income from continuing operations of \$3,150,000. However, you have been advised that the following transactions have not yet been considered.

1. A review of the company's depreciation policies for its computer equipment revealed that depreciation expense relating to 2020 was overstated by \$19,000.
2. During the year, the company wrote off \$62,500 in accounts receivable for which no allowance for doubtful accounts had been set up.
3. In 2020, the company sold old equipment for \$160,000. The equipment had a net book value of \$120,000.
4. During the year, Turnover disposed of one its subsidiaries. The CFO tells you that the transaction meets the criteria for discontinued operations. The after-tax losses on the subsidiary's operations and from disposal were \$120,000 and \$290,000, respectively.
5. The company made a payment of \$400,000 to settle a lawsuit. The lawsuit related to a 2015 event that the company lawyers had been working on since that time. Based on the lawyers' advice, no contingent liability had been set up.

Instructions

In good form, prepare a partial 2020 income statement for Turnover, 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 indicated, you may assume an income tax rate of 40% for all items. Earnings per share calculations are not required.

Solution 4-127

TURNOVER CORPORATION
Partial Income Statement
For the Year Ended December 31, 2020

Income from continuing operations*	\$2,746,500
Income taxes	<u>(1,091,000)</u>

Income before discontinued operations	1,655,500
Discontinued operations	
Loss from operations (net of tax)	(\$120,000)
Loss from disposal (net of tax)	<u>(290,000)</u> <u>(410,000)</u>
Net income	<u>\$1,245,500</u>

***Calculations**

Income from continuing operations (before adjustments)	\$3,150,000
1. Depreciation expense corrected	19,000
2. Expense for bad debts	(62,500)
3. Gain \$160,000 – \$120,000.....	40,000
4. To be shown in discontinued operations section.....	0
5. Loss on lawsuit.....	<u>(400,000)</u>
Adjusted income from continuing operations.....	\$2,746,500

Difficulty: Medium

Learning Objective: Measure income and prepare the income statement and the statement of comprehensive income using various formats.

Section Reference: The Statement of Income and the Statement of Comprehensive Income

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 4-128 Income statement and retained earnings statement

Macaroon Corporation's capital structure consists of 20,000 common shares. At December 31, 2020 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 shares	200,000
Accumulated depreciation	180,000
Dividend revenue	18,000
Inventory, January 1, 2020	152,000
Inventory, December 31, 2020.....	125,000
Unearned service revenue	4,400
Accrued interest payable.....	1,000
Land	370,000
Patents.....	100,000
Retained earnings, January 1, 2020	270,000
Interest expense.....	17,000

Cumulative effect of change from straight-line to accelerated depreciation (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 July 1, 2023).....	200,000
Machinery and equipment.....	450,000
Materials and supplies	40,000
Accounts payable.....	60,000

Unless indicated otherwise, you may assume a 30% income tax rate.

Instructions

- Prepare, in good form, a multiple-step income statement.
- Prepare, in good form, a retained earnings statement.

Solution 4-128

MACAROON CORPORATION
Income Statement
For the Year Ended December 31, 2020

Sales.....		\$1,200,000
Cost of goods sold		
Merchandise inventory, Jan 1.....	\$152,000	
Purchases.....	\$720,000	
Less purchase discounts.....	<u>18,000</u>	
Net purchases	702,000	
Merchandise available for sale	854,000	
Less merchandise inventory, Dec 31	<u>125,000</u>	
Cost of goods sold.....		<u>729,000</u>
Gross profit on sales.....		471,000
Operating expenses		
Selling expenses.....	128,000	
General and administrative expenses.....	<u>160,000</u>	
Total operating expenses		<u>288,000</u>
Operating income		183,000
Other revenue and gains		
Dividend revenue		18,000
Other expenses and losses		
Interest expense.....	(17,000)	
Loss from earthquake	<u>(60,000)</u>	<u>(77,000)</u>
Income before taxes.....		124,000
Income taxes		<u>37,200</u>
Net income		<u>\$ 86,800</u>

Earnings per share..... \$4.34

MACAROON CORPORATION
Retained Earnings Statement
For the Year Ended December 31, 2020

Retained earnings, January 1, 2020		\$270,000
Cumulative effect of change in depreciation method, net of applicable taxes of \$15,000		<u>(35,000)</u>
Adjusted beginning retained earnings		235,000
Add: Net income	\$86,800	
Deduct: Dividends declared.....	<u>29,000</u>	<u>57,800</u>
Retained earnings, December 31, 2020		<u>\$292,800</u>

Difficulty: Medium

Learning Objective: Measure income and prepare the income statement and the statement of comprehensive income using various formats.

Section Reference: The Statement of Income and the Statement of Comprehensive Income

Learning Objective: Prepare the statement of retained earnings and the statement of changes in equity.

Section Reference: The Statement of Retained Earnings and the Statement of Changes in Equity

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 4-129 Single-step income statement

The information below relates to the operations of Konun Corporation for the year ended December 31, 2020:

Cost of goods sold	\$84,500	
Interest expense	585	
Sales returns and allowances		2,240
Accounts payable	30,032	
Sales discounts	960	
Depreciation expense	71,148	
Sales revenue	245,586	
Salaries and wages	40,895	
Prepaid expenses	875	
Rent expense	9,500	
Loss due to fire	2,092	
Rental revenue	6,000	

Additional information:

- The effective tax rate is 30%.
- Depreciation expense: 60% administrative expense and 40% selling expense

- Salaries and wages: 35% administrative expense and 65% selling expense
 - Rent expense: 75% administrative expense and 25% selling expense
- Prepare a single-step income statement in good form by nature (round to the nearest dollar).

Solution 4-129

**Konun Corporation
Income Statement
For the Year Ended December 31, 2020**

Revenues

Net revenue (245,586-2,240-960)	\$242,386
Rental revenue	<u>6,000</u>
Total revenues	248,386

Expenses

Cost of goods sold	84,500
Depreciation expense	71,148
Salaries and wages	40,895
Rent expense	9,500
Loss due to fire	2,092
Interest expense	<u>585</u>
Total expenses	<u>208,720</u>

Net income before tax

39,666

Income tax expense

11,900

Net income

\$27,766

Difficulty: Medium

Learning Objective: Measure income and prepare the income statement and the statement of comprehensive income using various formats.

Section Reference: The Statement of Income and the Statement of Comprehensive Income

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

***Pr. 4-130** Cash to accrual accounting

Cupcake 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:

**CUPCAKE CORPORATION
Income Statement (Cash Basis)
For the Year Ended December 31, 2020**

Cash receipts from customers	\$380,000

Cash payments:

Wages.....	\$150,000	
Taxes.....	65,000	
Insurance.....	40,000	
Interest	<u>25,000</u>	<u>280,000</u>
Net income		<u>\$100,000</u>

Additional information:

	<u>Balances at Dec. 31</u>	
	<u>2020</u>	<u>2019</u>
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 depreciation	95,000	80,000
Interest payable	3,000	9,000

No assets were sold during 2020.

Solution 4-130

CUPCAKE CORPORATION
Income Statement (Accrual Basis)
For the Year Ended December 31, 2020

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)	<u>19,000</u>
Total expenses	<u>270,000</u>
Net income	<u>\$130,000</u>

Difficulty: Medium

Learning Objective: Explain the differences between the cash basis of accounting and the accrual basis of accounting.

Section Reference: Application of the Cash and Accrual Bases of Accounting (Appendix 4A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 4-131 Danger of using non-GAAP earnings

Explain non-GAAP earnings and the danger of using these earnings to assess the results of operations and the financial position of a company.

Solution 4-131

Companies often try to help users assess the results of operations and their financial position by providing modified GAAP information such as **non-GAAP earnings**. Non-GAAP earnings start with GAAP net income and add back or deduct nonrecurring or non-operating items to arrive at an adjusted net income number. If the calculation of the non-GAAP earnings is **clearly disclosed and explained**, and is also reconciled to net income, it hopefully adds value to the decision-making process. The danger with these numbers is that there are no standards to ensure that the calculation is **consistently** prepared and **comparable** between companies.

Difficulty: Easy

Learning Objective: Understand how disclosures and analysis help users of financial statements assess performance.

Section Reference: Disclosure and Analysis

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

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CHAPTER 5

FINANCIAL POSITION AND CASH FLOWS

CHAPTER STUDY OBJECTIVES

1. Understand the statement of financial position and statement of cash flows from a business perspective. It is important to understand how users of financial statements use the SFP and the cash flow statement. For example, potential investors in a company may use the SFP to analyze a company's liquidity and solvency in order to assess risk of investing. In addition, the SFP provides details about the company's financial structure. Users may use a company's statement of cash flows to assess its earnings quality and obtain information about its operating, investing, and financing activities.

2. Identify the uses and limitations of a statement of financial position. The SFP provides information about the nature and amounts of investments in enterprise resources, obligations to creditors, and the owners' equity in net resources. The SFP contributes to financial reporting by providing a basis for (1) calculating rates of return, (2) evaluating the enterprise's capital structure, and (3) assessing the enterprise's liquidity, solvency, and financial flexibility. The limitations of a SFP are as follows: (1) The SFP often does not reflect current value, because accountants have adopted a historical cost basis in valuing and reporting many assets and liabilities. (2) Judgements and estimates must be used in preparing a SFP. (3) The SFP leaves out many items that are of financial value to the business but cannot be recorded objectively, such as its human resources, customer base, and reputation.

3. Identify the major classifications of a statement of financial position. The SFP's general elements are assets, liabilities, and equity. The major classifications within the SFP on the asset side are current assets; investments; property, plant, and equipment; intangible assets; and other assets. The major classifications of liabilities are current and long-term liabilities. In a corporation, owners' equity is generally classified as shares, contributed surplus, retained earnings, and accumulated other comprehensive income.

4. Prepare a classified statement of financial position. The most common format lists liabilities and shareholders' equity directly below assets on the same page.

5. Identify statement of financial position information that requires supplemental disclosure. Five types of information are normally supplemental to account titles and amounts presented in the SFP. (1) Contingencies: Material events that have an uncertain outcome. (2) Accounting policies: Explanations of the valuation methods that are used or the basic assumptions that are made for inventory valuation, depreciation methods, investments in subsidiaries, and so on. (3) Contractual situations: Explanations of certain restrictions or covenants that are attached to specific assets or, more likely, to liabilities. (4) Additional information: Clarification by giving more detail about the composition of SFP items. (5) Subsequent events: Events that happen after the date of the SFP.

6. Identify major disclosure techniques for the statement of financial position. There are four methods of disclosing pertinent information in the SFP: (1) Parenthetical explanations: Additional information or description is often provided by giving explanations in parentheses that follow the item. (2) Notes: Notes are used if additional explanations or descriptions cannot be shown conveniently as parenthetical explanations. (3) Cross-reference and contra items: A direct relationship between an asset and a liability is cross-referenced on the SFP. (4) Supporting schedules: Often a separate schedule is needed to present more detailed information about certain assets or liabilities because the SFP provides just a single summary item.

7. Indicate the purpose and identify the content of the statement of cash flows. The main purpose of a statement of cash flows is to provide relevant information about an enterprise's cash receipts and cash payments during a period. Reporting the sources, uses, and net increase or decrease in cash lets investors, creditors, and others know what is happening to a company's most liquid resource. Cash receipts and cash payments during a period are classified in the statement of cash flows into three different activities: (1) Operating activities: Involve the cash effects of transactions that enter into the determination of net income. (2) Investing activities: Include making and collecting loans and acquiring and disposing of investments (both debt and equity) and property, plant, and equipment. (3) Financing activities: Involve liability and owners' equity items and include (a) obtaining capital from owners and providing them with a return on their investment and (b) borrowing money from creditors and repaying the amounts borrowed.

8. Prepare a statement of cash flows using the indirect and direct methods. This involves determining cash flows from operations by starting with net income and adjusting it for noncash activities, such as changes in accounts receivable (and other current asset/liability) balances, depreciation, and gains/losses. It is important to look carefully at prior years' operating activities that might affect cash this year, such as cash collected this year from last year's credit sales and cash spent this year for last year's accrued expenses. The cash flows

from investing and financing activities can then be determined by analyzing changes in SFP accounts and the cash account.

9. Understand the usefulness of the statement of cash flows. Creditors examine the statement of cash flows carefully because they are concerned about being paid. The amount of net cash flow provided by operating activities in relation to the company's liabilities is helpful in making this assessment. In addition, measures such as a free cash flow analysis provide creditors and shareholders with a better picture of the company's financial flexibility.

10. Identify differences in accounting between IFRS and ASPE and identify the significant changes planned by the IASB for financial statement presentation. Illustration 5-23 outlines the major differences in how both sets of standards account for and present items on the SFP and statement of cash flows. Both sets of standards largely require that the same SFP elements be presented. In addition, IFRS requires presentation of biological assets, investment properties, and provisions. The statement of cash flow presentation requirements are similar. The IASB issued an Exposure Draft (ED) in May 2015 entitled "Conceptual Framework for Financial Reporting" that included proposed changes to the definitions of assets and liabilities that is expected to be issued in 2018. The IASB is also working on a Primary Financial Statements project with a goal of targeted improvements to the structure and content of primary financial statements such as the statement of financial position and statement of cash flows.

11. Identify the major types of financial ratios and what they measure (Appendix 5A). Ratios express the mathematical relationship between one quantity and another, in terms of a percentage, a rate, or a proportion. Liquidity ratios measure the short-term ability to pay maturing obligations. Activity ratios measure how effectively assets are being used. Profitability ratios measure an enterprise's success or failure. Coverage ratios measure the degree of protection for long-term creditors and investors.

MULTIPLE CHOICE QUESTIONS

Answer	No.	Description
b	1.	Earnings quality
d	2.	Limitation of the balance sheet
d	3.	Uses of the statement of financial position
b	4.	Uses of the statement of financial position
c	5.	Uses of the statement of financial position
d	6.	Definition of solvency
a	7.	Definition of financial flexibility
b	8.	Risk of business failure
d	9.	Limitations of the statement of financial position
d	10.	Monetary assets
c	11.	Monetary assets
b	12.	Financial instruments
c	13.	Non-monetary assets
b	14.	Non-monetary assets
c	15.	Basis for classifying assets
d	16.	Definition of operating cycle
a	17.	Identification of current asset
d	18.	Identification of non-current asset
c	19.	Classification of securities
c	20.	Intangible assets
c	21.	Identification of current liabilities
d	22.	Definition of working capital
b	23.	Identification of working capital items
b	24.	Definition of liabilities
a	25.	Identification of long-term liabilities
d	26.	Classification of equity section accounts
c	27.	Classification of shareholders' equity
d	28.	Current assets on the balance sheet

b	29.	Value of receivables
c	30.	Calculate total current assets
b	31.	Calculate total current assets
d	32.	Calculate total current liabilities
b	33.	Calculate retained earnings balance
b	34.	Calculate current and long-term liabilities
d	35.	Supplemental disclosure
b	36.	Supplemental disclosure
c	37.	Summary of significant accounting policies
d	38.	Methods of disclosure
d	39.	Contra account
d	40.	Accounting policies
c	41.	Definition of statement of cash flows
a	42.	Disclosure of revenue-producing activities on the statement of cash flows
b	43.	Identify an investing activity
c	44.	Identify a financing activity
a	45.	Identify an investing activity
c	46.	Statement of cash flow
b	47.	Classification of investing activity
c	48.	Classification of investing activity
a	49.	Classification of operating activity
d	50.	Classification of financing activity
b	51.	Classification of investing activity
a	52.	Preparation of statement of cash flows under indirect method
c	53.	Cash flows from operating activities
d	54.	Preparation of statement of cash flows under indirect method
c	55.	Preparation of statement of cash flows under direct method
b	56.	Preparation of statement of cash flows under direct method
c	57.	Classification of operating activity
b	58.	Cash debt coverage ratio
c	59.	Current cash debt coverage ratio
d	60.	Financial flexibility measure
c	61.	Calculation of free cash flow
b	62.	Financial flexibility
a	63.	Disclosures under ASPE
c	64.	Disclosures under IFRS
c	65.	Reclassification of current debt
d	66.	Special disclosure under IFRS
b	67.	Listing of current assets
c	68.	Reporting requirements for SFP
c	69.	Primary Financial Statements Project

- a 70. New conceptual framework
- c 71. Disclosure Initiative—Amendments to IAS 7
- b *72. Definition of activity ratios
- c *73. Definition of solvency ratios
- d *74. Definition of asset turnover
- c *75. Calculate asset turnover ratio
- d *76. Calculate rate of return on assets
- c *77. Financial or capital market risks

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

EXERCISES

Item	Description
E5-78	Earnings quality
E5-79	Creditworthiness; debt to total assets
E5-80	Liquidity, solvency, and financial flexibility
E5-81	Limitations of the statement of financial position
E5-82	Terminology
E5-83	Definitions
E5-84	IFRS Practice Statement 2
E5-85	Account classification
E5-86	Current liabilities
E5-87	Current assets
E5-88	Account classification
E5-89	Valuation of statement of financial position items
E5-90	Statement of financial position classifications
E5-91	Statement of financial position classifications
E5-92	Statement of financial position classifications
E5-93	Statement of financial position
E5-94	Statement of financial position presentation
E5-95	Subsequent events
E5-96	Contractual disclosures and ethical consideration
E5-97	Notes
E5-98	Contra or adjunct accounts
E5-99	Statement of cash flows
E5-100	Statement of cash flows purpose
E5-101	Statement of cash flows basic format
E5-102	Cash provided (used) by operating activities
E5-103	Ending cash balance
E5.104	Cash flows from investing activities
E5-105	Cash flows from operating activities – indirect method

E5-106	Cash flows from operating activities – indirect method
E5-107	Cash flows from operating activities – direct method
E5-108	Statement of cash flows ratios
E5-109	Calculation of free cash flow and ratio
*E5-110	Calculation of ratios
*E5-111	Interpretation of ratios
*E5-112	Calculation of ratios
*E5-113	Calculation of ratios

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

PROBLEMS

Item	Description
P5-114	Statement of financial position format
P5-115	Statement of financial position presentation
P5-116	Calculation of ending retained earnings
P5-117	Statement of cash flows – direct method
P5-118	Statement of cash flows – indirect method
*P5-119	Calculation of ratios
P5-120	Statement of cash flows – indirect method
P5-121	Statement of cash flows – direct method

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

MULTIPLE CHOICE QUESTIONS

1. When assessing earnings quality, financial analysts are concerned that management may attempt to manipulate information to make earnings appear better or worse than they really are. Which of the following would NOT suggest poor earnings quality?
- a) reduction of the allowance for doubtful accounts
 - b) consistent application of GAAP
 - c) significantly higher net income than cash flows from operations
 - d) reliance on share issuances to offset repeated negative cash flow from operations

Answer: b

Difficulty: Easy

Learning Objective: Understand the statement of financial position and statement of cash flows from a business perspective.

Section Reference: Usefulness of the Statements of Financial Position and Cash Flows from a Business Perspective

CPA: Audit and Assurance

CPA: Financial Reporting

CPA: Strategy & Governance

Bloomcode: Knowledge

AACSB: Analytic

2. 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 answer choices are correct.

Answer: d

Difficulty: Easy

Learning Objective: Understand the statement of financial position and statement of cash flows from a business perspective.

Section Reference: Usefulness of the Statements of Financial Position and Cash Flows from a Business Perspective

Learning Objective: Identify the uses and limitations of a statement of financial position.

Section Reference: Usefulness and Limitations of the Statement of Financial Position

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

3. The statement of financial position is useful for all of the following EXCEPT

- a) assessing a company's risk.
- b) evaluating a company's liquidity.
- c) evaluating a company's financial flexibility.
- d) determining free cash flows.

Answer: d

Difficulty: Easy

Learning Objective: Understand the statement of financial position and statement of cash flows from a business perspective.

Section Reference: Usefulness of the Statements of Financial Position and Cash Flows from a Business Perspective

Learning Objective: Identify the uses and limitations of a statement of financial position.

Section Reference: Usefulness and Limitations of the Statement of Financial Position

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

4. The statement of financial position is useful for all of the following EXCEPT to

- a) compute rates of return.
- b) analyze cash inflows and outflows for the period.
- c) evaluate capital structure.
- d) assess future cash flows.

Answer: b

Difficulty: Easy

Learning Objective: Understand the statement of financial position and statement of cash flows from a business perspective.

Section Reference: Usefulness of the Statements of Financial Position and Cash Flows from a Business Perspective

Learning Objective: Identify the uses and limitations of a statement of financial position.

Section Reference: Usefulness and Limitations of the Statement of Financial Position

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

5. The statement of financial position is useful for analyzing all of the following EXCEPT

- a) liquidity.
- b) solvency.
- c) profitability.
- d) financial flexibility.

Answer: c

Difficulty: Easy

Learning Objective: Identify the uses and limitations of a statement of financial position.

Section Reference: Usefulness and Limitations of the Statement of Financial Position

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

6. An enterprise's ability to pay its debts and related interest is called

- a) liquidity.

- b) financial flexibility.
- c) the amount of time expected to pass until an asset is realized.
- d) solvency.

Answer: d

Difficulty: Easy

Learning Objective: Identify the uses and limitations of a statement of financial position.

Section Reference: Usefulness and Limitations of the Statement of Financial Position

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

7. An enterprise's ability to take effective actions to alter the amounts and timing of cash flows so it can respond to unexpected needs and opportunities is called

- a) financial flexibility.
- b) liquidity.
- c) the quick ratio.
- d) solvency.

Answer: a

Difficulty: Easy

Learning Objective: Identify the uses and limitations of a statement of financial position.

Section Reference: Usefulness and Limitations of the Statement of Financial Position

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

8. Generally, as financial flexibility increases, the risk of enterprise or business failure will

- a) increase.
- b) decrease.
- c) stay the same.
- d) be eliminated.

Answer: b

Difficulty: Easy

Learning Objective: Identify the uses and limitations of a statement of financial position.

Section Reference: Usefulness and Limitations of the Statement of Financial Position

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

9. Which of the following is NOT a limitation of the statement of financial position?

- a) Many assets are reported at historical cost.
- b) Judgements and estimates are used.
- c) Only “hard” numbers are reported.
- d) Disclosure of all pertinent information in the notes.

Answer: d

Difficulty: Easy

Learning Objective: Identify the uses and limitations of a statement of financial position.

Section Reference: Usefulness and Limitations of the Statement of Financial Position

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

10. Monetary assets represent

- a) only cash.
- b) contractual rights to receive cash.
- c) equity investments in other companies.
- d) cash or claims to future cash flows that are fixed and determinable in amounts and timing.

Answer: d

Difficulty: Easy

Learning Objective: Identify the major classifications of a statement of financial position.

Section Reference: Classification in the Statement of Financial Position

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

11. Monetary assets include

- a) cash, accounts receivable and inventory.
- b) accounts and notes receivable and inventory.
- c) cash, accounts and notes receivable.
- d) accounts receivable and property, plant and equipment.

Answer: c

Difficulty: Easy

Learning Objective: Identify the major classifications of a statement of financial position.

Section Reference: Classification in the Statement of Financial Position
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

12. Financial instruments do NOT include
- a) cash.
 - b) inventory.
 - c) derivatives.
 - d) accounts payable.

Answer: b

Difficulty: Easy
Learning Objective: Identify the major classifications of a statement of financial position.
Section Reference: Classification in the Statement of Financial Position
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

13. Non-monetary assets include
- a) accounts and notes receivable and inventory.
 - b) accounts receivable and property, plant and equipment.
 - c) inventory, property, plant and equipment, and intangibles.
 - d) accounts receivable and investments.

Answer: c

Difficulty: Easy
Learning Objective: Identify the major classifications of a statement of financial position.
Section Reference: Classification in the Statement of Financial Position
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

14. Non-monetary assets
- a) are those for which the cash value is determinable in amount and timing.
 - b) are often measured at historical cost.
 - c) are always classified as non-current.
 - d) will required future cash outflows from the company.

Answer: b

Difficulty: Easy

Learning Objective: Identify the major classifications of a statement of financial position.

Section Reference: Classification in the Statement of Financial Position

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

15. The basis for classifying assets as current or non-current is conversion to cash within

- a) the accounting cycle or one year, whichever is shorter.
- b) the accounting cycle or one year, whichever is longer.
- c) the operating cycle or one year, whichever is longer.
- d) the operating cycle or one year, whichever is shorter.

Answer: c

Difficulty: Easy

Learning Objective: Prepare a classified statement of financial position.

Section Reference: Preparation of the Classified Statement of Financial Position (Balance Sheet)

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

16. The operating cycle is the time between

- a) selling products to customers and the realization of cash.
- b) purchase of inventory and selling to customers.
- c) manufacture of products and receiving cash from customers.
- d) acquisition of assets for processing and the realization in cash or cash equivalents.

Answer: d

Difficulty: Easy

Learning Objective: Prepare a classified statement of financial position.

Section Reference: Preparation of the Classified Statement of Financial Position (Balance Sheet)

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

17. Which of the following is a current asset?

- a) trade instalment receivables normally collectible in eighteen months

- b) intangible assets
- c) investment in associates (significant influence investments)
- d) cash designated for the purchase of property, plant and equipment

Answer: a

Difficulty: Easy

Learning Objective: Prepare a classified statement of financial position.

Section Reference: Preparation of the Classified Statement of Financial Position (Balance Sheet)

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

18. Which of the following should NOT be considered current assets in the statement of financial position?

- a) instalment notes receivable due over eighteen months, in accordance with normal trade practice
- b) prepaid taxes, which cover assessments for the current year
- c) equity or debt securities purchased with cash available for current operations
- d) franchises and copyrights

Answer: d

Difficulty: Easy

Learning Objective: Prepare a classified statement of financial position.

Section Reference: Preparation of the Classified Statement of Financial Position (Balance Sheet)

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

19. Equity or debt securities held to finance future construction of additional plants should be classified on a statement of financial position as

- a) current assets.
- b) property, plant, and equipment.
- c) non-current investments.
- d) intangible assets.

Answer: c

Difficulty: Easy

Learning Objective: Prepare a classified statement of financial position.

Section Reference: Preparation of the Classified Statement of Financial Position (Balance Sheet)

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

20. Which of the following statements about intangible assets is INCORRECT?

- a) They are capital assets that have no physical substance.
- b) Intangibles with finite lives are amortized but not tested for impairment.
- c) Intangibles with indefinite lives are not amortized but are tested for impairment.
- d) Internally recognized intangibles are never recognized on the statement of financial position.

Answer: c

Difficulty: Easy

Learning Objective: Prepare a classified statement of financial position.

Section Reference: Preparation of the Classified Statement of Financial Position (Balance Sheet)

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

21. Which of the following is NOT a current liability?

- a) unearned revenue
- b) derivatives
- c) stock dividends distributable
- d) trade accounts payable

Answer: c

Difficulty: Easy

Learning Objective: Prepare a classified statement of financial position.

Section Reference: Preparation of the Classified Statement of Financial Position (Balance Sheet)

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

22. Working capital is

- a) capital which has been reinvested in the business.

- b) cash invested by owners.
- c) cash and receivables less current liabilities.
- d) current assets less current liabilities.

Answer: d

Difficulty: Easy

Learning Objective: Prepare a classified statement of financial position.

Section Reference: Preparation of the Classified Statement of Financial Position (Balance Sheet)

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

23. An example of an item which is NOT an element of working capital is

- a) accrued interest on notes receivable.
- b) goodwill.
- c) inventory.
- d) short-term investments.

Answer: b

Difficulty: Easy

Learning Objective: Prepare a classified statement of financial position.

Section Reference: Preparation of the Classified Statement of Financial Position (Balance Sheet)

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

24. Which of the following statements 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) Deferred income taxes are always shown as liabilities.

Answer: b

Difficulty: Easy

Learning Objective: Prepare a classified statement of financial position.

Section Reference: Preparation of the Classified Statement of Financial Position (Balance Sheet)

CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

25. Which of the following should be EXCLUDED from long-term liabilities?

- a) derivatives
- b) employee future benefits obligations
- c) long-term liabilities maturing within the operating cycle, but will be paid from a sinking fund
- d) bonds payable maturing in five years

Answer: a

Difficulty: Easy

Learning Objective: Prepare a classified statement of financial position.

Section Reference: Preparation of the Classified Statement of Financial Position (Balance Sheet)

CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

26. Which of the following would NOT appear in the equity section of a statement of financial position?

- a) preferred shares
- b) accumulated other comprehensive income
- c) stock dividend distributable
- d) investment in affiliate

Answer: d

Difficulty: Easy

Learning Objective: Prepare a classified statement of financial position.

Section Reference: Preparation of the Classified Statement of Financial Position (Balance Sheet)

CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

27. The shareholders' equity section is usually divided into which four parts?

- a) preferred shares, common shares, retained earnings, contributed surplus
- b) preferred shares, common shares, retained earnings, other comprehensive income

- c) capital shares, contributed surplus, retained earnings, accumulated other comprehensive income
- d) capital shares, appropriated retained earnings, unappropriated retained earnings, contributed surplus

Answer: c

Difficulty: Easy

Learning Objective: Prepare a classified statement of financial position.

Section Reference: Preparation of the Classified Statement of Financial Position (Balance Sheet)

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

28. The current assets section of the balance sheet should include

- a) machinery.
- b) patents.
- c) goodwill.
- d) inventory.

Answer: d

Difficulty: Easy

Learning Objective: Prepare a classified statement of financial position.

Section Reference: Preparation of the Classified Statement of Financial Position (Balance Sheet)

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

29. Receivables are valued based on their _____.

- a) fair value
- b) estimated amount collectible
- c) lower of cost or market value
- d) historical cost

Answer: b

Difficulty: Easy

Learning Objective: Prepare a classified statement of financial position.

Section Reference: Preparation of the Classified Statement of Financial Position (Balance Sheet)

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

30. Scooby Corp.'s trial balance included the following account balances at December 31, 2020:

Accounts receivable (net)	\$82,000
Trading securities.....	14,000
Accumulated depreciation on equipment and furniture	30,000
Cash	20,000
Inventory	54,000
Equipment.....	50,000
Patent	8,000
Prepaid expenses	3,000
Land held for future business site	36,000

In Scooby's December 31, 2020 statement of financial position, the current assets total is

- a) \$209,000.
- b) \$181,000.
- c) \$173,000.
- d) \$147,000.

Answer: c

Difficulty: Medium

Learning Objective: Prepare a classified statement of financial position.

Section Reference: Preparation of the Classified Statement of Financial Position (Balance Sheet)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$82,000 + \$14,000 + \$20,000 + \$54,000 + \$3,000 = \$173,000$

Use the following information for questions 31–33.

Polis Corp.'s trial balance at December 31, 2020 is properly adjusted except for the income tax expense adjustment.

Polis Corp.
Trial Balance
December 31, 2020

<u>Dr.</u>	<u>Cr.</u>

Cash	\$ 337,500	
Accounts receivable (net)	1,447,500	
Inventory	1,192,500	
Property, plant, and equipment (net)	4,183,000	
Accounts payable and accrued liabilities		\$990,500
Income taxes payable		342,000
Future income tax liability		37,500
Common shares		1,675,000
Contributed surplus		1,340,000
Retained earnings, Jan 1, 2020		2,325,000
Net sales and other revenues		6,180,000
Costs and expenses	5,040,000	
Income tax expenses	<u>689,500</u>	
	<u>\$12,890,000</u>	<u>\$12,890,000</u>

Other financial data for the year ended December 31, 2020:

- Included in accounts receivable is \$360,000 due from a customer and payable in quarterly instalments of \$45,000. The last payment is due December 29, 2022.
- The balance in the future income tax liability account relates to a temporary difference that arose in a prior year, of which \$15,000 is classified as a current liability.
- During the year, estimated tax payments of \$330,000 were charged to income tax expense. The current and future tax rate on all types of income is 35 percent.

31. In Polis' December 31, 2020 statement of financial position, the current assets total is

- \$2,977,500.
- \$2,797,500.
- \$1,530,000.
- \$2,247,500.

Answer: b

Difficulty: Medium

Learning Objective: Prepare a classified statement of financial position.

Section Reference: Preparation of the Classified Statement of Financial Position (Balance Sheet)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$337,500 + [\$1,447,500 - (\$45,000 \times 4)] + \$1,192,500 = \$2,797,500$

32. In Polis' December 31, 2020 statement of financial position, the current liabilities total is

- \$1,217,500.

- b) \$1,347,500.
- c) \$1,100,000.
- d) \$1,057,000.

Answer: d

Difficulty: Medium

Learning Objective: Prepare a classified statement of financial position.

Section Reference: Preparation of the Classified Statement of Financial Position (Balance Sheet)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: Note the adjusted income tax expense will be \$399,000 $[(\$6,180,000 - \$5,040,000) \times 35\%] = \$399,000$. When the expense is reduced by \$290,500 $(\$689,500 - \$399,000 = \$290,500)$, the liability will also be reduced by the same amount to \$51,500 $(\$990,500 + \$51,500) + \$15,000 = \$1,057,000$

33. In Polis' December 31, 2020 statement of financial position, the final retained earnings balance is

- a) \$2,775,500.
- b) \$3,066,000.
- c) \$2,567,500.
- d) \$3,008,000.

Answer: b

Difficulty: Medium

Learning Objective: Prepare a classified statement of financial position.

Section Reference: Preparation of the Classified Statement of Financial Position (Balance Sheet)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$2,325,000 + \$6,180,000 - \$5,040,000 - \$399,000$ (income tax exp) = \$3,066,000

34. On January 1, 2020, Neptune Inc. leased a building to Saturn Corp. for a ten-year term at an annual rental of \$200,000. At inception of the lease, Neptune received \$800,000, which covered the first two years rent of \$400,000 and a security deposit of \$400,000. This deposit will not be returned to Saturn 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 \$800,000 should be shown as a

current and long-term liability in Neptune's December 31, 2020 statement of financial position?

	<u>Current Liability</u>	<u>Long-term Liability</u>
a)	\$0	\$800,000
b)	\$200,000	\$400,000
c)	\$400,000	\$400,000
d)	\$400,000	\$200,000

Answer: b

Difficulty: Medium

Learning Objective: Prepare a classified statement of financial position.

Section Reference: Preparation of the Classified Statement of Financial Position (Balance Sheet)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

35. Which of the following balance sheet classifications would normally require the greatest amount of supplemental disclosure?

- a) Current assets
- b) Current liabilities
- c) Plant assets
- d) Long-term liabilities

Answer: d

Difficulty: Easy

Learning Objective: Identify statement of financial position information that requires supplemental disclosure.

Section Reference: Information Requiring Supplemental Disclosure

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

36. Which of the following is NOT a required supplemental disclosure for the balance sheet?

- a) Contingencies
- b) Financial forecasts
- c) Accounting policies
- d) Contractual situations

Answer: b

Difficulty: Easy

Learning Objective: Identify statement of financial position information that requires supplemental disclosure.

Section Reference: Information Requiring Supplemental Disclosure

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

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

Depreciation Method Composition

a)	No	Yes
b)	Yes	Yes
c)	Yes	No
d)	No	No

Answer: c

Difficulty: Easy

Learning Objective: Identify statement of financial position information that requires supplemental disclosure.

Section Reference: Information Requiring Supplemental Disclosure

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

38. Which of the following is NOT a method of disclosing additional information in the financial statements?

- a) supporting schedules
- b) parenthetical explanations
- c) cross-reference and contra items
- d) press releases

Answer: d

Difficulty: Easy

Learning Objective: Identify major disclosure techniques for the statement of financial position.

Section Reference: Techniques of Disclosure

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

39. Which of the following is a contra account?

- a) Premium on bonds payable
- b) Unearned revenue
- c) Patents
- d) Accumulated depreciation

Answer: d

Difficulty: Easy

Learning Objective: Identify major disclosure techniques for the statement of financial position.

Section Reference: Techniques of Disclosure

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

40. Significant accounting policies may NOT be

- a) selected on the basis of judgement.
- b) selected from existing acceptable alternatives.
- c) unusual or innovative in application.
- d) omitted from financial-statement disclosure.

Answer: d

Difficulty: Easy

Learning Objective: Identify major disclosure techniques for the statement of financial position.

Section Reference: Techniques of Disclosure

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

41. 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.

Answer: c

Difficulty: Easy

Learning Objective: Indicate the purpose and identify the content of the statement of cash flows.

Section Reference: Purpose, Content, and Format of a Statement of Cash Flows

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

42. On a statement of cash flows, the enterprise's main revenue-producing activities are disclosed in the
- a) operating activities.
 - b) investing activities.
 - c) financing activities.
 - d) both operating and investing activities.

Answer: a

Difficulty: Easy

Learning Objective: Indicate the purpose and identify the content of the statement of cash flows.

Section Reference: Purpose, Content, and Format of a Statement of Cash Flows

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

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

Answer: b

Difficulty: Easy

Learning Objective: Indicate the purpose and identify the content of the statement of cash flows.

Section Reference: Purpose, Content, and Format of a Statement of Cash Flows

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

44. 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) extraordinary activity.
- c) financing activity.
- d) investing activity.

Answer: c

Difficulty: Easy

Learning Objective: Indicate the purpose and identify the content of the statement of cash flows.

Section Reference: Purpose, Content, and Format of a Statement of Cash Flows

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

45. 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

Answer: a

Difficulty: Easy

Learning Objective: Indicate the purpose and identify the content of the statement of cash flows.

Section Reference: Purpose, Content, and Format of a Statement of Cash Flows

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

46. The statement of cash flows reports all of the following EXCEPT

- a) the net change in cash for the period.
- b) the cash effects of operations during the period.
- c) the free cash flows generated during the period.
- d) investing transactions.

Answer: c

Difficulty: Easy

Learning Objective: Indicate the purpose and identify the content of the statement of cash flows.

Section Reference: Purpose, Content, and Format of a Statement of Cash Flows

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

47. 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.

Answer: b

Difficulty: Easy

Learning Objective: Indicate the purpose and identify the content of the statement of cash flows.

Section Reference: Purpose, Content, and Format of a Statement of Cash Flows

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

48. In a statement of cash flows, receipts from sales of property, plant, and equipment and other productive assets should be classified as cash inflows from

- a) operating activities.
- b) financing activities.
- c) investing activities.
- d) selling activities.

Answer: c

Difficulty: Easy

Learning Objective: Indicate the purpose and identify the content of the statement of cash flows.

Section Reference: Purpose, Content, and Format of a Statement of Cash Flows

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

49. 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.

Answer: a

Difficulty: Easy

Learning Objective: Indicate the purpose and identify the content of the statement of cash flows.

Section Reference: Purpose, Content, and Format of a Statement of Cash Flows

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

50. 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.

Answer: d

Difficulty: Easy

Learning Objective: Indicate the purpose and identify the content of the statement of cash flows.

Section Reference: Purpose, Content, and Format of a Statement of Cash Flows

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

51. 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.

Answer: b

Difficulty: Easy

Learning Objective: Indicate the purpose and identify the content of the statement of cash flows.

Section Reference: Purpose, Content, and Format of a Statement of Cash Flows

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

52. A statement of cash flows prepared under the INDIRECT method adds and subtracts certain items to the base number. Decreases in unearned revenues 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.

Answer: a

Difficulty: Easy

Learning Objective: Prepare a statement of cash flows using the indirect and direct methods

Section Reference: Preparation of the Statement of Cash Flows

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

53. In preparing a statement of cash flows under the INDIRECT method, 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.

Answer: c

Difficulty: Easy

Learning Objective: Prepare a statement of cash flows using the indirect and direct methods

Section Reference: Preparation of the Statement of Cash Flows

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

54. Preparing a statement of cash flows under the INDIRECT method 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.

Answer: d

Difficulty: Easy

Learning Objective: Prepare a statement of cash flows using the indirect and direct methods

Section Reference: Preparation of the Statement of Cash Flows

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

55. A statement of cash flows prepared under the DIRECT method starts with
- a) net income.
 - b) gross profit.
 - c) cash received from customers.
 - d) income from operations.

Answer: c

Difficulty: Easy

Learning Objective: Prepare a statement of cash flows using the indirect and direct methods

Section Reference: Preparation of the Statement of Cash Flows

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

56. Which of the following is NOT included in a statement of cash flows prepared under the DIRECT method?
- a) cash flows from operating activities
 - b) gross profit
 - c) cash paid to suppliers and employees
 - d) interest paid or received

Answer: b

Difficulty: Easy

Learning Objective: Prepare a statement of cash flows using the indirect and direct methods

Section Reference: Preparation of the Statement of Cash Flows

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

57. SingSong Corporation reports the following information:

Net income	\$720,000
Depreciation expense	210,000
Increase in accounts receivable	90,000

SingSong should report cash provided by operating activities of

- a) \$420,000.
- b) \$600,000.
- c) \$840,000.
- d) \$1,020,000.

Answer: c

Difficulty: Easy

Learning Objective: Prepare a statement of cash flows using the indirect and direct methods

Section Reference: Preparation of the Statement of Cash Flows

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$720,000 + \$210,000 - \$90,000 = \$840,000$.

58. The cash debt coverage ratio is calculated 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.

Answer: b

Difficulty: Easy

Learning Objective: Understand the usefulness of the statement of cash flows.

Section Reference: Usefulness of the Statement of Cash Flows

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

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

Answer: c

Difficulty: Easy

Learning Objective: Understand the usefulness of the statement of cash flows.

Section Reference: Usefulness of the Statement of Cash Flows

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

60. 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.

Answer: d

Difficulty: Easy

Learning Objective: Understand the usefulness of the statement of cash flows.

Section Reference: Usefulness of the Statement of Cash Flows

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

61. 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 depreciation.

Answer: c

Difficulty: Easy

Learning Objective: Understand the usefulness of the statement of cash flows.

Section Reference: Usefulness of the Statement of Cash Flows

CPA: Financial Reporting

Bloomcode: Knowledge
AACSB: Analytic

62. One of the benefits of the statement of cash flows is that it helps users evaluate financial flexibility. Which of the following explanations is a description of financial flexibility?

- a) the nearness to cash of assets and liabilities
- b) the firm's ability to respond and adapt to financial adversity and unexpected needs and opportunities
- c) the firm's ability to pay its debts as they mature
- d) the firm's ability to invest in a number of projects with different objectives and costs

Answer: b

Difficulty: Easy

Learning Objective: Understand the usefulness of the statement of cash flows.

Section Reference: Usefulness of the Statement of Cash Flows

CPA: Finance

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

63. A company that follows ASPE

- a) must not disclose cash flow per share.
- b) may disclose cash flow per share.
- c) may disclose cash flow per share if it makes a special election to do so.
- d) must disclose cash flow per share.

Answer: a

Difficulty: Easy

Learning Objective: Identify differences in accounting between IFRS and ASPE and identify the significant changes planned by the IASB for financial statement presentation.

Section Reference: IFRS/ASPE Comparison

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

64. A company that follows IFRS

- a) may disclose cash flow per share if it makes a special election to do so.
- b) must not disclose cash flow per share.
- c) is generally allowed to disclose cash flow per share.
- d) only discloses cash flow per share if there are more than two shareholders.

Answer: c

Difficulty: Easy

Learning Objective: Identify differences in accounting between IFRS and ASPE and identify the significant changes planned by the IASB for financial statement presentation.

Section Reference: IFRS/ASPE Comparison

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

65. 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 ASPE or IFRS.
 - c) if the company follows ASPE.
 - d) only if the company is a subsidiary.

Answer: c

Difficulty: Easy

Learning Objective: Identify differences in accounting between IFRS and ASPE and identify the significant changes planned by the IASB for financial statement presentation.

Section Reference: IFRS/ASPE Comparison

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

66. Which of the following items would require special disclosure under IFRS?
- a) investment property only
 - b) biological assets and investment property only
 - c) provisions and biological assets
 - d) biological assets, investment property and provisions

Answer: d

Difficulty: Easy

Learning Objective: Identify differences in accounting between IFRS and ASPE and identify the significant changes planned by the IASB for financial statement presentation.

Section Reference: IFRS/ASPE Comparison

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

67. Some companies following IFRS list current assets in

- a) alphabetical order.
- b) the reverse order of liquidity.
- c) the ascending order of their balances.
- d) the descending order of their balances.

Answer: b

Difficulty: Easy

Learning Objective: Identify differences in accounting between IFRS and ASPE and identify the significant changes planned by the IASB for financial statement presentation.

Section Reference: IFRS/ASPE Comparison

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

68. Which of the following statements about IFRS and ASPE accounting and reporting requirements for the statement of financial position is NOT correct?

- a) The presentation formats required by IFRS and ASPE for the statement of financial position are similar.
- b) One difference between the reporting requirements under IFRS and those of ASPE is that an IFRS balance sheet may list long-term assets first.
- c) Both IFRS and ASPE require that cash flow per share information be reported on the statement of financial position.
- d) Both IFRS and ASPE require that comparative information be reported.

Answer: c

Difficulty: Easy

Learning Objective: Identify differences in accounting between IFRS and ASPE and identify the significant changes planned by the IASB for financial statement presentation.

Section Reference: IFRS/ASPE Comparison

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

69. Significant changes to the presentation of financial statements (Primary Financial Statements Project) are currently being developed by the IASB. Which of the following best describes the focus of the 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 financial statements

Answer: c

Difficulty: Easy

Learning Objective: Identify differences in accounting between IFRS and ASPE and identify the significant changes planned by the IASB for financial statement presentation.

Section Reference: Looking Ahead

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

70. The IASB issued a new “Conceptual Framework for Financial Reporting” in March 2018 that included changes to the definitions of assets and liabilities. For most assets and liabilities, applying the new definition

- a) yields the same accounting results as the previous definitions.
- b) results in more conservative reporting of assets, and more aggressive reporting of liabilities.
- c) results in more aggressive reporting of assets and more conservative reporting of liabilities.
- d) results in more conservative reporting of both assets and liabilities.

Answer: a

Difficulty: Easy

Learning Objective: Identify differences in accounting between IFRS and ASPE and identify the significant changes planned by the IASB for financial statement presentation.

Section Reference: Looking Ahead

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

71. The “Disclosure Initiative—Amendments to IAS7” issued by the IASB in January 2016 proposes

- a) the replacement of IAS 7: Statement of Cash Flows.
- b) amendments that would provide additional information about investing activities.
- c) amendments that would provide additional information about financing activities.
- d) amendments that would provide additional information about operating activities.

Answer: c

Difficulty: Easy

Learning Objective: Identify differences in accounting between IFRS and ASPE and identify the significant changes planned by the IASB for financial statement presentation.

Section Reference: Looking Ahead

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

*72. Ratios that measure how effectively an entity is using its assets are called

- a) liquidity ratios.
- b) activity ratios.
- c) solvency ratios.
- d) profitability ratios.

Answer: b

Difficulty: Easy

Learning Objective: Identify the major types of financial ratios and what they measure.

Section Reference: Ratio Analysis: A Reference (Appendix 5A)

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

*73. Ratios that measure the degree of protection for long-term creditors and investors or the ability to meet long-term obligations are called

- a) liquidity ratios.
- b) activity ratios.
- c) solvency ratios.
- d) profitability ratios.

Answer: c

Difficulty: Easy

Learning Objective: Identify the major types of financial ratios and what they measure.

Section Reference: Ratio Analysis: A Reference (Appendix 5A)

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

*74. Net sales divided by average total assets is called

- a) inventory turnover.
- b) receivables turnover.

- c) rate of return on assets.
- d) asset turnover.

Answer: d

Difficulty: Easy

Learning Objective: Identify the major types of financial ratios and what they measure.

Section Reference: Ratio Analysis: A Reference (Appendix 5A)

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

*75. Maggins Inc. gives you the following information pertaining to the year 2020:

Net sales	\$880,000
Cost of goods sold	550,000
Current assets	525,000
Current liabilities.....	262,500
Average total assets	950,000
Total liabilities.....	577,500
Net income	165,000

The asset turnover ratio of Maggins Inc. is

- a) 0.56.
- b) 0.17.
- c) 0.93.
- d) 1.08.

Answer: c

Difficulty: Medium

Learning Objective: Identify the major types of financial ratios and what they measure.

Section Reference: Ratio Analysis: A Reference (Appendix 5A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$880,000 \div \$950,000 = 0.93$.

*76. Charlie's Inc. gives you the following information pertaining to the year 2020:

Net sales	\$925,000
Cost of goods sold	575,000
Current assets	525,000
Current liabilities.....	275,000
Average total assets	1,000,000

Total liabilities.....	560,000
Net income	225,000

The rate of return on assets Charlie's Inc. is

- a) 92.5%.
- b) 42.9%.
- c) 4.44%.
- d) 22.5%.

Answer: d

Difficulty: Medium

Learning Objective: Identify the major types of financial ratios and what they measure.

Section Reference: Ratio Analysis: A Reference (Appendix 5A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$225,000 \div \$1,000,000 = 22.5\%$

*77. Financial or capital market risks are related to

- a) financing activities only.
- b) investing activities only.
- c) both financing and investing activities.
- d) operating and financing activities.

Answer: c

Difficulty: Easy

Learning Objective: Identify the major types of financial ratios and what they measure.

Section Reference: Ratio Analysis: A Reference (Appendix 5A)

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

EXERCISES

Ex. 5-78 Earnings quality

An analysis of the financial statements of Scion Inc. shows that net income is significantly higher than cash flows from operations. What does this indicate about the quality of Scion's earnings? Where else can analysts look for further information?

Solution 5-78

A net income significantly higher than cash flows from operations could be a sign of poor earnings quality that may require further analysis. Analysts should look to the financing activities section to see if Scion is relying on issuance of shares or other financing activities to generate cash flow. They could also look towards industry reports and analyst expectations to see if Scion's cash flow and earnings quality are expected to improve.

Difficulty: Easy

Learning Objective: Understand the statement of financial position and statement of cash flows from a business perspective.

Section Reference: Usefulness of the Statements of Financial Position and Cash Flows from a Business Perspective

CPA: Communication

CPA: Finance

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 5-79 Creditworthiness; debt to total assets

Explain why a high debt to total assets ratio means a company has a higher risk of bankruptcy.

Solution 5-79

The debt to total assets ratio is a coverage ratio that measures the percentage of total assets provided by creditors. Coverage ratios are said to measure the degree of protection for long-term creditors and investors. A company whose assets are heavily financed by creditors (also known as heavily leveraged) is liable to pay those creditors back first in the event they are forced to liquidate. Where leveraged assets represent the majority of a company's value, it is likely that there would be little or nothing left after repaying these creditors, and that the company would declare bankruptcy before repaying investors or other equity providers.

Difficulty: Easy

Learning Objective: Understand the statement of financial position and statement of cash flows from a business perspective.

Section Reference: Usefulness of the Statements of Financial Position and Cash Flows from a Business Perspective

Learning Objective: Identify the major types of financial ratios and what they measure.

Section Reference: Ratio Analysis: A Reference (Appendix 5A)

CPA: Communication

CPA: Finance

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 5-80 Liquidity, solvency, and financial flexibility

Explain the relation between the concepts of liquidity, solvency and financial flexibility.

Solution 5-80

Liquidity depends on the amount of time expected to pass until an asset is realized (converted into cash) or until a liability is paid. Solvency reflects an enterprise's ability to pay its debts and related interest.

Together, liquidity and solvency affect an entity's financial flexibility, a measure of the enterprise's ability to take effective actions to alter the amounts and timing of cash flows so it can respond to unexpected needs and opportunities. For example, if a company's cash sources to finance expansion or pay off maturing debt are limited it will have difficulty surviving bad times, recovering from unexpected setbacks, and taking advantage of investment opportunities.

Difficulty: Easy

Learning Objective: Identify the uses and limitations of a statement of financial position.

Section Reference: Usefulness and Limitations of the Statement of Financial Position

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 5-81 Limitations of the statement of financial position

The statement of financial position has many limitations. One of these limitations is that it necessarily leaves out many items. Of greatest concern to investors are omitted liabilities.

Explain why some liabilities are left off the statement of financial position, and how investors can identify and measure potentially omitted items.

Solution 5-81

Assets or liabilities may be left off the statement of financial position because they cannot be recorded objectively. To preserve the quality of their liquidity and solvency ratios (which measure the enterprise's short-term ability to pay maturing obligations) a company may be particularly biased against including liabilities in the financial statements.

When reviewing a company, an analyst's knowledge of the business and industry can make it possible to identify and measure off-balance sheet items that often represent additional risk to the company. For example, manufacturers or utilities companies may have capital lease obligations which have not been capitalised. Analysts can search for corresponding note disclosures and industry stats to estimate and incorporate these lease obligations into the liquidity and solvency ratios.

Difficulty: Easy

Learning Objective: Identify the uses and limitations of a statement of financial position.

Section Reference: Usefulness and Limitations of the Statement of Financial Position

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 5-82 Terminology

In the space provided at the 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

2. Claims to future cash flows that are fixed or determinable in amount and timing _____
3. Short-term, highly liquid investments that are readily convertible into known amounts of cash _____
4. Assets that are held for sale in the ordinary course of business _____
5. Expenditures already made for benefits that will be received within one year or the operating cycle _____
6. Assets of physical substance that are used in ongoing business operations _____
7. Assets that have no physical substance _____
8. The excess of total current assets over total current liabilities _____
9. Unrealized gains and losses included as part of equity _____

Solution 5-82

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

Difficulty: Easy

Learning Objective: Identify the uses and limitations of a statement of financial position.

Section Reference: Usefulness and Limitations of the Statement of Financial Position

Learning Objective: Identify the major classifications of a statement of financial position.

Section Reference: Classification in the Statement of Financial Position

Learning Objective: Prepare a classified statement of financial position.

Section Reference: Preparation of the Classified Statement of Financial Position (Balance Sheet)

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

Ex. 5-83 Definitions

Provide clear, concise answers for the following:

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

Solution 5-83

1. Classification of 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 that create financial assets for one party and a financial liability or equity instrument for the other and include cash, the right to receive cash or another financial instrument, and investments in other companies.
3. 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.

4. "Other assets" includes assets that are not included anywhere else. They commonly include items such as non-current receivables and assets in special funds and require the disclosure of sufficient detail.
5. Supplemental disclosure is required for contingencies, accounting policies, contractual situations, and subsequent events. Additional information is also required for many individual statement of financial position items.
6. The purpose of the statement of cash flows 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.
7. 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.

Difficulty: Easy

Learning Objective: Identify the uses and limitations of a statement of financial position.

Section Reference: Usefulness and Limitations of the Statement of Financial Position

Learning Objective: Identify the major classifications of a statement of financial position.

Section Reference: Classification in the Statement of Financial Position

Learning Objective: Prepare a classified statement of financial position.

Section Reference: Preparation of the Classified Statement of Financial Position (Balance Sheet)

Learning Objective: Identify statement of financial position information that requires supplemental disclosure.

Section Reference: Information Requiring Supplemental Disclosure

Learning Objective: Indicate the purpose and identify the content of the statement of cash flows.

Section Reference: Purpose, Content, and Format of a Statement of Cash Flows

Learning Objective: Understand the usefulness of the statement of cash flows.

Section Reference: Usefulness of the Statement of Cash Flows

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 5-84 IFRS Practice Statement 2

IFRS Practice Statement 2 (PS2) was issued in September 2017 and provides (non-mandatory) guidance for reporting entities to consider. Given that information is material if its omission or misstatement could influence financial information users' decisions, identify the four-step process for assessing materiality suggested by PS2.

Solution 5-84

PS2 suggests a four-step process for assessing materiality when preparing financial statements, including:

- (a) Identifying information that is potentially material;
- (b) Assessing whether the identified information is material;
- (c) Organizing the information to communicate it clearly and concisely to key users;
- (d) Reviewing the draft financial statements to determine if all material information has been properly identified and materiality considered based on the complete set of financial statements.

Difficulty: Easy

Learning Objective: Identify the uses and limitations of a statement of financial position.

Section Reference: Usefulness and Limitations of the Statement of Financial Position

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

Ex. 5-85 Account classification

Although the statement of financial position can be classified and presented in several ways, the major subdivisions noted in Illustration 5.1 tend to be closely followed. Explain how following these classifications contributes to the financial statement objectives of representational faithfulness and transparency.

Solution 5-85

Standard classifications make it easier to calculate important ratios, such as the current ratio for assessing liquidity and debt to equity ratios for assessing solvency. Breaking down assets and liabilities into categories helps users calculate which assets are more significant than other and how these relationships change over time. This gives insight into management's strategy and stewardship. If classifications were uncommon across companies and years this type of intra- and inter-company analysis would not be possible, and some adjustment would be necessary to bring statements to a comparable and transparent format. Keeping the same format enhances transparency. Where there is a change in presentation to preserve representational faithfulness, the company should disclose any supplementary information, including, but not limited to, comparative data for prior years, to facilitate analysis and enhance the understanding of financial statement users.

Difficulty: Easy

Learning Objective: Identify the major classifications of a statement of financial position.

Section Reference: Classification in the Statement of Financial Position

CPA: Communication
CPA: Financial Reporting
Bloomcode: Comprehension
AACSB: Communication

Ex. 5-86 Current liabilities

Define current liabilities without using the word "liability."

Solution 5-86

Current liabilities are legally enforceable obligations that are due within one year from the date of the statement of financial position or the operating cycle, whichever is longer.

Difficulty: Easy

Learning Objective: Identify the major classifications of a statement of financial position.

Section Reference: Classification in the Statement of Financial Position

Learning Objective: Prepare a classified statement of financial position.

Section Reference: Preparation of the Classified Statement of Financial Position (Balance Sheet)

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

Ex. 5-87 Current assets

Define current assets without using the word "asset."

Solution 5-87

Current assets are resources (future economic benefits) expected to be converted to cash, sold, or consumed in one year or the operating cycle, whichever is longer.

Difficulty: Easy

Learning Objective: Identify the major classifications of a statement of financial position.

Section Reference: Classification in the Statement of Financial Position

Learning Objective: Prepare a classified statement of financial position.

Section Reference: Preparation of the Classified Statement of Financial Position (Balance Sheet)

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

Ex. 5-88 Account classification

ASSETS

- a) Current assets
- b) Investments
- c) Property, plant and equipment
- d) Intangibles
- e) Other assets

LIABILITIES AND CAPITAL

- f) Current liabilities
- g) Long-term liabilities
- h) Preferred shares
- i) Common shares
- j) Contributed surplus
- k) Retained earnings
- l) Items excluded from statement of financial position

Using the letters above, classify the following accounts according to the preferred statement of financial position presentation.

- _____ 1. Bond sinking fund
- _____ 2. Common stock dividend distributable
- _____ 3. Appropriation for plant expansion
- _____ 4. Bank overdraft
- _____ 5. Bonds payable (due 2024)
- _____ 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 2024)
- _____ 11. Patents
- _____ 12. Unearned revenue

Solution 5-88

- 1. b
- 2. k
- 3. k
- 4. f
- 5. g
- 6. j
- 7. l

- 8. b
- 9. a
- 10. g
- 11. d
- 12. f

Difficulty: Easy

Learning Objective: Prepare a classified statement of financial position.

Section Reference: Preparation of the Classified Statement of Financial Position (Balance Sheet)

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

Ex. 5-89 Valuation of statement of financial position items

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

- 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 statement of financial position date
- f) Net realizable value
- g) Lower of cost and net realizable value
- h) Original cost less accumulated depreciation/amortization
- i) Original cost less accumulated depletion
- j) Historical cost
- k) Unexpired or unconsumed cost

_____ 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	

Solution 5-89

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

Difficulty: Easy

Learning Objective: Prepare a classified statement of financial position.

Section Reference: Preparation of the Classified Statement of Financial Position (Balance Sheet)

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

Ex. 5-90 Statement of financial position classifications

Typical statement of financial position (SFP) classifications are as follows:

a) Current Assets	g) Long-Term Liabilities
b) Investments	h) Share Capital
c) Plant Assets	i) Contributed Surplus
d) Intangible Assets	j) Retained Earnings

e) Other Assets

k) Notes to Financial Statements

f) Current Liabilities

l) Not Reported on SFP

Indicate by use of the above letters how each of the following items would be classified on a statement of financial position prepared at December 31, 2020. If a contra account, or any amount that is negative or opposite the normal balance, place parentheses around the letter selected. A letter may be used more than once or not at all.

- _____ 1. Accrued salaries and wages
- _____ 2. Rental revenues for three months collected in advance
- _____ 3. Land used as plant site
- _____ 4. Equity securities classified as short term
- _____ 5. Cash
- _____ 6. Accrued interest payable due in thirty days
- _____ 7. Premium on preferred shares issued
- _____ 8. Dividends in arrears on preferred shares
- _____ 9. Petty cash fund
- _____ 10. Unamortized discount on bonds payable due in 2026
- _____ 11. Common shares at no par value
- _____ 12. Bond indenture covenants
- _____ 13. Unamortized premium on bonds payable due in 2026
- _____ 14. Allowance for doubtful accounts
- _____ 15. Accumulated depletion, oil well
- _____ 16. Natural resources—timberlands
- _____ 17. Deficit (no income earned since beginning of company)
- _____ 18. Goodwill
- _____ 19. Ninety-day notes payable
- _____ 20. Investment in bonds in another company; that will be held to 2024 maturity
- _____ 21. Land held for speculation
- _____ 22. Death of company president
- _____ 23. Current maturity of bonds payable
- _____ 24. Investment in subsidiary; no plans to sell in the near future
- _____ 25. Trade accounts payable
- _____ 26. Preferred shares, no par value
- _____ 27. Prepaid expenses for next twelve months
- _____ 28. Copyright
- _____ 29. Accumulated depreciation, equipment
- _____ 30. Earnings, not distributed to shareholders

Solution 5-90

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

Difficulty: Easy

Learning Objective: Prepare a classified statement of financial position.

Section Reference: Preparation of the Classified Statement of Financial Position (Balance Sheet)

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

Ex. 5-91 Statement of financial position classifications

The various classifications listed below have been used in the past by Mercury Ltd. in its statement of financial position. The corporation asks your professional opinion concerning the appropriate classification of each of the items 1–14 below.

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

Indicate by letter how each of the following items should be classified. If an item need not be reported on the statement of financial position, 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 bond indebtedness

Solution 5-91

1. f

2. b

3. f

4. a or e

5. d

- 6. a
- 7. x
- 8. a
- 9. a
- 10. g
- 11. f
- 12. x
- 13. a
- 14. i

Difficulty: Easy

Learning Objective: Prepare a classified statement of financial position.

Section Reference: Preparation of the Classified Statement of Financial Position (Balance Sheet)

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

Ex. 5-92 Statement of financial position classifications

The various classifications listed below have been used in the past by Droid Inc. in its statement of financial position.

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, 2020. If an item is not reported on the December 31, 2020 statement of financial position, 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 2021
- _____ 4. Accumulated depreciation
- _____ 5. Appropriation of retained earnings for plant expansion
- _____ 6. Impairment of goodwill for 2020
- _____ 7. On December 31, 2020, Droid signed a purchase commitment to buy all of its raw materials from Jupiter Inc. for the next two years
- _____ 8. Discount on bonds payable due March 31, 2023
- _____ 9. Launching of Droid's internet retailing division in February, 2020
- _____ 10. Cash dividends declared on December 15, 2020, payable on January 15, 2021

Solution 5-92

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

10. e

Difficulty: Easy

Learning Objective: Prepare a classified statement of financial position.

Section Reference: Preparation of the Classified Statement of Financial Position (Balance Sheet)

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

Ex. 5-93 Statement of financial position

The following statement of financial position was prepared by the bookkeeper for Hauser Company as of December 31, 2020:

Hauser Company
Statement of Financial Position
as of December 31, 2020

Cash	\$ 95,000	Accounts payable	\$ 85,000
Accounts receivable (net)	52,200	Bonds payable	100,000
Inventory	62,000	Shareholders' equity	238,500
Investments	76,300		
Equipment (net)	106,000		
Patents	<u>32,000</u>		
	<u>\$423,500</u>		<u>\$423,500</u>

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 \$2,500 has been deducted.
2. The net accounts receivable balance includes:
 - (a) accounts receivable—debit balances \$60,000;
 - (b) accounts receivable—credit balances \$4,000;
 - (c) allowance for doubtful accounts \$3,800.
3. Inventory does not include goods costing \$3,000 shipped out on consignment. Receivables of \$3,000 were recorded on these goods.
4. Investments include investments in common shares, trading \$19,000 and available-for-sale \$48,300, and franchises \$9,000.
5. Equipment costing \$5,000 with accumulated depreciation \$4,000 is no longer used and is held for sale. Accumulated depreciation on the other equipment is \$40,000.

Instructions

Prepare a statement of financial position in good form (shareholders' equity details can be omitted.) Assume Hauser reports in accordance with ASPE.

Solution 5-93

**Hauser Company
Statement of Financial Position
As of December 31, 2020**

		<u>Assets</u>	
<u>Current assets</u>			
Cash		\$ 88,100	(1)
Trading securities		19,000	
Accounts receivable	\$ 57,000		(2)
Less: Allowance for doubtful accounts	<u>3,800</u>	53,200	
Inventories		65,000	(3)
*Equipment held for sale		<u>1,000</u>	(4)
Total current assets		226,300	
<u>Investments</u>			
Available-for-sale securities	48,300		
Cash surrender value	<u>9,400</u>	57,700	
<u>Property, plant, and equipment</u>			
Equipment	145,000		(5)
Less: accumulated depreciation	<u>40,000</u>	105,000	
<u>Intangible assets</u>			
Patents	32,000		
Franchises	<u>9,000</u>	<u>41,000</u>	
Total assets		<u>\$430,000</u>	
		<u>Liabilities and Shareholders' Equity</u>	
<u>Current liabilities</u>			
Accounts payable		\$ 85,000	
Bank overdraft		2,500	
Unearned revenue		<u>4,000</u>	(6)
Total current liabilities		91,500	
<u>Long-term liabilities</u>			
Bonds payable		<u>100,000</u>	
Total liabilities		191,500	

Shareholders' equity	<u>238,500</u>
Total liabilities and shareholders' equity	<u>\$430,000</u>

- (1) $(\$95,000 - \$9,400 + \$2,500)$
- (2) $(\$60,000 - \$3,000)$
- (3) $(\$62,000 + \$3,000)$
- (4) $(\$5,000 - \$4,000)$
- (5) $(\$106,000 + \$40,000 - \$5,000 + \$4,000)$
- (6) Credit balances in accounts receivable

*An alternative is to show it as another asset.

Difficulty: Medium

Learning Objective: Prepare a classified statement of financial position.

Section Reference: Preparation of the Classified Statement of Financial Position (Balance Sheet)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 5-94 Statement of financial position presentation

Given the following account information for the first year of Howard Corporation, prepare a balance sheet in report form for the company as of December 31, 2020. All accounts have normal balances.

Equipment.....	60,000
Interest Expense.....	2,400
Interest Payable	600
Retained Earnings	?
Dividends.....	50,400
Land	137,320
Accounts Receivable	102,000
Bonds Payable.....	78,000
Notes Payable (due in 6 months)	29,400
Common Shares.....	70,000
Accumulated Depreciation—Equip	10,000
Prepaid Advertising.....	5,000
Service Revenue	341,400
Buildings.....	80,400
Supplies	1,860
Income Taxes Payable	3,000
Utilities Expense.....	1,320

Advertising Expense.....	1,560
Salaries and Wages Expense.....	53,040
Salaries and Wages Payable	900
Accumulated Depr.—Bld.....	15,000
Cash	45,000
Depreciation Expense	8,000

Solution 5-94

**Howard Corporation
Balance Sheet
December 31, 2020**

Assets		
Cash		\$ 45,000
Accounts Receivable		102,000
Supplies		1,860
Prepaid advertising		<u>5,000</u>
Total current assets		\$ 153,860
Land		137,320
Building	\$ 80,400	
Accumulated depreciation - bld	<u>(15,000)</u>	65,400
Equipment	60,000	
Accumulated depreciation—eq	<u>(10,000)</u>	50,000
Total assets		<u>\$ 406,580</u>
Liabilities & Shareholders' Equity		
Notes payable		\$ 29,400
Income taxes payable		3,000
Salaries and wages payable		900
Interest payable		<u>600</u>
Total current liabilities		\$ 33,900
Long-term liabilities		
Bonds payable		78,000
Total liabilities		111,900
Common shares	70,000	
Retained earnings (\$275,080* - \$50,400)	<u>224,680</u>	
Total shareholders' equity		<u>294,680</u>
Total liabilities & shareholders' equity		<u>\$ 406,580</u>

*\$341,400 – \$53,040 – \$8,000 – \$2,400 – \$1,560 – \$1,320

Difficulty: Medium

Learning Objective: Prepare a classified statement of financial position.

Section Reference: Preparation of the Classified Statement of Financial Position (Balance Sheet)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 5-95 Subsequent events

Explain the importance of considering subsequent events before financial statements are issued. What two types of subsequent events should be considered prior to financial statement issuance?

Solution 5-95

There are generally several weeks or months after the year end before the financial statements are issued. This time is to count inventory, reconcile subsidiary ledgers with controlling accounts, prepare necessary adjusting entries, ensure all transactions have been entered and obtain an audit. It's possible that, in this period, important transactions and events may occur that materially affect the company's financial position. These events are known as subsequent events, and fall into two types:

1. Events that provide further evidence of conditions that existed at the date of the Statement of Financial Position
2. Events that indicate conditions that occurred after the financial statement date.

Difficulty: Easy

Learning Objective: Prepare a classified statement of financial position.

Section Reference: Preparation of the Classified Statement of Financial Position (Balance Sheet)

CPA: Audit and Assurance

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 5-96 Contractual disclosures and ethical consideration

Contractual obligations should be disclosed in the notes to financial statements when they are significant. Considerable judgement is needed to determine whether leaving out such information is misleading. What principle should the accountant's judgment consider in this situation? Describe anything that should be factored into the disclosure decision.

Solution 5-96

The basis for including additional information is the full disclosure principle; that is, the information needs to be important enough to influence the decisions of an informed user.

When in doubt, it is better to disclose a little too much information than not enough. However, the accountant's judgement should also include ethical considerations, because the way of disclosing accounting principles, methods, and other items that have important effects on the enterprise may reflect the interests of a particular stakeholder in subtle ways that are at the expense of other stakeholders. For example, a reader might benefit from comprehensive note disclosures that potentially jeopardize the company's competitive advantage or its stance with regard to a legal matter.

Difficulty: Easy

Learning Objective: Identify statement of financial position information that requires supplemental disclosure.

Section Reference: Information Requiring Supplemental Disclosure

CPA: Communication

CPA: Financial Reporting

CPA: Professional and Ethical behaviour

Bloomcode: Comprehension

AACSB: Ethics

Ex. 5-97 Notes

Describe the purpose and appropriate use of notes to the financial statements. How should notes be presented, and what information should they provide? Name an area of the financial statements for which notes are frequently used.

Solution 5-97

Notes are used if additional explanations cannot be shown conveniently as parenthetical explanations or to reduce the amount of detail on the face of the statement. The notes should present all essential facts as completely and concisely as possible. Loose wording can mislead readers instead of helping them. Notes should add to the total information made available in the financial statements, while not raising unanswered questions or contradicting other parts of the statements.

An area of the financial statements often accompanied by notes is the property, plant, and equipment portion.

Difficulty: Easy

Learning Objective: Identify major disclosure techniques for the statement of financial position.

Section Reference: Techniques of Disclosure

CPA: Audit and Assurance

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 5-98 Contra or adjunct accounts

The use of contra or adjunct accounts is common in financial statement preparation. Though the function of these accounts is similar, they are slightly different in nature. Describe each, and name one scenario in which it would be used.

Solution 5-98

Contra Account—Is an SFP item that reduces an asset, liability, or owners' equity account. Examples include Accumulated Depreciation and Allowance for Doubtful Accounts.

Adjunct Account—Is an SFP item that increases an asset, liability, or owners' equity account. An example is Premium on Bonds Payable.

Difficulty: Easy

Learning Objective: Identify major disclosure techniques for the statement of financial position.

Section Reference: Techniques of Disclosure

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 5-99 Statement of cash flows

For each event listed below, select the appropriate category, which describes its effect 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 5-99

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

Difficulty: Easy

Learning Objective: Indicate the purpose and identify the content of the statement of cash flows.

Section Reference: Purpose, Content, and Format of a Statement of Cash Flows

CPA: Financial Reporting
Bloomcode: Comprehension
AACSB: Analytic

Ex. 5-100 Statement of cash flows purpose

What simple but important questions does the statement of cash flows help answer?

Solution 5-100

The statement of cash flows helps answer the following simple but important questions:

1. Where did cash come from during the period?
2. What was cash used for during the period?
3. What was the change in the cash balance during the period?

Difficulty: Easy

Learning Objective: Indicate the purpose and identify the content of the statement of cash flows.

Section Reference: Purpose, Content, and Format of a Statement of Cash Flows

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 5-101 Statement of cash flows basic format

Illustrate the basic format of the statement of cash flows.

Solution 5-101

Statement of Cash Flows	
Cash flows from operating activities	\$xxx
Cash flows from investing activities	xxx
Cash flows from financing activities.....	xxx
Net increase (decrease) in cash	xxx
Cash at beginning of year	xxx
Cash at end of year	\$xxx

Difficulty: Easy

Learning Objective: Indicate the purpose and identify the content of the statement of cash flows.

Section Reference: Purpose, Content, and Format of a Statement of Cash Flows

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

Ex. 5-102 Cash provided (used) by operating activities

Willows Corporation reports the following information:

Net income	\$320,000
Depreciation expense	70,000
Increase in accounts receivable	30,000

What amount should Willows report under the cash provided (used) by operating activities portion of their statement of cash flows?

Solution 5-102

Willows should report cash provided by operating activities of \$360,000.

Calculation:

$$\$320,000 + \$70,000 - \$30,000 = \$360,000$$

Difficulty: Medium

Learning Objective: Prepare a statement of cash flows using the indirect and direct methods

Section Reference: Preparation of the Statement of Cash Flows

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 5-103 Ending cash balance

Caldwell Corporation reports:

Cash provided by operating activities.....	\$280,000
Cash used by investing activities.....	110,000
Cash provided by financing activities	140,000
Beginning cash balance	70,000

What is Caldwell's ending cash balance?

Solution 5-103

Caldwell's ending cash balance is \$380,000.

Calculation:

$$\$70,000 + \$280,000 - \$110,000 + \$140,000 = \$380,000$$

Difficulty: Medium

Learning Objective: Prepare a statement of cash flows using the indirect and direct methods

Section Reference: Preparation of the Statement of Cash Flows

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 5-104 Cash flows from investing activities

Markle Corporation reports:

Cash provided by operating activities.....	\$70,000
Cash provided by financing activities	35,000
Beginning cash balance	17,500
Ending cash balance	95,000

What is Markle`s cash provided/(used) by investing activities?

Solution 5-104

Markle`s cash used by investing activities is \$27,500.

Calculation:

$$\$95,000 - \$17,500 - \$70,000 - \$35,000 = \$(27,500)$$

Difficulty: Medium

Learning Objective: Prepare a statement of cash flows using the indirect and direct methods

Section Reference: Preparation of the Statement of Cash Flows

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 5-105 Cash flows from operating activities – indirect method

Carla Limited had the following financial statements:

Carla Limited
Income Statement
For the Year Ended December 31, 2020

Net sales	\$165,000
Cost of goods sold	<u>97,500</u>
Gross profit	67,500
Operating expenses	<u>27,500</u>
Income from operations	40,000
Interest expense	<u>3,500</u>
Income before income taxes	36,500
Income taxes	<u>11,000</u>

Net income \$ 25,500

Carla Limited.
Comparative Statement of Financial Position
As at December 31

	<u>2020</u>	<u>2019</u>
Cash	\$15,000	\$9,750
Accounts receivable	11,750	8,750
Inventories	16,500	11,750
Prepaid insurance	2,500	2,000
Equipment	25,500	33,500
Accumulated depreciation—equipment	<u>(16,250)</u>	<u>(17,750)</u>
Total assets	<u>\$55,000</u>	<u>\$48,000</u>
Accounts payable	\$5,000	\$6,750
Wages payable	2,000	2,000
Income taxes payable	3,000	1,000
Long-term note payable	0	8,750
Common shares	15,000	15,000
Retained earnings	<u>30,000</u>	<u>14,500</u>
Total liabilities and shareholders' equity	<u>\$55,000</u>	<u>\$48,000</u>

Additional information:

- Equipment that cost \$8,000 was sold for the carrying amount of \$3,750.
- Dividends declared and paid were \$10,000.

Prepare the operating activities section of a statement of cash flows using the indirect method.

Solution 5-105

Carla Limited
Partial Statement of Cash Flows
For the Year Ended December 31, 2020

Operating activities	
Net income	\$25,500
Depreciation*	2,750
Increase in accounts receivable	(3,000)
Increase in inventories	(4,750)
Increase in prepaid insurance	(500)

Decrease in accounts payable	(1,750)
Increase in income taxes payable	<u>2,000</u>
Cash from operating activities	<u>\$20,250</u>

* Calculation for depreciation:

\$8,000 - \$3,750 = \$4,250 accumulated depreciation on sold asset

\$4,250 + \$16,250 = \$20,500 accumulated depreciation before asset disposal

\$20,500 - \$17,750 = \$2,750 depreciation expense

Difficulty: Medium

Learning Objective: Prepare a statement of cash flows using the indirect and direct methods

Section Reference: Preparation of the Statement of Cash Flows

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 5-106 Cash flows from operating activities – indirect method

Titiki Ltd. had the following comparative statement of financial position:

Titiki Ltd.
Comparative Statement of Financial Position
As at December 31

	<u>2020</u>	<u>2019</u>
Cash	\$20,500	\$12,500
Accounts receivable	34,000	25,500
Inventories	20,000	30,000
Prepaid insurance	2,500	2,000
Equipment	102,000	90,000
Accumulated depreciation—equipment	<u>(22,500)</u>	<u>(12,500)</u>
Total assets	<u>\$156,500</u>	<u>\$147,500</u>
Accounts payable	\$23,000	\$20,000
Wages payable	4,000	2,000
Interest payable	2,000	3,000
Income taxes payable	4,000	5,000
Long-term note payable	30,000	34,500
Common shares	65,000	65,000
Retained earnings	<u>28,500</u>	<u>18,000</u>
Total liabilities and shareholders' equity	<u>\$156,500</u>	<u>\$147,500</u>

Additional information:

- Net income for the fiscal year was \$13,500.
- Equipment that cost \$10,000 and was sold for a gain of \$1,000 during 2020. The equipment's accumulated depreciation was \$7,000.

Prepare the operating activities section of a statement of cash flows using the indirect method.

Solution 5-106

**Titiki Ltd.
Partial Statement of Cash Flows
For the Year Ended December 31, 2020**

Operating activities	
Net income	\$13,500
Depreciation	17,000
Gain on sale of equipment	(1,000)
Increase in accounts receivable	(8,500)
Decrease in inventories	10,000
Increase in prepaid insurance	(500)
Increase in accounts payable	3,000
Decrease in interest payable	(1,000)
Increase in wages payable	2,000
Decrease in income taxes payable	<u>(1,000)</u>
Cash from operating activities	<u>\$33,500</u>

Difficulty: Medium

Learning Objective: Prepare a statement of cash flows using the indirect and direct methods

Section Reference: Preparation of the Statement of Cash Flows

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 5-107 Cash flows from operating activities – direct method

Carla Limited had the following financial statements:

**Carla Limited
Income Statement**

For the Year Ended December 31, 2020

Net sales	\$165,000
Cost of goods sold	<u>97,500</u>
Gross profit	67,500
Operating expenses	<u>27,500</u>
Income from operations	40,000
Interest expense	<u>3,500</u>
Income before income taxes	36,500
Income taxes	<u>11,000</u>
Net income	<u>\$ 25,500</u>

**Carla Limited.
Comparative Statement of Financial Position
As at December 31**

	<u>2020</u>	<u>2019</u>
Cash	\$15,000	\$9,750
Accounts receivable	11,750	8,750
Inventories	16,500	11,750
Prepaid insurance	2,500	2,000
Equipment	25,500	33,500
Accumulated depreciation—equipment	<u>(16,250)</u>	<u>(17,750)</u>
Total assets	<u>\$55,000</u>	<u>\$48,000</u>
Accounts payable	\$5,000	\$6,750
Wages payable	2,000	2,000
Income taxes payable	3,000	1,000
Long-term note payable	0	8,750
Common shares	15,000	15,000
Retained earnings	<u>30,000</u>	<u>14,500</u>
Total liabilities and shareholders' equity	<u>\$55,000</u>	<u>\$48,000</u>

Additional information:

- Equipment that cost \$8,000 was sold for the carrying amount of \$3,750.
- Dividends declared and paid were \$10,000.

Prepare the operating activities section of a statement of cash flows using the direct method.

Solution 5-107

Carla Limited
Partial Statement of Cash Flows
For the Year Ended December 31, 2020

Cash received from customers		\$162,000
Cash paid to suppliers.....	\$104,000	
Cash paid for operating expenses	25,250	
Cash paid for interest.....	3,500	
Cash paid for income taxes.....	9,000	<u>\$141,750</u>
Net cash provided by operating activities		<u>\$20,250</u>

Calculations:

Cash received from customers:

Net sales	\$ 165,000
– Increase in accounts receivable.....	<u>(3,000)</u>
	\$ 162,000

Cash paid to suppliers:

Cost of goods sold	\$ 97,500
+ Increase in inventory	4,750
+ Decrease in accounts payable	<u>1,750</u>
	\$ 104,000

Cash paid for operating expenses:

Operating expenses	\$ 27,500
+ Increase in prepaid insurance.....	500
- Depreciation expense	<u>(2,750)</u>
	\$ 25,250

Cash paid for interest:

Interest expense	\$ 3,500

Cash paid for income tax:

Income tax expense	\$ 11,000
- Increase in income tax payable	<u>2,000</u>
	\$ 9,000

Difficulty: Medium

Learning Objective: Prepare a statement of cash flows using the indirect and direct methods

Section Reference: Preparation of the Statement of Cash Flows

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 5-108 Statement of cash flows ratios

Financial statements for Comet Ltd. are presented below:

Comet Ltd. Statement of Financial Position December 31, 2020			
<u>Assets</u>		<u>Liabilities & Shareholders' Equity</u>	
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.....	<u>24,000</u>	Retained earnings	<u>64,000</u>
	<u>\$215,000</u>		<u>\$215,000</u>

Comet Ltd. Statement of Cash Flows For the Year Ended December 31, 2020			
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.....	<u>3,000</u>		<u>(4,000)</u>
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	<u>(52,000)</u>		
Net cash used by investing activities			(65,000)
Cash flows from financing activities			
Payment of cash dividend	(25,000)		
Sale of bonds.....	<u>45,000</u>		
Net cash provided by financing activities			<u>20,000</u>

Net increase in cash	11,000
Cash, January 1, 2020	<u>33,000</u>
Cash, December 31, 2020	<u>\$ 44,000</u>

At the beginning of 2020, the accounts payable balance was \$21,000, and the bonds payable balance was \$9,000. All of Comet's bonds have been issued at par.

Instructions

Calculate the following for Comet Ltd.:

- Current cash debt coverage ratio
- Cash debt coverage ratio
- Free cash flow

Solution 5-108

$$\begin{aligned} \text{a) Current cash debt coverage ratio} &= \frac{\text{Net cash provided by operating activities}}{\text{Average current liabilities}} \\ &= \frac{\$56,000}{(\$21,000 + \$28,000) \div 2} = \frac{\$56,000}{\$24,500} = \underline{2.29:1} \end{aligned}$$

$$\begin{aligned} \text{b) Cash debt coverage ratio} &= \frac{\text{Net cash provided by operating activities}}{\text{Average total liabilities}} \\ &= \frac{\$56,000}{(\$30,000 + \$82,000) \div 2} = \frac{\$56,000}{\$56,000} = \underline{1:1} \end{aligned}$$

$$\begin{aligned} \text{c) Free cash flow} &= \text{Net cash provided by operating activities} - \\ &\quad \text{capital expenditures and dividends} \\ &= \$56,000 - *\$79,000 - \$25,000 = \underline{\$(48,000)} \end{aligned}$$

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

Difficulty: Medium

Learning Objective: Understand the usefulness of the statement of cash flows.

Section Reference: Usefulness of the Statement of Cash Flows

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 5-109 Calculation of free cash flow and ratio

Dawe Corporation reports the following information:

Net cash provided by operating activities	\$285,000
Average current liabilities	150,000
Average long-term liabilities	100,000
Dividends declared	60,000
Capital expenditures.....	110,000
Payments of debt	35,000

Instructions

Calculate the following:

- Cash Debt Coverage Ratio
- Free Cash Flow

Solution 5-109

a) $\$285,000 \div (\$150,000 + \$100,000) = 1.14:1$

b) $\$285,000 - \$60,000 - \$110,000 = \$115,000$

Difficulty: Medium

Learning Objective: Understand the usefulness of the statement of cash flows.

Section Reference: Usefulness of the Statement of Cash Flows

CPA: Finance

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

***Ex. 5-110** Calculation of ratios

Keefe Enterprises reported the following:

Net sales	\$285,000
Average trade receivables	150,000
Cost of goods sold	100,000
Average inventory	60,000
Average total assets	110,000
Average current liabilities	35,000

Instructions

Calculate the activity ratios of Keefe Enterprises.

Solution 5-110

- a) Receivables turnover: $\text{Net sales} / \text{Average trade receivables} = \$285,000 / \$150,000 = 1.9:1$
- b) Inventory turnover: $\text{Cost of goods sold} / \text{Average inventory} = \$100,000 / \$60,000 = 1.67:1$
- c) Asset turnover: $\text{Net sales} / \text{Average total assets} = \$285,000 / \$110,000 = 2.59:1$

Difficulty: Medium

Learning Objective: Identify the major types of financial ratios and what they measure.

Section Reference: Ratio Analysis: A Reference (Appendix 5A)

CPA: Finance

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

***Ex. 5-111** Interpretation of ratios

For each ratio you calculated for Keefe Enterprises in exercise 5-xx explain what the ratio measures and provide a brief interpretation of the ratio you calculated for Keefe Enterprises.

Solution 5-111

- a) Receivables turnover: Liquidity of receivables. Keefe's receivables are fairly liquid and turnovers 1.9 times per period. This indicates a healthy rate of collection, though we'd need to look more closely at the customer terms to know this for certain.
- b) Inventory turnover: Liquidity of inventory. Keefe's inventory is also fairly liquid, and is turning over 1.67 times per period.
- c) Asset turnover: How efficiently assets are used to generate sales. Keefe appears to make efficient use of their assets, generating sales at over two times the assets' value.

Difficulty: Hard

Learning Objective: Identify the major types of financial ratios and what they measure.

Section Reference: Ratio Analysis: A Reference (Appendix 5A)

CPA: Finance

CPA: Financial Reporting

Bloomcode: Evaluation

AACSB: Analytic

***Ex. 5-112** Calculation of ratios

A company reported current assets of \$120,000 and current liabilities of \$150,000.

Instructions

Calculate the following:

- a) Working capital
- b) Current ratio

Solution 5-112

(a) Working capital: $\$120,000 - \$150,000 = \$30,000$ negative

(b) Current ratio: $\$120,000 / \$150,000 = 0.80:1$

Difficulty: Medium

Learning Objective: Identify the major types of financial ratios and what they measure.

Section Reference: Ratio Analysis: A Reference (Appendix 5A)

CPA: Finance

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

***Ex. 5-113** Calculation of ratios

A company reported current assets of \$450,000, current liabilities of \$250,000, and total assets of \$1 million.

Instructions

Calculate the following:

- a) Working capital
- b) Current ratio

Solution 5-113

(a) Working capital: $\$450,000 - \$250,000 = \$200,000$

(b) Current ratio: $\$450,000 / \$250,000 = 1.8:1$

Difficulty: Medium

Learning Objective: Identify the major types of financial ratios and what they measure.

Section Reference: Ratio Analysis: A Reference (Appendix 5A)

CPA: Finance

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

PROBLEMS

Pr. 5-114 Statement of financial position format

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

**Hathaway Industries Inc.
Statement of Financial Position
For the Period Ended December 31, 2020**

<u>Assets</u>			
Fixed Assets—Tangible			
Equipment.....	\$110,000		
Less: reserve for depreciation	<u>(40,000)</u>	\$ 70,000	
Factory supplies		22,000	
Land and buildings.....	400,000		
Less: reserve for depreciation	<u>(150,000)</u>	250,000	
Plant site held for future use		<u>90,000</u>	\$ 432,000
Current Assets			
Accounts receivable		175,000	
Cash		80,000	
Inventory		220,000	
Treasury stock (at cost).....		<u>20,000</u>	495,000

Fixed Assets—Intangible		
Goodwill	80,000	
Notes receivable.....	40,000	
Patents.....	<u>26,000</u>	146,000
Deferred Charges		
Advances to salespersons.....	60,000	
Prepaid rent.....	27,000	
Returnable containers	<u>75,000</u>	<u>162,000</u>
TOTAL ASSETS.....		<u>\$1,235,000</u>
<u>Liabilities</u>		
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.....	<u>17,000</u>	\$ 242,000
Long-Term Liabilities, 5% debenture bonds, due 2023	500,000	
Reserve for contingencies.....	<u>150,000</u>	<u>650,000</u>
TOTAL LIABILITIES		<u>892,000</u>
<u>Equity</u>		
Common 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	<u>100,000</u>	
TOTAL EQUITY		<u>343,000</u>
TOTAL LIABILITIES AND EQUITY		<u>\$1,235,000</u>

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 5-114

1. The heading should be at a specific date rather than for a period of time.
2. “Fixed Assets – Tangible” and “Reserve for Depreciation” is poor terminology; should be Property, Plant and Equipment and Accumulated Depreciation.

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. Popular practice lists current assets first; as well, current assets are usually listed in order of liquidity. Factory supplies should be shown as a current asset.
6. Treasury stock is not an asset, but a deduction from shareholders' equity.
7. Notes receivable should be reported as a current asset or an investment.
8. The deferred charge items should be reclassified as follows:
 - 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 stock dividend distributable should be shown in shareholders' equity.
11. The debenture bonds should be shown on a separate line below the heading Long-Term Liabilities.
12. Earned surplus is poor terminology. The term "retained earnings" is more appropriate.
13. Other Accumulated Past Earnings is poor terminology. Accumulated Other Comprehensive Income is the term required by IFRS.
14. "Dividends paid" title is a misnomer. It probably is a "dividends declared" item that should be closed to retained earnings.
15. No reference in the body of the statement is made to the notes. The order of the notes is wrong.
16. Note 2 indicates that the inventory account is understated by \$30,000. Inventory and earned surplus amounts should both be adjusted by increasing them by \$30,000.

17. 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.
18. Goodwill should be listed as an asset by itself. It is not an intangible asset.

Difficulty: Medium

Learning Objective: Identify the major classifications of a statement of financial position.

Section Reference: Classification in the Statement of Financial Position

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 5-115 Statement of financial position presentation

The following statement of financial position was prepared by the bookkeeper for Badger Corp. at December 31, 2020.

Badger Corp.			
Statement of Financial Position			
December 31, 2020			
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.....	<u>32,000</u>		
.....	<u>\$393,500</u>		<u>\$393,500</u>

The following additional information is provided:

1. "Cash" includes prepaid insurance of \$9,400; as well, 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 statement of financial position in good form (shareholders' equity details can be omitted.)

Solution 5-115

Badger Corp.
Statement of Financial Position
December 31, 2020

AssetsCurrent assets

Cash		\$ 82,100 (1)
Trading securities.....		24,000
Accounts receivable	\$ 57,000 (2)	
Less allowance for doubtful accounts	<u>4,800</u>	52,200
Inventories.....		62,000 (3)
Prepaid insurance		9,400
*Equipment held for sale		<u>2,000</u> (4)
Total current assets.....		231,700

Investments

Long-term securities	43,300

Property, plant, and equipment

Equipment.....	124,000 (5)	
Less accumulated depreciation	<u>40,000</u>	84,000

Intangible assets

Patents.....	32,000	
Franchises.....	<u>9,000</u>	<u>41,000</u>
Total assets.....		<u>\$400,000</u>

Liabilities and Shareholders' EquityCurrent liabilities

Accounts payable	\$ 80,000 (6)
Bank overdraft.....	<u>1,500</u>
Total current liabilities.....	81,500

Long-term liabilities

.....	<u>110,000</u>
Total liabilities.....	191,500

<u>Shareholders' equity</u>	<u>208,500</u>

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 this as an "other asset."

Difficulty: Medium

Learning Objective: Prepare a classified statement of financial position.

Section Reference: Preparation of the Classified Statement of Financial Position (Balance Sheet)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 5-116 Calculation of ending retained earnings

The records of Biloxi Corp. for calendar 2020 reflected the following correct pre-tax amounts: gain from discontinued operations, \$50,000; cash dividends declared and paid, \$45,000; retained earnings, January 1, 2020, \$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% applies to all items except the dividends.

Instructions

Calculate the December 31, 2020 ending balance of retained earnings.

Solution 5-116

Beginning balance.....	\$275,000
Correction of error $(\$35,000 \times 60\%)$	(21,000)
Income $(\$165,000 \times 60\%)$	99,000
Gain from discontinued operations $(\$50,000 \times 60\%)$	30,000
Dividends.....	<u>(45,000)</u>
Ending balance.....	<u>\$338,000</u>

Difficulty: Medium

Learning Objective: Prepare a classified statement of financial position.

Section Reference: Preparation of the Classified Statement of Financial Position (Balance Sheet)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 5-117 Statement of cash flows – direct method

The controller of Nebula Corporation has provided you with the following information:

**Nebula Corporation
Income Statement
For the Year Ended December 31, 2020**

Net sales	\$620,000
Operating expenses	<u>410,000</u>
Income from operations	210,000
Other revenues and expenses	
Gain on sale of equipment..... 30,000	
Interest expense..... 8,000	<u>22,000</u>
Income before income taxes	232,000
Income taxes	<u>92,800</u>
Net income	<u>\$139,200</u>

**Nebula Corporation
Comparative Account Information
Relating to Operations
For the Year Ended December 31, 2020**

	<u>2020</u>	<u>2019</u>
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 operating activities only) for the year ended December 31, 2020, using the *direct* method.

Solution 5-117

**Nebula Corporation
Partial Statement of Cash Flows
For the Year Ended December 31, 2020**

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

Calculations:

Cash received from customers:

Net sales	\$ 620,000
– Increase in accounts receivable.....	(16,000)
+ Increase in unearned revenue	<u>6,000</u>
	\$ 610,000

Cash paid for operating expenses:

Operating expenses	\$ 410,000
– Decrease in prepaid insurance	(1,000)
– Increase in accounts payable.....	<u>(12,000)</u>
	\$ 397,000

Cash paid for interest:

Interest expense	\$ 8,000
+ Decrease in interest payable.....	<u>900</u>
	\$ 8,900

Cash paid for income tax:

Income tax expense	\$ 92,800
+ Decrease in income tax payable	<u>1,800</u>
	\$ 94,600

Difficulty: Medium

Learning Objective: Prepare a statement of cash flows using the indirect and direct methods

Section Reference: Preparation of the Statement of Cash Flows

CPA: Financial Reporting

CPA: Taxation

Bloomcode: Application

AACSB: Analytic

Pr. 5-118 Statement of cash Flows – indirect method

Use the information provided in Pr. 5-113. Prepare a statement of cash flows (for operating activities only) for the year ended December 31, 2020 using the *indirect* method.

Solution 5-118

Nebula Corporation

**Partial Statement of Cash Flows
For the Year Ended December 31, 2020**

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	<u>6,000</u>
Net cash provided by operating activities	<u>\$109,500</u>

Difficulty: Medium

Learning Objective: Prepare a statement of cash flows using the indirect and direct methods

Section Reference: Preparation of the Statement of Cash Flows

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

***Pr. 5-119** Calculation of ratios

Brandon Systems Inc. has provided you with the following information:

	<u>2020</u>	<u>2019</u>
Cash	\$ 21,000	\$ 47,000
Short-term (trading) investments	28,000	–
Accounts receivable	102,000	116,000
Inventory	86,000	64,000
Prepaid expenses	11,000	9,000
Total assets.....	1,503,000	1,489,000
Total current liabilities.....	205,000	241,000
Net sales, all on credit.....	877,000	850,000
Cost of goods sold	570,000	555,000
Operating income	165,000	158,000
Income tax expense	20,000	18,000
Net income	109,000	100,000
Interest expense	36,000	40,000
Common shares (no preferred)	420,000	420,000
Retained earnings	153,000	74,000

Instructions

Calculate the following ratios for 2020. Round all values to two decimals, including percentages, e.g., 12.34, 34.56%. Show all calculations.

- a) Profit margin on sales
- b) Quick (acid-test) ratio
- c) Receivables turnover
- d) Debt to total assets
- e) Times interest earned
- f) Rate of return on assets
- g) Rate of return on common share equity

Solution 5-119

a) Profit margin on sales = Net income/net sales x 100 =

$$\frac{109,000}{877,000} \times 100 = 12.43\%$$

b) Quick (acid-test) ratio = Quick assets/current liabilities

$$= \frac{21,000 + 28,000 + 102,000}{205,000} = .74 \text{ to } 1$$

c) Receivables turnover = Net sales/average A/R

$$= \frac{877,000}{(102,000 + 116,000)/2} = 8.05 \text{ (times)}$$

d) Debt to total assets = Total liabilities/total assets x 100

$$= \frac{930,000}{1,503,000} \times 100 = 61.88\%$$

Total liabilities = 1,503,000 – 420,000 – 153,000 = 930,000

e) Times interest earned = Net income before interest and income taxes/interest exp

$$= \frac{109,000 + 36,000 + 20,000 \text{ (i.e., operating income)}}{36,000} = 4.58 \text{ (times)}$$

f) Rate of return on assets = Net income/average total assets

$$= \frac{109,000}{1,496,000} \times 100 = 7.29\%$$

average total assets = (1,503,000 + 1,489,000)/2 = 1,496,000

g) Rate of return on common share equity = NI/average common S/H equity x 100

$$= \frac{109,000}{536,000} \times 100 = 20.43\%$$

533,500

Average equity = $(420,000 + 420,000 + 153,000 + 74,000)/2 = 533,500$

Difficulty: Medium

Learning Objective: Prepare a statement of cash flows using the indirect and direct methods

Section Reference: Preparation of the Statement of Cash Flows

CPA: Financial Reporting

CPA: Taxation

Bloomcode: Application

AACSB: Analytic

Pr. 5-120 Statement of cash flows – indirect method

Titiki Ltd. had the following comparative statement of financial position:

Titiki Ltd.
Comparative Statement of Financial Position
As at December 31

	<u>2020</u>	<u>2019</u>
Cash	\$20,500	\$12,500
Accounts receivable	34,000	25,500
Inventories	20,000	30,000
Prepaid insurance	2,500	2,000
Equipment	102,000	90,000
Accumulated depreciation—equipment	<u>(22,500)</u>	<u>(12,500)</u>
Total assets	<u>\$156,500</u>	<u>\$147,500</u>
Accounts payable	\$23,000	\$20,000
Wages payable	4,000	2,000
Interest payable	2,000	3,000
Income taxes payable	4,000	5,000
Long-term note payable	30,000	34,500
Common shares	65,000	65,000
Retained earnings	<u>28,500</u>	<u>18,000</u>
Total liabilities and shareholders' equity	<u>\$156,500</u>	<u>\$147,500</u>

Additional information:

- Net income for the fiscal year was \$13,500.
- Equipment that cost \$10,000 and was sold for a gain of \$1,000 during 2020. The equipment's accumulated depreciation was \$7,000.

Prepare the statement of cash flows using the indirect format.

Solution 5-120

Titiki Ltd.
Partial Statement of Cash Flows
For the Year Ended December 31, 2020

Operating activities		
Net income		\$13,500
Depreciation		17,000
Gain on sale of equipment		(1,000)
Increase in accounts receivable		(8,500)
Decrease in inventories		10,000
Increase in prepaid insurance		(500)
Increase in accounts payable		3,000
Increase in wages payable		2,000
Decrease in interest payable		(1,000)
Decrease in income taxes payable		<u>(1,000)</u>
Cash from operating activities		<u>\$33,500</u>
Investing activities		
Proceeds from sale of equipment	\$4,000	
Purchase of equipment	<u>(22,000)</u>	
Net cash used by investing activities		(18,000)
Financing activities		
Cash dividends (18,000 + 13,500 - 28,500)	(3,000)	
Repayment of notes payable - long term	<u>(4,500)</u>	
Net cash used by financing activities		<u>(7,500)</u>
Net increase in cash		8,000
Cash at beginning of year		<u>12,500</u>
Cash at end of year		<u>\$20,500</u>

Difficulty: Medium

Learning Objective: Prepare a statement of cash flows using the indirect and direct methods

Section Reference: Preparation of the Statement of Cash Flows

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 5-121 Statement of cash flows – direct method

Carla Limited had the following financial statements:

**Carla Limited
Income Statement
For the Year Ended December 31, 2020**

Net sales	\$165,000
Cost of Goods Sold	<u>97,500</u>
Gross Profit	67,500
Operating expenses	<u>27,500</u>
Income from operations	40,000
Interest expense	<u>3,500</u>
Income before income taxes	36,500
Income taxes	<u>11,000</u>
Net income	<u>\$ 25,500</u>

**Carla Limited.
Comparative Statement of Financial Position
As at December 31**

	<u>2020</u>	<u>2019</u>
Cash	\$15,000	\$9,750
Accounts receivable	11,750	8,750
Inventories	16,500	11,750
Prepaid insurance	2,500	2,000
Equipment	25,500	33,500
Accumulated depreciation—equipment	<u>(16,250)</u>	<u>(17,750)</u>
Total assets	<u>\$55,000</u>	<u>\$48,000</u>
Accounts payable	\$5,000	\$6,750
Wages payable	2,000	2,000
Income taxes payable	3,000	1,000
Long-term note payable	0	8,750
Common shares	15,000	15,000
Retained earnings	<u>30,000</u>	<u>14,500</u>
Total liabilities and shareholders' equity	<u>\$55,000</u>	<u>\$48,000</u>

Additional information:

- Equipment that cost \$8,000 was sold for its carrying amount of \$3,750.
- Dividends declared and paid were \$10,000.

Prepare the statement of cash flows using the direct method.

Solution 5-121

Carla Limited
Statement of Cash Flows
For the Year Ended December 31, 2020

Operating activities		
Cash received from customers		\$162,000
Cash paid to suppliers.....	\$104,000	
Cash paid for operating expenses	25,250	
Cash paid for interest.....	3,500	
Cash paid for income taxes.....	9,000	<u>141,750</u>
Net cash provided by operating activities.....		<u>20,250</u>
Investing activities		
Sale of equipment.....	<u>\$3,750</u>	
Net cash provided by investing activities		3,750
Financing activities		
Redemption of note payable	\$(8,750)	
Payment of cash dividends.....	<u>(10,000)</u>	
Net cash used by financing activities.....		<u>(18,750)</u>
Net increase in cash		5,250
Cash, January 1		<u>9,750</u>
Cash, December 31.....		<u>\$ 15,000</u>

Calculations:

Cash received from customers:

Net sales	\$ 165,000
– Increase in accounts receivable.....	<u>(3,000)</u>
	\$ 162,000

Cash paid to suppliers:

Cost of goods sold	\$ 97,500
+ Increase in inventories	4,750
+ Decrease in accounts payable	<u>1,750</u>
.....	\$ 104,000

Cash paid for operating expenses:

Operating expenses	\$ 27,500
+ Increase in prepaid insurance.....	500
- Depreciation expense	<u>(2,750)</u>
.....	\$ 25,250

Cash paid for interest:

Interest expense	\$ 3,500

Cash paid for income tax:

Income tax expense	\$ 11,000
- Increase in income tax payable	<u>2,000</u>
	\$ 9,000

Difficulty: Medium

Learning Objective: Prepare a statement of cash flows using the indirect and direct methods

Section Reference: Preparation of the Statement of Cash Flows

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

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CHAPTER 6

REVENUE RECOGNITION

CHAPTER STUDY OBJECTIVES

Note: *The Contract Asset/Liability account may be used instead of Construction in Process and Billings.*

- 1. Understand the economics and legalities of selling transactions from a business perspective.** It is critical to understand a transaction from a business perspective before attempting to account for it. The analysis should begin with what is being sold to the customer (goods or services) and also the nature and amount of the consideration. When one party is in a better bargaining position than the other, it may be able to negotiate concessions such as more lenient payment terms. These concessions often complicate the accounting because they introduce measurement uncertainty in many cases. Selling transactions are based on contractual arrangements between a buyer and a seller. Contracts create rights and obligations under law that must be considered when accounting for the transactions. In addition to contractual law, rights and obligations may exist under other forms of the law, such as common law or contract law. These should also be considered.
- 2. Identify the five steps in the revenue recognition process.** The five steps in the revenue recognition process are (1) identify the contract with customers, (2) identify the separate performance obligations in the contract, (3) determine the transaction price, (4) allocate the transaction price to the separate performance obligations, and (5) recognize revenue when each performance obligation is satisfied.
- 3. Identify the contract with customers.** A contract is an agreement that creates enforceable rights or obligations. A company applies the revenue guidance to contracts with customers and must determine if new performance obligations are created by a contract modification.
- 4. Identify the separate performance obligations in the contract.** A performance obligation is a promise in a contract to provide a product or service to a customer. A contract may be composed of multiple performance obligations. The accounting for multiple performance obligations is based on evaluation of whether the product or service is distinct within the contract. If each of the goods or services is distinct, but they are interdependent and interrelated, these goods and services are combined and reported as one performance obligation.

5. **Determine the transaction price.** The transaction price is the amount of consideration that a company expects to receive from a customer in exchange for transferring goods and services. In determining the transaction price, companies must consider the following factors: (1) variable consideration, (2) time value of money, (3) noncash consideration, and (4) consideration paid or payable to a customer.

6. **Allocate the transaction price to the separate performance obligations.** If more than one performance obligation exists in a contract, allocate the transaction price based on relative fair values. The best measure of fair value is what the good or service could be sold for on a stand-alone basis (the stand-alone selling price). Estimates of stand-alone selling price can be based on (1) adjusted market assessment, (2) expected cost plus a margin approach, or (3) a residual approach.

7. **Understand how to recognize revenue when the company satisfies its performance obligation.** A company satisfies its performance obligation when the customer obtains control of the good or service. Companies satisfy performance obligations either at a point in time or over a period of time. Companies recognize revenue over a period of time if (1) the customer controls the asset as it is created or the company does not have an alternative use for the asset, and (2) the company has a right to payment.

8. **Analyze and determine whether a company has earned revenues under the earnings approach.** Under ASPE, the revenues are earned when the risks and rewards of ownership are passed or when the company has done what it said it would do to be entitled to the revenues. Where the sale of goods is involved, legal title and possession provide evidence of this. The accounting is more complex when the contract is a long-term contract and when it involves both goods and services.

9. **Identify other revenue recognition issues.** Refer to Illustration 6-13 for a summary of the accounting for (1) repurchase agreements, (2) bill-and-hold sales, (3) principal-agent relationships, and (4) consignments.

10. **Describe presentation and disclosure regarding revenue.** Under the asset-liability approach, to recognize revenue, companies present contract assets and contract liabilities on their balance sheets (net). Contract assets are rights to receive consideration. A contract liability is a company's obligation to transfer goods or services to a customer for which the company has received consideration from the customer. Companies may also report assets associated with fulfillment costs and contract acquisition costs related to a revenue

arrangement. Companies disclose qualitative and quantitative information about (1) contracts with customers with disaggregation of revenue, presentation of opening and closing balances in contract assets and contract liabilities, and significant information related to their performance obligations; (2) significant judgements that affect the determination of the transaction price, the allocation of the transaction price, and the determination of the timing of revenue; and (3) assets recognized from costs incurred to fulfill a contract.

11. Identify differences in accounting between IFRS and ASPE and potential changes. The main differences are identified in the chart in Illustration 6-16.

12. Apply the percentage-of-completion method for long-term contracts. To apply the percentage-of-completion method to long-term contracts, a company must have some basis for measuring the progress toward completion at particular interim dates. One of the most popular input measures used to determine the progress toward completion is the cost-to-cost basis. Using this basis, a company measures the percentage of completion by comparing costs incurred to date with the most recent estimate of the total costs to complete the contract. The company applies that percentage to the total revenue or the estimated total gross profit on the contract, to arrive at the amount of revenue or gross profit to be recognized to date.

13. Apply the zero-profit method for long-term contracts. Under this IFRS method, revenue equal to costs is recognized when the outcome is not determinable. This results in no profits being recognized. Otherwise the journal entries are the same as under the percentage-of-completion method.

14. Apply the completed-contract method for long-term contracts. Under this ASPE method, companies recognize revenue and gross profit only when the company completes the contract. Therefore, unlike the zero-profit method, no revenue is recognized until the contract is completed. The company accumulates costs of long-term contracts in process and current billings. It makes no interim charges or credits to income statement accounts for revenues, costs, and gross profit. The annual journal entries to record costs of construction, progress billings, and collections from customers would be identical to those for the percentage-of-completion method—with the significant exclusion of the recognition of revenue and gross profit.

15. Account for losses on long-term contracts. There are two types of situations: losses in the period on a profitable contract and losses on an unprofitable contract (onerous contracts). For all three methods of accounting for long-term contracts, the second type must

be accrued for. The first type must only be adjusted for when using the percentage-of-completion method.

MULTIPLE CHOICE

Answer	No.	Description
a	1.	Definition of "acquired"
b	2.	Definition of credit risk
c	3.	Concept of commercial substance
d	4.	Definition of concessionary terms
d	5.	Concessionary or abnormal terms
c	6.	Definition of constructive obligation
b	7.	Allocation of selling price in bundled sales
b	8.	Reasons to recognize revenue
a	9.	Problems with the earnings approach
b	10.	Definition of revenue
a	11.	Definition of "recognition."
c	12.	Control of an asset
c	13.	Revenue recognition process
c	14.	Definition of control

a	15.	Revenue to be recognized under collection uncertainty
d	16.	Calculation of the net contract position – contract-based approach
d	17.	Sales on consignment
b	18.	Reporting inventory on consignment
b	19.	Calculate contract costs incurred during year.
b	20.	New IFRS standard
a	21.	Contract signing
d	22.	Contract modification
c	23.	Performance obligation
b	24.	Performance obligation
b	25.	Accounting for a volume rebate
d	26.	Recording sales when right of return exists
c	27.	Recording sales when right of return exists
d	28.	Transaction price
c	29.	Expected value approach
b	30.	Returned asset
b	31.	Right to return under IFRS
a	32.	Allocation approach
d	33.	Selling price of a bundle
b	34.	Revenue recognition over a period of time
c	35.	Revenue recognition over a period of time
c	36.	Definition of earnings process
c	37.	Definition of discrete earnings process
d	38.	Earnings process
d	39.	Calculate gross profit using percentage-of-completion method.
a	40.	Calculate gross profit using completed-contract method.
d	41.	Calculate gross profit using completed-contract method.
a	42.	Consignment sales
b	43.	Consignment sales—consignor vs. consignee
d	44.	Consignment sales—revenue recognition
a	45.	Revenue recognition in consignment sales
c	46.	Revenue to be recognized from consignment sales
d	47.	Contract liability
a	48.	Conditional rights
a	49.	Long-term contract revenue under APSE
a	50.	ASPE requirements
c	51.	ASPE requirements
b	52.	Accounting for long-term contracts – principal factors
b	53.	Preferred method under ASPE
c	54.	Classification of progress billings and construction in process
a	55.	Disclosure of earned but unbilled revenues
b	56.	Disadvantage of using percentage-of-completion method

- c 57. Measuring progress of long-term contracts
- c 58. Measuring progress of long-term contracts
- c 59. Gross profit to be recognized using percentage-of-completion
- b 60. Gross profit to be recognized using percentage-of-completion
- b 61. Calculate cash collected on long-term construction contract
- d 62. Calculate gross profit using percentage-of-completion
- c 63. Gross profit to be recognized using percentage-of-completion
- b 64. Gross profit to be recognized using percentage-of-completion
- b 65. Gross profit to be recognized using percentage-of-completion
- c 66. Calculate total construction costs
- a 67. Application of the percentage-of-completion method
- d 68. Revenue, cost, and gross profit under completed-contract method
- c 69. Recognition of loss on long-term contract
- a 70. Completed-contract method
- b 71. Completed-contract method
- b 72. Measuring progress of long-term contracts
- c 73. Gross profit to be recognized using completed-contract method
- a 74. Gross profit to be recognized using completed-contract method
- c 75. Gross profit or loss to be recognized using completed-contract method
- d 76. Gross profit to be recognized using completed-contract method
- c 77. Reporting a current liability with completed-contract method
- a 78. Reporting assets under completed-contract method
- c 79. Definition of onerous contract
- a 80. Recognition of loss on long-term contract
- d 81. Recognition of loss on long-term contract
- c 82. Measuring progress of long-term contracts

EXERCISES

Item	Description
E6-83	Constructive obligation
E6-84	Economies of a transaction
E6-85	Concessionary terms
E6-86	Definitions
E6-87	Terminology
E6-88	Revenue recognition process
E6-89	Revenue recognition process
E6-90	Contract identification
E6-91	Contract identification
E6-92	Multiple Goods and Services - Warranties
E6-93	Breakage
E6-94	Upfront Fees

E6-95	Performance obligations
E6-96	Performance obligations
E6-97	Transaction price
E6-98	Allocate transaction price
E6-99	Discounted transaction price
E6-100	Bundled sales
E6-101	Contract-based approach
E6-102	Timing of revenue recognition
E6-103	Timing of revenue recognition/percentage of completion
E6-104	Percentage-of-completion method
E6-105	Risks & rewards of ownership
E6-106	Earnings approach to revenue recognition
E6-107	Percentage-of-completion method
E6-108	Bill-and-Hold arrangement
E6-109	Performance obligations and warranties
E6-110	Revenue recognition
E6-111	Consignment sale
E6-112	Reporting of gross or net revenues
E6-113	Presentation & the percentage-of-completion method
E6-114	Percentage-of-completion method
E6-115	Advantages and Disadvantages – Completed-Contract method

PROBLEMS

Item	Description
P6-116	Long-term contract (contract-based approach)
P6-117	Long-term construction project accounting
P6-118	Accounting for long-term construction contracts
P6-119	Percentage-of-completion and completed-contract methods
P6-120	Percentage-of-completion and completed-contract methods
P6-121	Completed-contract method
P6-122	Consignment sales
P6-123	Percentage-of-completion method
P6-124	Completed-contract method

MULTIPLE CHOICE

1. When dealing with sales agreements, “acquired” means

- a) consideration or rights to consideration.
- b) goods to be delivered in the future.
- c) dealing at arm’s length.
- d) measurement of the transaction.

Answer: a

Difficulty: Easy

Learning Objective: Understand the economics and legalities of selling transactions from a business perspective.

Section Reference: Understanding the Nature of Sales Transactions from a Business Perspective

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

2. If an entity sells on credit, the risk that the customer will not pay is called

- a) price risk.
- b) credit risk.
- c) commercial substance.
- d) credit policy.

Answer: b

Difficulty: Easy

Learning Objective: Understand the economics and legalities of selling transactions from a business perspective.

Section Reference: Understanding the Nature of Sales Transactions from a Business Perspective

CPA: Finance

CPA: Financial Reporting

CPA: Strategy and Governance

Bloomcode: Knowledge

AACSB: Analytic

3. 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 is a bona fide purchase and sale, and the entity's cash flows are expected to change.
- d) the transaction must involve tangible assets.

Answer: c

Difficulty: Easy

Learning Objective: Understand the economics and legalities of selling transactions from a business perspective.

Section Reference: Understanding the Nature of Sales Transactions from a Business Perspective

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

4. Terms negotiated by a party to the contract that are more favourable than normal are called

- a) credit terms.
- b) barter transactions.
- c) arm's length terms.
- d) concessionary terms.

Answer: d

Difficulty: Easy

Learning Objective: Understand the economics and legalities of selling transactions from a business perspective.

Section Reference: Understanding the Nature of Sales Transactions from a Business Perspective

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

5. Concessionary or abnormal terms may

- a) reflect that risks and reward has not yet passed to the customer.
- b) create additional recognition and measurement uncertainty.
- c) indicate that no sale has taken place at all.
- d) all of the above

Answer: d

Difficulty: Easy

Learning Objective: Understand the economics and legalities of selling transactions from a business perspective.

Section Reference: Understanding the Nature of Sales Transactions from a Business Perspective

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

6. In many cases, an entity may have an implicit obligation even if it is NOT explicitly noted in a sales contract. This is called a(n)

- a) onerous obligation.
- b) legal obligation.
- c) constructive obligation.
- d) earnings obligation.

Answer: c

Difficulty: Easy

Learning Objective: Understand the economics and legalities of selling transactions from a business perspective.

Section Reference: Understanding the Nature of Sales Transactions from a Business Perspective

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

7. 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.

Answer: b

Difficulty: Easy

Learning Objective: Understand the economics and legalities of selling transactions from a business perspective.

Section Reference: Understanding the Nature of Sales Transactions from a Business Perspective

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

8. Under the earnings approach for the sale of goods, which of the following would NOT be a reason to recognize revenue?

- a) The risks and rewards are transferred to the buyer.
- b) The vendor continues to have control over the goods sold.
- c) Collectability is reasonably assured.
- d) Costs and revenues can be reliably measured.

Answer: b

Difficulty: Easy

Learning Objective: Understand the economics and legalities of selling transactions from a business perspective.

Section Reference: Understanding the Nature of Sales Transactions from a Business Perspective

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

9. Under the earnings approach, revenue from selling products is generally recognized

- a) at the point of delivery.
- b) at the completion of production.
- c) after costs are recovered.
- d) as cash is collected.

Answer: a

Difficulty: Easy

Learning Objective: Understand the economics and legalities of selling transactions from a business perspective.

Section Reference: Understanding the Nature of Sales Transactions from a Business Perspective

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

10. A credit that is realized through an entity's ordinary activities would be treated as

- a) a gain.
- b) revenue.
- c) other income.
- d) other comprehensive income.

Answer: b

Difficulty: Easy

Learning Objective: Understand the economics and legalities of selling transactions from a business perspective.

Section Reference: Understanding the Nature of Sales Transactions from a Business Perspective

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

11. 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.

Answer: a

Difficulty: Easy

Learning Objective: Understand the economics and legalities of selling transactions from a business perspective.

Section Reference Understanding the Nature of Sales Transactions from a Business Perspective

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

12. Control of an asset normally coincides with

- a) transfer of possession to the buyer.
- b) transfer of legal title to the buyer.
- c) transfer of both possession and legal title to the buyer.
- d) the receipt of payment from the buyer.

Answer: c

Difficulty: Easy

Learning Objective: Understand the economics and legalities of selling transactions from a business perspective.

Section Reference: Understanding the Nature of Sales Transactions from a Business Perspective

Learning Objective: Identify the five steps in the revenue recognition process.

Section Reference: The Asset-Liability Approach to Revenue Recognition: An Overview of the Five-Step Process

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

13. The first step in the revenue recognition process under IFRS is

- a) determine the transaction price.
- b) identify the separate performance obligations of the contract.
- c) identify the contract with customers.
- d) allocate the transaction price to the separate performance obligations.

Answer: c

Difficulty: Easy

Learning Objective: Understand the economics and legalities of selling transactions from a business perspective.

Section Reference: Understanding the Nature of Sales Transactions from a Business Perspective

Learning Objective: Identify the five steps in the revenue recognition process.

Section Reference: Five-Step Process

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

14. Which of the following is NOT part of the definition of control?

- a) ability to direct use of the asset
- b) ability to obtain substantially all remaining benefits of the asset
- c) ability to return the asset to its original owner
- d) ability to prevent other companies from directing the use or receiving benefits from assets

Answer: c

Difficulty: Easy

Learning Objective: Understand the economics and legalities of selling transactions from a business perspective.

Section Reference: Understanding the Nature of Sales Transactions from a Business Perspective

Learning Objective: Understand how to recognize revenue when the company satisfies its performance obligation.

Section Reference: Recognizing Revenue When (or as) Each Performance Obligation Is Satisfied—Step 5

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

15. On January 1, 2020, Reggae Ltd. sold land that cost \$ 180,000 for \$ 240,000, receiving a note bearing interest at 10 percent. The note will be paid in three annual instalments of \$ 96,510 starting December 31, 2020. Assuming that collection of the note is very uncertain, how much revenue from this sale should Reggae recognize in 2020?

- a) \$ 0
- b) \$ 18,000
- c) \$ 24,000
- d) \$ 96,510

Answer: a

Difficulty: Medium

Learning Objective: Understand the economics and legalities of selling transactions from a business perspective.

Section Reference: Understanding the Nature of Sales Transactions from a Business Perspective

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: \$ 0

16. Halo Company entered into a contract with Ringo Corporation, in which Halo agreed to provide Ringo with building supplies. Ringo agreed to pay a total of \$ 27,000 at delivery. Under the contract-based view, Halo's *net contract position* can be assumed to be

- a) \$ 27,000.
- b) \$ 18,000.
- c) \$ 9,000.
- d) \$ 0.

Answer: d

Difficulty: Medium

Learning Objective: Understand the economics and legalities of selling transactions from a business perspective.

Section Reference: Understanding the Nature of Sales Transactions from a Business Perspective

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: \$ 0

Use the following information for questions 63–64.

On April 1, Heavy Metal Corp. consigned 50 handcrafted benches to Disco Co. Heavy Metal's cost was \$ 350 per bench. Total freight costs were \$ 700, which were paid by Disco. On August 1, Heavy Metal received a cheque for \$ 14,100 from Disco which included the following information:

Number of units sold:.....	20
Expenses deducted:	
Freight:.....	\$ 700
Commission (20% of sales price).....	?
Advertising.....	\$ 450
Delivery.....	\$ 290

17. Under the earnings approach, total sales were

- a) \$ 15,540.
- b) \$ 18,550.
- c) \$ 19,060.
- d) \$ 19,425.

Answer: d

Difficulty: Medium

Learning Objective: Understand the economics and legalities of selling transactions from a business perspective.

Section Reference: Understanding the Nature of Sales Transactions from a Business Perspective

Learning Objective: Analyze and determine whether a company has earned revenues under the earnings approach.

Section Reference: Earnings Approach to Revenue Recognition

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $80\% \text{ Sales} - \$ 700 - \$ 450 - \$ 290 = \$ 14,100$ (cheque received)

$80\% \text{ Sales} = \$ 15,540$

$\text{Sales} = \$ 19,425$

18. The inventory of benches will be reported on whose statement of financial position and at what amount?

- a) Heavy Metal's statement of financial position, \$ 10,500
- b) Heavy Metal's statement of financial position, \$ 10,920
- c) Disco's statement of financial position \$ 10,500
- d) Disco's statement of financial position, \$ 10,920

Answer: b

Difficulty: Medium

Learning Objective: Understand the economics and legalities of selling transactions from a business perspective.

Section Reference: Understanding the Nature of Sales Transactions from a Business Perspective

Learning Objective: Analyze and determine whether a company has earned revenues under the earnings approach.

Section Reference: Earnings Approach to Revenue Recognition

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $(\$ 350 \times 30) + (\$ 700 \times 30 \div 50) = \$ 10,920$

19. Blues Construction Corp. has consistently used the percentage-of-completion method. During 2020, Blues 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	
	2020	2021
Percentage of completion	15%	45%
Estimated total cost at completion	\$ 4,500,000	\$ 4,800,000
Gross profit recognized (cumulative)	225,000	540,000

Under the earnings approach, contract costs incurred during 2020 were

- a) \$ 1,440,000.
- b) \$ 1,485,000.
- c) \$ 1,575,000.
- d) \$ 2,160,000.

Answer: b

Difficulty: Medium

Learning Objective: Understand the economics and legalities of selling transactions from a business perspective.

Section Reference: Understanding the Nature of Sales Transactions from a Business Perspective

Learning Objective: Analyze and determine whether a company has earned revenues under the earnings approach.

Section Reference: Earnings Approach to Revenue Recognition

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $(\$ 4,800,000 \times 45\%) - (\$ 4,500,000 \times 15\%) = \$ 1,485,000$

Use the following information for questions 66–67.

A product and service are bundled together and sold to customers for \$ 450. The fair values of the product and service are \$ 350 and \$ 150 respectively.

20. The new IFRS standard, *IFRS 15 Revenue from Contracts with Customers* adopts a(n)

- a) earnings approach to revenue recognition.
- b) asset-liability approach to revenue recognition.
- c) cash-based approach to revenue recognition.
- d) earned and realized approach to revenue recognition.

Answer: b

Difficulty: Easy

Learning Objective: Identify the five steps in the revenue recognition process.

Section Reference: The Asset-Liability Approach to Revenue Recognition: An Overview of the Five-Step Process

Learning Objective: Identify differences in accounting between IFRS and ASPE and potential changes.

Section Reference: IFRS/ASPE Comparison

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

21. At the time of contract signing,

- a) no journal entry is recorded.
- b) a contract liability is recorded.
- c) a contract asset is recorded.
- d) a note to the financial statements must be included.

Answer: a

Difficulty: Easy

Learning Objective: Identify the contract with customers.

Section Reference: Identifying the Contract with Customers—Step 1

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

22. When contract modification occurs, and the company determines a new contract and performance obligation has resulted,

- a) the accounting for the original contract must be modified to reflect the new contract.
- b) the original contract remains the same.
- c) the new contract must be recorded separately.

d) Both b) and c) are correct.

Answer: d

Difficulty: Easy

Learning Objective: Identify the contract with customers.

23. To determine if a performance obligation exists,

- a) the company must provide a distinct product or service.
- b) a customer must be able to benefit from the product or service.
- c) Both a) and b) are correct.
- d) none of the above

Answer: c

Difficulty: Easy

Learning Objective: Identify the separate performance obligations in the contract.

Section Reference: Identifying Separate Performance Obligations—Step 2

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

24. Where there are potentially multiple performance obligations within a single contract, if products or services are interdependent and interrelated, they must be

- a) accounted for as multiple performance obligations.
- b) combined and reported as a single performance obligation.
- c) sold separately.
- d) combined under a new contract.

Answer: b

Difficulty: Easy

Learning Objective: Identify the separate performance obligations in the contract.

Section Reference: Identifying Separate Performance Obligations—Step 2

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

25. Under IFRS, when a vendor gives a volume rebate to a customer, the vendor should account for it as a(n)

- a) expense.
- b) reduction of revenue.
- c) reduction of inventory.
- d) other gain or loss.

Answer: b

Difficulty: Easy

Learning Objective: Determine the transaction price. .

Section Reference: Determining the Transaction Price—Step 3

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

26. When a vendor is exposed to continued risks of ownership because of potential return of the product, which of the following accounting procedures should NOT be used?

- a) recording the sale, and accounting for returns as they occur in future periods
- b) not recording the sale until all return privileges have expired
- c) recording the sale, but reducing revenue by an estimate of future returns
- d) recording the sale, but ignoring future returns

Answer: d

Difficulty: Easy

Learning Objective: Determine the transaction price.

Section Reference: Determining the Transaction Price—Step 3

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

27. Under the earnings approach, 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 if

- a) the market for returnable goods is untested.
- b) there is a transfer of the risks and rewards of ownership.
- c) the amount of future returns can be reasonably estimated.
- d) the amount of goods returned is likely to be high.

Answer: c

Difficulty: Easy

Learning Objective: Determine the transaction price.

Section Reference: Determining the Transaction Price—Step 3

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

28. The transaction price recorded by a company should be based on
- a) the expected value.
 - b) the most likely amount.
 - c) the amount agreed to under contract.
 - d) Both a) and b) are correct.

Answer: d

Difficulty: Easy

Learning Objective: Determine the transaction price.

Section Reference: Determining the Transaction Price—Step 3

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

29. Which of the following is NOT true with regard to the expected value approach to measuring earnings?
- a) It must be highly probable that there will not be a significant reversal of revenue previously recognized.
 - b) The company likely has experience with similar contracts.
 - c) It must be highly probable that there will be a significant reversal of revenue previously recognized.
 - d) The company is able to estimate the cumulative amount of net revenue.

Answer: c

Difficulty: Easy

Learning Objective: Determine the transaction price.

Section Reference: Determining the Transaction Price—Step 3

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

30. A returned asset should be recorded
- a) as a direct reduction to inventory.
 - b) in a separate account from inventory.
 - c) at the same value it was sold for, without considering impairment.
 - d) Silly question, returned assets aren't recorded.

Answer: b

Difficulty: Easy

Learning Objective: Determine the transaction price.

Section Reference: Determining the Transaction Price—Step 3

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

31. Under IFRS, where a right to return exists,
- a) sales returns and allowances are recognized as contra accounts to Revenues and Accounts Receivable.
 - b) a refund liability is recognized.
 - c) this right is disclosed in the financial statements; no accrual necessary.
 - d) this right does not need to be disclosed or accrued anywhere.

Answer: b

Difficulty: Easy

Learning Objective: Determine the transaction price.

Section Reference: Determining the Transaction Price—Step 3

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

32. Which of the following is NOT an acceptable allocation approach to transaction pricing?
- a) expected value approach
 - b) adjusted market assessment approach
 - c) expected cost plus a margin approach
 - d) residual approach

Answer: a

Difficulty: Easy

Learning Objective: Allocate the transaction price to the separate performance obligations.

Section Reference: Allocating the Transaction Price to Separate Performance Obligations—Step 4

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

33. When a company sells a bundle of goods or services, the selling price of the bundle
- a) will always be greater than the sum of individual stand-alone prices.
 - b) will always be equal to the sum of individual stand-alone prices.
 - c) may be less than the sum of individual stand-alone prices.
 - d) will always be less than the sum of individual stand-alone prices.

Answer: d

Difficulty: Easy

Learning Objective: Allocate the transaction price to the separate performance obligations.

Section Reference: Allocating the Transaction Price to Separate Performance Obligations—Step 4

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

34. Which of the following is NOT a scenario under which a company may recognize revenue over a period in time?

- a) The customer receives and consumes the benefits as the seller performs.
- b) The company's earnings would be more consistent under this approach.
- c) The customer controls the asset as it is created or enhanced.
- d) The company does not have an alternative use for the asset created or enhanced.

Answer: b

Difficulty: Easy

Learning Objective: Understand how to recognize revenue when the company satisfies its performance obligation.

Section Reference: Recognizing Revenue When (or as) Each Performance Obligation Is Satisfied—Step 5

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

35. The most popular input measure used to determine the progress toward completion in the event a company qualifies to recognize revenue over a period of time is

- a) cost-benefit basis.
- b) percentage-of-completion basis.
- c) cost-to-cost basis.
- d) collection basis.

Answer: c

Difficulty: Easy

Learning Objective: Understand how to recognize revenue when the company satisfies its performance obligation.

Section Reference: Recognizing Revenue When (or as) Each Performance Obligation Is Satisfied—Step 5

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

36. The actions a company takes to add value are referred to as the

- a) critical event.
- b) earnings approach.
- c) earnings process.
- d) risks and rewards of ownership.

Answer: c

Difficulty: Easy

Learning Objective: Analyze and determine whether a company has earned revenues under the earnings approach.

Section Reference: Earnings Approach to Revenue Recognition

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

37. If the earnings process has a critical event, it is often referred to as a

- a) point of delivery.
- b) constructive obligation.
- c) discrete earnings process.
- d) transfer of risks and rewards of ownership.

Answer: c

Difficulty: Easy

Learning Objective: Analyze and determine whether a company has earned revenues under the earnings approach.

Section Reference: Earnings Approach to Revenue Recognition

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

38. The earnings process

- a) is the same for every company.
- b) is unique to each company.
- c) is unique to each industry.
- d) Both b) and c) are correct.

Answer: d

Difficulty: Easy

Learning Objective: Analyze and determine whether a company has earned revenues under the earnings approach.

Section Reference: Earnings Approach to Revenue Recognition

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

39. Manson Construction Corp. has consistently used the percentage-of-completion method. In 2020, Manson started work on a \$ 10,500,000 construction contract that was completed in 2021. The following information was taken from Manson's 2020 accounting records:

Billings to date	\$ 3,300,000
Costs incurred	3,150,000
Collections to date	2,100,000
Estimated costs to complete	6,300,000

Under the earnings approach, what amount of gross profit should Manson recognize in 2020 on this contract?

- a) \$ 1,050,000
- b) \$ 700,000
- c) \$ 525,000
- d) \$ 350,000

Answer: d

Difficulty: Medium

Learning Objective: Analyze and determine whether a company has earned revenues under the earnings approach.

Section Reference: Earnings Approach to Revenue Recognition

Learning Objective: Apply the percentage-of-completion method for long-term contracts.

Section Reference: Percentage-of-Completion Method

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: \$ 3,150,000
 ————— × (\$ 10,500,000 – \$ 9,450,000) = \$ 350,000
 \$ 9,450,000

Use the following information to answers questions 69–70.

During 2020, Bing Corp. started a construction job with a total contract price of \$ 1,050,000. Bing has consistently used the completed contract method. The job was completed on December 15, 2021. Additional data are as follows:

<u>2020</u>	<u>2021</u>

Actual costs incurred	\$ 405,000	\$ 457,500
Estimated remaining costs	405,000	—
Billings to date	360,000	690,000
Collections to date	200,000	480,000

40. For 2020, what amount should Bing recognize as gross profit?

- a) \$ 0
- b) \$ 120,000
- c) \$ 142,500
- d) \$ 187,500

Answer: a

Difficulty: Medium

Learning Objective: Analyze and determine whether a company has earned revenues under the earnings approach.

Section Reference: Earnings Approach to Revenue Recognition

Learning Objective: Apply the completed contract method for long-term contracts.

Section Reference: Completed-Contract Method.

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: \$ 0

41. For 2021, what amount should Bing recognize as gross profit?

- a) \$ 0
- b) \$ 120,000
- c) \$ 142,500
- d) \$ 187,500

Answer: d

Difficulty: Medium

Learning Objective: Analyze and determine whether a company has earned revenues under the earnings approach.

Section Reference: Earnings Approach to Revenue Recognition

Learning Objective: Apply the completed contract method for long-term contracts.

Section Reference: Completed-Contract Method.

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: \$ 1,050,000 – \$ 405,000 – \$ 457,500 = \$ 187,500

42. Under a consignment arrangement, the risk that merchandise might NOT sell is
- a) held with the consignor.
 - b) held with the consignee.
 - c) shared by the consignor and the consignee.
 - d) There is no risk associated with goods held on consignment.

Answer: a

Difficulty: Easy

Learning Objective: Identify other revenue recognition issues.

Section Reference: Other Revenue Recognition Issues

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

43. 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.

Answer: b

Difficulty: Easy

Learning Objective: Identify other revenue recognition issues.

Section Reference: Other Revenue Recognition Issues

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

44. 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.

Answer: d

Difficulty: Easy

Learning Objective: Identify other revenue recognition issues.

Section Reference: Other Revenue Recognition Issues

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

45. 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.

Answer: a

Difficulty: Easy

Learning Objective: Identify other revenue recognition issues.

Section Reference: Other Revenue Recognition Issues

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

46. On June 1, Freedom Distributions (FD) shipped 100 TVs to Universal TV (UTV) on consignment. FD buys these TVs from their supplier for \$ 600 each and sells them to UTV for \$ 800. UTV then retails them for \$ 1,200 each. By the end of June, Universal TV reported that they had sold 60 of these TVs, and remitted the appropriate amount to FD. How much revenue should be recorded by FD in connection with this transaction?
- a) \$ 72,000
 - b) \$ 60,000
 - c) \$ 48,000
 - d) \$ 36,000

Answer: c

Difficulty: Medium

Learning Objective: Identify other revenue recognition issues.

Section Reference: Other Revenue Recognition Issues

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $60 \times \$ 800 = \$ 48,000$

47. A contract liability is often referred to as
- a) a contra-contract asset.
 - b) a performance obligation.

- c) unearned revenue.
- d) Both b) and c) are correct.

Answer: d

Difficulty: Easy

Learning Objective: Describe presentation and disclosure regarding revenue.

Section Reference: Presentation and Disclosure

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

48. Conditional rights should be reported on the statement of financial position

- a) as contract assets.
- b) as receivables.
- c) only once the conditions have been met.
- d) as contract liabilities.

Answer: a

Difficulty: Easy

Learning Objective: Describe presentation and disclosure regarding revenue.

Section Reference: Presentation and Disclosure

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

49. The appropriate approach to recognize long-term contract revenue under ASPE is

- a) earnings approach to revenue recognition.
- b) asset-liability approach to revenue recognition.
- c) cash-based approach to revenue recognition.
- d) earned and realized approach to revenue recognition.

Answer: a

Difficulty: Easy

Learning Objective: Identify differences in accounting between IFRS and ASPE and potential changes.

Section Reference: IFRS/ASPE Comparison

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

50. When there is a continuous earnings process, but the progress toward completion is not measurable, ASPE requires the use of the

- a) completed-contract method.
- b) percentage-of-completion method.
- c) zero-profit method.
- d) discrete earnings method.

Answer: a

Difficulty: Easy

Learning Objective: Apply the percentage-of-completion method for long-term contracts.

Section Reference: Percentage-of-Completion Method

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

51. Under ASPE, 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.

Answer: c

Difficulty: Easy

Learning Objective: Apply the percentage-of-completion method for long-term contracts.

Section Reference: Percentage-of-Completion Method

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

52. Under ASPE, when selecting an accounting method for a newly contracted long-term construction project, 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 can be made.
- 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.

Answer: b

Difficulty: Easy

Learning Objective: Apply the percentage-of-completion method for long-term contracts.

Section Reference: Percentage-of-Completion Method

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

53. Under ASPE, when work to be done and costs to be incurred on a long-term contract can be estimated reliably, which of the following methods of revenue recognition is preferable?

- a) instalment method
- b) percentage-of-completion method
- c) completed-contract method
- d) zero-profit method

Answer: b

Difficulty: Easy

Learning Objective: Apply the percentage-of-completion method for long-term contracts.

Section Reference: Percentage-of-Completion Method

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

54. Under the percentage-of-completion method, how should the balances of progress billings and construction in process be disclosed in the financial statements prior to the completion of the contract?

- a) progress billings as deferred income, construction in process as a deferred expense
- b) progress billings as income, construction in process as inventory
- c) net, as a current asset if a debit balance, and a current liability if a credit balance
- d) net, as income from construction if a credit balance, and loss from construction if a debit balance

Answer: c

Difficulty: Easy

Learning Objective: Apply the percentage-of-completion method for long-term contracts.

Section Reference: Percentage-of-Completion Method

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

55. Under the percentage-of-completion method, how should earned but unbilled revenues on a long-term contract be disclosed on the statement of financial position?
- a) as contract asset/liability in the current asset section
 - b) as contract asset/liability in the noncurrent asset section
 - c) as a receivable in the noncurrent asset section
 - d) in a note to the financial statements until the customer is formally billed for the portion of work completed

Answer: a

Difficulty: Easy

Learning Objective: Apply the percentage-of-completion method for long-term contracts.

Section Reference: Percentage-of-Completion Method

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

56. 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 a large amount of revenue was actually earned.
 - d) no revenue is recognized during the contract.

Answer: b

Difficulty: Easy

Learning Objective: Apply the percentage-of-completion method for long-term contracts.

Section Reference: Percentage-of-Completion Method

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

57. All of the following are disadvantages of input measures in measuring progress toward completion of long-term contracts EXCEPT
- a) inefficiencies may cause the productivity relationship to change.
 - b) front-end loading.
 - c) units are not comparable in time, effort, or cost to complete.
 - d) the measures are not universally applicable.

Answer: c

Difficulty: Easy

Learning Objective: Apply the percentage-of-completion method for long-term contracts.

Section Reference: Percentage-of-Completion Method

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

58. The principal disadvantage of output measures in measuring progress toward completion of long-term contracts is

- a) inefficiencies may cause the productivity relationship to change.
- b) front-end loading.
- c) units are not comparable in time, effort, or cost to complete.
- d) the measures are not universally applicable.

Answer: c

Difficulty: Easy

Learning Objective: Apply the percentage-of-completion method for long-term contracts.

Section Reference: Percentage-of-Completion Method

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

59. Haven Corp. contracted to construct a building for \$ 750,000. Construction began in 2020 and was completed in 2021. Data relating to the contract follow:

	Year ended December 31,	
	<u>2020</u>	<u>2021</u>
Costs incurred	\$ 300,000	\$ 230,000
Estimated costs to complete	200,000	—

Haven uses the percentage-of-completion method. For the calendar years 2020 and 2021, respectively, Haven should report gross profit of

- a) \$ 135,000 and \$ 85,000.
- b) \$ 450,000 and \$ 300,000.
- c) \$ 150,000 and \$ 70,000.
- d) \$ 0 and \$ 220,000.

Answer: c

Difficulty: Medium

Learning Objective: Apply the percentage-of-completion method for long-term contracts.

Section Reference: Percentage-of-Completion Method

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: \$ 300,000

$$\frac{\$ 300,000}{\$ 300,000 + \$ 200,000} \times (\$ 750,000 - \$ 500,000) = \$ 150,000$$

$$(\$ 750,000 - \$ 530,000) - \$ 150,000 = \$ 70,000$$

60. In 2020, Pop Construction Corp. began work on a contract for \$ 3,700,000. Other details follow:

	<u>2020</u>
Costs incurred during the year	\$ 1,800,000
Estimated costs to complete as of December 31.....	1,200,000
Billings during the year	1,650,000
Collections during the year.....	975,000

Pop uses the percentage-of-completion method. For calendar 2020, Pop should report gross profit of

- a) \$ 150,000.
- b) \$ 420,000.
- c) \$ 700,000.
- d) \$ 2,220,000.

Answer: b

Difficulty: Medium

Learning Objective: Apply the percentage-of-completion method for long-term contracts.

Section Reference: Percentage-of-Completion Method

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: \$ 1,800,000

$$\frac{\$ 1,800,000}{\$ 1,800,000 + \$ 1,200,000} \times (\$ 3,700,000 - \$ 3,000,000) = \$ 420,000$$

Use the following information for questions 74–75.

In 2020, Cement Inc. began a three year construction contract for \$ 3,500,000. Cement uses the percentage-of-completion method. 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 presentation relating to this contract for calendar 2020 follow:

Statement of Financial Position

Current assets:

Accounts receivable \$ 150,000

Contract asset/liability.....	105,000
(Contract costs \$425,000 less Billings of \$320,000)	
<u>Income Statement</u>	
Income (before tax) on the contract recognized in 2020	\$ 105,000

61. How much cash was collected in 2020 on this contract?

- a) \$ 25,000
- b) \$ 170,000
- c) \$ 200,000
- d) \$ 300,000

Answer: b

Difficulty: Medium

Learning Objective: Apply the percentage-of-completion method for long-term contracts.

Section Reference: Percentage-of-Completion Method

CPA: Financial Reporting

Bloomcode: Application

Feedback: \$ 320,000 – \$ 150,000 = \$ 170,000

AACSB: Analytic

62. What was the initial estimated gross profit on this contract?

- a) \$ 381,430
- b) \$ 405,231
- c) \$ 650,204
- d) \$ 864,703

Answer: d

Difficulty: Medium

Learning Objective: Apply the percentage-of-completion method for long-term contracts.

Section Reference: Percentage-of-Completion Method

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: \$ 425,000 – \$ 105,000 = \$ 320,000

$$\frac{\$ 320,000}{\text{Total estimated cost}} \times (\$ 3,500,000 - \text{Total estimated cost}) = \$ 105,000$$

$$\begin{aligned} \text{Total estimated cost} &= \$ 2,635,294 \\ \$ 3,500,000 - \$ 2,635,294 &= \$ 864,706 \end{aligned}$$

63. Mobey Construction Corp. uses the percentage-of-completion method. In 2020, Mobey began work on a contract for \$ 2,475,000 which was completed in 2021. Data on the costs are:

	Year Ended December 31	
	<u>2020</u>	<u>2021</u>
Costs incurred	\$ 877,500	\$ 630,000
Estimated costs to complete	585,000	—

For the calendar years 2020 and 2021, Mobey should recognize gross profit of

	<u>2020</u>	<u>2021</u>
a) \$ 0		\$ 967,500
b) \$ 580,500		\$ 387,000
c) \$ 607,500		\$ 360,000
d) \$ 607,500		\$ 967,500

Answer: c

Difficulty: Medium

Learning Objective: Apply the percentage-of-completion method for long-term contracts.

Section Reference: Percentage-of-Completion Method

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: \$ 877,500
 ————— × (\$ 2,475,000 – \$ 1,462,500) = \$ 607,500
 \$ 1,462,500

(\$ 2,475,000 – \$ 1,507,500) – \$ 607,500 = \$ 360,000

Use the following information for questions 77–78.

Hemsworth Ltd. began work in 2020 on a contract for \$ 960,000. Other details follow:

	<u>2020</u>	<u>2021</u>
Costs incurred during the year	\$ 160,000	\$ 490,000
Estimated costs to complete as of December 31.....	480,000	0
Billings during the year	180,000	720,000
Collections during the year.....	150,000	975,000

64. Assume that Hemsworth uses the percentage-of-completion method of accounting. The portion of the total gross profit to be recognized in 2020 is

- a) \$ 60,000.
- b) \$ 80,000.
- c) \$ 240,000.

d) \$ 320,000.

Answer: b

Difficulty: Medium

Learning Objective: Apply the percentage-of-completion method for long-term contracts.

Section Reference: Percentage-of-Completion Method

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: \$ 160,000
 ———— × (\$ 960,000 – \$ 640,000) = \$ 80,000
 \$ 640,000

65. Classical Ltd. Began work in 2020 on a contract for \$ 1,250,000. Other data are:

	<u>2020</u>	<u>2021</u>
Costs incurred to date.....	\$ 540,000	\$ 335,000
Estimated costs to complete as of December 31.....	360,000	—
Billings to date	420,000	1,250,000
Collections to date	300,000	1,000,000

If Classical uses the percentage-of-completion method, the gross profit to be recognized in 2020 is

- a) \$ 450,000.
- b) \$ 210,000.
- c) \$ 200,000.
- d) \$ 100,000.

Answer: b

Difficulty: Medium

Learning Objective: Apply the percentage-of-completion method for long-term contracts.

Section Reference: Percentage-of-Completion Method

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: \$ 540,000
 ———— × (\$ 1,250,000 – \$ 900,000) = \$ 210,000
 \$ 900,000

66. A project 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 \$ 3,500,000. Assuming that total gross profit of \$ 1,200,000 was recognized throughout the contract, total construction costs were

- a) \$ 4,600,000.
- b) \$ 3,500,000.
- c) \$ 2,300,000.
- d) \$ 2,100,000.

Answer: c

Difficulty: Medium

Learning Objective: Apply the percentage-of-completion method for long-term contracts.

Section Reference: Percentage-of-Completion Method

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 3,500,000 - \$ 1,200,000 = \$ 2,300,000$

67. At the end of year 2, the accounting records for a multi-year construction project indicate actual costs incurred to date of \$ 3,200,000, and the most recent estimate of total costs of \$ 9,500,000. Assuming the percentage-of completion method is used, to one decimal, at the end of year 2 the project is

- a) 33.7% complete.
- b) 31.2% complete.
- c) 26.1% complete.
- d) 25.2% complete.

Answer: a

Difficulty: Medium

Learning Objective: Apply the percentage-of-completion method for long-term contracts.

Section Reference: Percentage-of-Completion Method

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 3,200,000 \div \$ 9,500,000 = 33.7\%$

68. Under the completed-contract method,

- a) revenue, costs, and gross profit are recognized during the contract.
- b) revenue and costs are recognized during the contract, but gross profit recognition is deferred until the contract is completed.
- c) costs are recognized during the contract, but revenue and gross profit are not.
- d) revenue, costs and gross profit are not recognized until the contract is finished.

Answer: d

Difficulty: Easy

Learning Objective: Apply the completed-contract method for long-term contracts.

Section Reference: Completed-Contract Method

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

69. 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.

Answer: c

Difficulty: Easy

Learning Objective: Apply the completed-contract method for long-term contracts.

Section Reference: Completed-Contract Method

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

70. The completed contract method for accounting for long-term construction projects requires that

- a) no revenue is recognized until the project is completed.
- b) costs are accumulated and revenue is recognized in proportion to cash collected.
- c) gross profit is calculated each period, but deferred until the end of the contract.
- d) revenue is calculated each period, but deferred until the end of the contract.

Answer: a

Difficulty: Easy

Learning Objective: Apply the completed-contract method for long-term contracts.

Section Reference: Completed-Contract Method

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

71. 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 at the end of the contract.
- b) Revenues are recognized evenly throughout the contract.
- c) Gross profit is recognized at the end of the contract.
- d) Losses are recognized immediately.

Answer: b

Difficulty: Easy

Learning Objective: Apply the completed-contract method for long-term contracts.

Section Reference: Completed-Contract Method

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

72. Which of the following statements regarding the completed contract method is NOT true?

- a) The company makes the same annual entries to record costs of construction, progress billings, and collections from customers as those under the percentage-of-completion method.
- b) The company makes the same entries to recognize revenue as those under the percentage-of-completion method.
- c) The company makes different entries to recognize revenue than under the percentage-of-completion method.
- d) Losses on an unprofitable contract are immediately recorded.

Answer: b

Difficulty: Easy

Learning Objective: Apply the completed-contract method for long-term contracts.

Section Reference: Completed-Contract Method

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

73. Assume that Hemsworth uses the completed-contract method of accounting. The portion of the total gross profit to be recognized in 2021 is

- a) \$ 120,000.
- b) \$ 180,000.
- c) \$ 310,000.
- d) \$ 960,000.

Answer: c

Difficulty: Medium

Learning Objective: Apply the completed contract method for long-term contracts.

Section Reference: Completed-Contract Method.

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 960,000 - \$ 650,000 = \$ 310,000$

74. Classical Ltd. Began work in 2020 on a contract for \$ 1,250,000. Other data are:

	<u>2020</u>	<u>2021</u>
Costs incurred to date.....	\$ 540,000	\$ 335,000
Estimated costs to complete as of December 31.....	360,000	—
Billings to date	420,000	1,250,000
Collections to date	300,000	1,000,000

If Classical uses the completed-contract method, the gross profit to be recognized in 2021 is

- a) \$ 375,000.
- b) \$ 400,000.
- c) \$ 850,000.
- d) \$ 1,000,000.

Answer: a

Difficulty: Medium

Learning Objective: Apply the completed-contract method for long-term contracts.

Section Reference: Completed-Contract Method

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 1,250,000 - \$ 875,000 = \$ 375,000$

75. Bluegrass Builders Ltd. Is using the completed-contract method for a \$ 2,000,000 contract that will take two years to complete. Data at December 31, 2020, the end of the first year, are

Costs incurred to date.....	\$ 925,000
Estimated costs to complete	1,100,000
Billings to date	850,000
Collections to date	700,000

The gross profit or loss that should be recognized for 2020 is

- a) \$ 50,000 gross profit.
- b) \$ 25,000 gross profit.
- c) \$ 25,000 loss.
- d) \$ 0.

Answer: c

Difficulty: Medium

Learning Objective: Apply the completed-contract method for long-term contracts.

Section Reference: Completed-Contract Method

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$2,000,000 - (\$925,000 + \$1,100,000) = (\$25,000)$ loss; must be recognized in current year.

Use the following information for questions 84–86.

Folk Construction Corp. began operations in 2020. Construction activity for 2020 is shown below. Folk uses the completed-contract method.

Contract	Contract Price	Billings Through	Collections Through	Estimated Costs to	
		12/31/20	12/31/20	12/31/20Complete	
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

76. Which of the following should be shown on the income statement for 2020 related to Contract 1?

- a) gross profit, \$180,000
- b) gross profit, \$240,000
- c) gross profit, \$400,000
- d) gross profit, \$420,000

Answer: d

Difficulty: Medium

Learning Objective: Apply the completed-contract method for long-term contracts.

Section Reference: Completed-Contract Method

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$1,280,000 - \$860,000 = \$420,000$

77. Which of the following should be shown on the statement of financial position at December 31, 2020 related to Contract 2?

- a) inventory, \$272,000
- b) inventory, \$328,000

- c) liability, \$ 272,000
- d) liability, \$ 600,000

Answer: c

Difficulty: Medium

Learning Objective: Apply the completed-contract method for long-term contracts.

Section Reference: Completed-Contract Method

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 600,000 - \$ 328,000 = \$ 272,000$

78. Which of the following should be shown on the statement of financial position at December 31, 2020 related to Contract 3?

- a) current asset contract asset/liability, \$ 140,000
- b) current liability contract asset/liability, \$ 60,000
- c) accounts receivable, \$ 760,000
- d) current asset contract asset/liability, \$ 80,000

Answer: d

Difficulty: Medium

Learning Objective: Apply the completed-contract method for long-term contracts.

Section Reference: Completed-Contract Method

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: Overall loss expected: $(\$900,000 + \$480,000) - \$1,320,000 = \$60,000$

$\$900,000 - \$760,000 = \$140,000$ less loss of \$60,000 = \$80,000

79. When a contract becomes unprofitable to an entity, this is called a(n)

- a) uncompleted contract.
- b) zero-profit contract.
- c) onerous contract.
- d) unenforceable contract.

Answer: c

Difficulty: Easy

Learning Objective: Account for losses on long-term contracts.

Section Reference: Losses on Long-Term Contracts.

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

80. 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 used.
- 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 used.

Answer: a

Difficulty: Easy

Learning Objective: Account for losses on long-term contracts.

Section Reference: Losses on Long-Term Contracts.

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

81. Losses on unprofitable long-term construction projects

- a) are generally deferred until the contract is complete.
- b) are only recognized immediately under the completed-contract method.
- c) are only recognized immediately under the percentage-of-completion method.
- d) are recognized immediately under both the completed-contract method and the percentage-of-completion method.

Answer: d

Difficulty: Easy

Learning Objective: Account for losses on long-term contracts.

Section Reference: Losses on Long-Term Contracts.

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

82. Losses in a current period on a profitable contract

- a) are generally deferred until the contract is complete.
- b) are only recognized immediately under the completed-contract method.

- c) are only recognized immediately under the percentage-of-completion method.
- d) are recognized immediately under both the completed-contract method and the percentage-of-completion method.

Answer: c

Difficulty: Easy

Learning Objective: Account for losses on long-term contracts.

Section Reference: Losses on Long-Term Contracts.

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

EXERCISES

Ex. 6-83 Constructive obligation

Picot Ltd. Sells goods with \$ 200 with a standard return policy. The policy states customers may return goods within 30 days of purchase if defective. This policy is stated on the bill and contract; however, Picot advertises that it stands by its products 100%. In the past, they have been known to accept returns beyond the 30 day return policy. Sally made her purchase from Picot 45 days ago and now wishes to return it.

Instructions

Discuss whether Picot has an obligation to accept Sally's return. Explain your answer.

Solution 6-83

Yes, Picot has an obligation to accept customer returns for any reason at any time because it has created an expectation. This is known as a constructive obligation.

Difficulty: Easy

Learning Objective: Understand the economics and legalities of selling transactions from a business perspective.

Section Reference: Understanding the Nature of Sales Transactions from a Business Perspective

CPA: Communication

CPA: Financial Reporting
Bloomcode: Comprehension
AACSB: Communication

Ex. 6-84 Economics of a transaction

The following are independent situations that require professional judgement for determining when to recognize revenue from the transactions.

1. Volkswagen sells all its vehicles with the promise that any service required in the first year of ownership will be free of charge.
2. Walmart sells you a new wardrobe online. The wardrobe is shipped and arrives in November, and you charge it to your Walmart credit card. In December, you receive your Walmart credit card statement and pay the amount due.
3. Norwegian Cruise lines sells you a 10-day Mediterranean cruise. The cost includes your transportation (of course), room and board, and meals and entertainment on the ship. Shore excursions are an additional cost.
4. You go back to Walmart and buy some hangers and socks to go in your new wardrobe. You pay with cash.
5. Students pre-register for online classes at Royal Roads University year round, one month in advance of their course start-date.
6. In February, Splashes sells dishwashers with 3 year extended warranties. The dishwashers are delivered in April, and payment is due upon delivery. Warranty plans are normally sold separately.

Instructions

For each scenario, identify what is being “sold”: goods, services, or a combination.

Solution 6-84

1. Combination. The car is a goods, while the promised service is a service.
2. Combination. The wardrobe is a good. By using Walmart’s credit card, you have also used their credit-lending services.
3. Combination. The room is a good (though if cleaned, part of the room is a service). The food is part good/part service. Entertainment is a service. Transportation is a service.
4. Good
5. Service
6. Combination

Difficulty: Medium

Learning Objective: Understand the economics and legalities of selling transactions from a business perspective.

Section Reference: Understanding the Nature of Sales Transactions from a Business Perspective

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 6-85 Concessionary terms

Explain what concessionary terms are, and give four examples.

Solution 6-85

Concessionary terms are terms that are more favourable than normal. This is often seen when supply exceeds demand, and the buyer can negotiate a better deal than usual.

Examples include:

1. Deep discounts on selling price
2. Looser credit policy (e.g. giving the customer a longer period to pay)
3. Extended trial periods, with the sale subject to customer acceptance after the trial period
4. Seller provides ongoing or additional services that are beyond normal practice
5. Extended warranties or free warranties
6. More lenient (looser) return policies than normal

Difficulty: Easy

Learning Objective: Understand the economics and legalities of selling transactions from a business perspective.

Section Reference: Understanding the Nature of Sales Transactions from a Business Perspective

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 6-86 Definitions

Provide clear, concise answers for the following:

1. Explain the conceptual difference between the earnings approach and the contract-based approach 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 allowed under ASPE?
6. Why is it important to understand the business perspective of selling transactions?
7. Explain the term *onerous contracts* and its implications.

Solution 6-86

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, the transaction can be measured, 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 ASPE 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.

Difficulty: Easy

Learning Objective: Understand the economics and legalities of selling transactions from a business perspective.

Section Reference: Understanding the Nature of Sales Transactions from a Business Perspective

Learning Objective: Identify the five steps in the revenue recognition process.

Section Reference: The Asset-Liability Approach to Revenue Recognition: An Overview of the Five-Step Process

Learning Objective: Identify the contract with customers.

Section Reference: Identifying the Contract with Customers—Step 1

Learning Objective: Identify the separate performance obligations in the contract.

Section Reference: Identifying Separate Performance Obligations—Step 2

Learning Objective: Understand how to recognize revenue when the company satisfies its performance obligation.

Section Reference: Recognizing Revenue When (or as) Each Performance Obligation Is Satisfied—Step 5

Learning Objective: Analyze and determine whether a company has earned revenues under the earnings approach.

Section Reference: Earnings Approach to Revenue Recognition

Learning Objective: Identify other revenue recognition issues.

Section Reference: Other Revenue Recognition Issues

Learning Objective: Apply the percentage-of-completion method for long-term contracts.

Section Reference: Percentage-of-Completion Method

Learning Objective: Apply the completed-contract method for long-term contracts.

Section Reference: Completed-Contract Method

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 6-87 Terminology

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

1. A contract that is no longer profitable to the company. _____
2. An entity may have an implicit obligation even if it is not explicitly noted in the sales contract. _____
3. Sales that are comprised of several individual components. _____
4. The party acting as an agent for the seller. _____
5. The method to allocate sales prices to individual components of a sales bundle where the fair value of the undelivered item is subtracted from the overall purchase price. _____
6. The method used to account for long-term contracts that do not recognize profits before the completion _____

of the project.

7. The account used in the percentage-of completion and completed-contract methods to accumulate costs and recognize profits. _____
8. Cash or other assets an entity receives in return for the provision of goods or services. _____
9. The actions a company takes to add value. _____

Solution 6-87

1. onerous
2. constructive obligation
3. bundled sales
4. consignee
5. residual value method
6. completed-contract method
7. construction in process account
8. consideration
9. earnings process

Difficulty: Easy

Learning Objective: Understand the economics and legalities of selling transactions from a business perspective.

Section Reference: Understanding the Nature of Sales Transactions from a Business Perspective

Learning Objective: Identify the five steps in the revenue recognition process.

Section Reference: The Asset-Liability Approach to Revenue Recognition: An Overview of the Five-Step Process

Learning Objective: Identify the contract with customers.

Section Reference: Identifying the Contract with Customers—Step 1

Learning Objective: Identify the separate performance obligations in the contract.

Section Reference: Identifying Separate Performance Obligations—Step 2

Learning Objective: Understand how to recognize revenue when the company satisfies its performance obligation.

Section Reference: Recognizing Revenue When (or as) Each Performance Obligation Is Satisfied—Step 5

Learning Objective: Analyze and determine whether a company has earned revenues under the earnings approach.

Section Reference: Earnings Approach to Revenue Recognition

Learning Objective: Identify other revenue recognition issues.

Section Reference: Other Revenue Recognition Issues

Learning Objective: Apply the percentage-of-completion method for long-term contracts.

Section Reference: Percentage-of-Completion Method

Learning Objective: Apply the completed-contract method for long-term contracts.

Section Reference: Completed-Contract Method

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

Ex. 6-88 Revenue recognition process

Assume that Bombardier Inc. signs a contract to sell light-rail-transit (LRT) vehicles to the Region of Waterloo for \$ 15 million.

Instructions

Using this transaction as an example, illustrate the five steps in the revenue recognition process for Bombardier.

Solution 6-88

1. A contract is an agreement between two parties that creates enforceable rights or obligations. In this case, Bombardier has signed a contract to deliver LRT vehicles to Waterloo.
2. Bombardier has only one performance obligation: to deliver LRT vehicles to Waterloo.
3. Transaction price is the amount of consideration that a company expects to receive from a customer in exchange for transferring a good or service. In this case, the transaction price is straightforward. It is \$ 15 million.
4. In this case, Bombardier has only one performance obligation, to deliver LRT vehicles to the Region of Waterloo.

5. Bombardier recognizes revenue of \$ 15 million for the sale of LRT vehicle when it satisfies its performance obligation, the delivery of the LRT vehicles to the Region of Waterloo.

Difficulty: Easy

Learning Objective: Identify the five steps in the revenue recognition process.

Section Reference: The Asset-Liability Approach to Revenue Recognition: An Overview of the Five-Step Process

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 6-89 Revenue recognition process

How would your answer to Exercise 6-92 change if Bombardier had also contracted to maintain the LRT vehicles for the Region of Waterloo?

Solution 6-89

1. Bombardier may have signed two contracts, or the maintenance could be included in the initial contract. Either way they should acknowledge that one deliverable is relatively punctuated and the other is long-term.
2. A separate performance obligation is recorded for the promise to maintain the cars in whatever magnitude of cost the expected maintenance is anticipated to create.
3. The transaction price would need to be estimated unless, for example, a flat annual rate were set out in the original contract.
4. In this case, Bombardier has two performance obligations – to deliver LRT vehicles and to maintain them.
5. Bombardier recognizes revenue of \$ 15 million for the sale of LRT vehicle when it satisfies its performance obligation, the delivery of the LRT vehicles to the Region of Waterloo. Cost relating to the service portion of the contract would be recognizes as service is provided, or with the passage of time, depending on the terms of the contract.

Difficulty: Easy

Learning Objective: Identify the five steps in the revenue recognition process.

Section Reference: The Asset-Liability Approach to Revenue Recognition: An Overview of the Five-Step Process

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 6-90 Contract identification

Coffee Co. enters into a contract to delivery coffee to the House of Commons on July 1, 2020. The House agrees to pay the full price of \$ 3,000 on August 1, 2020. The cost of goods is \$ 1,400. Coffee Co. delivers the coffee to the House on July 1, 2020 and receives payment on August 1, 2020.

Instructions

Prepare the journal entries for Coffee Co. related to this contract.

Solution 6-90

On July 1, 2020, Coffee Co. delivers and therefore should recognize the revenue on that date because it satisfies the performance obligation by delivering the coffee to the House. There is now an unconditional right to receive the payment (and therefore an accounts receivable)

The journal entry to record the sale and related cost of goods sold is as follows:

July 1, 2020

Accounts Receivable	3,000	
Sales Revenue		3,000
Costs of Goods Sold	1,400	
Inventory		1,400

After receiving payment on August 1, 2020, Coffee Co makes the following entry:

August 1, 2020

Cash	3,000	
Accounts Receivable		3,000

Difficulty: Medium

Learning Objective: Identify the contract with customers.

Section Reference: Identifying the Contract with Customers—Step 1

Learning Objective: Describe presentation and disclosure regarding revenue.

Section Reference: Presentation and Disclosure

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex 6-91 Contract identification

Tiger Ltd. has an ongoing contract with to deliver 700 stripes to Orange Inc. over a seven-month period for \$ 7,000. After 400 stripes have been delivered, Tiger modifies the contract by promising to delivery 140 more stripes for \$ 1,120, or \$ 8 per stripe (which is the stand-alone selling price of stripes at the time of contract modification). Tiger regularly sells stripes separately.

Instructions

Will the additional promise be considered part of the original contract? Explain.

Solution 6-91

In this situation, the contract modification for the additional 140 stripes is, in effect, a new and separate contract because it meets both of the conditions:

1. The promised goods or services are distinct
2. The price increased by an amount of consideration that reflects the stand-alone selling price of the promised goods or services (in this case, the stripes).

It does not affect the accounting for the original service.

Difficulty: Easy

Learning Objective: Identify the contract with customers.

Section Reference: Identifying the Contract with Customers—Step 1

Learning Objective: Describe presentation and disclosure regarding revenue.

Section Reference: Presentation and Disclosure

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

Ex 6-92

Appliance Plus sold 1,000 refrigerators during 2020 at a total price of \$ 1,620,000, with a warranty guarantee that the product was free from any defects. The cost of the refrigerators sold was \$ 1,080,000. The term of the assurance warranty is one year, with an estimated cost of \$ 10,000. In addition, Appliance Plus sold extended warranties on 600 refrigerators for four years beyond the one-year period for \$ 210,000.

Instructions

Prepare the journal entries to record the sale and related warranties for 2020.

Solution 6-92

Cash	1,830,000	
Warranty Expense	10,000	
Warranty Liability		10,000
Unearned Revenue		210,000
Sales Revenue	1,620,000	
<i>(To record revenue and liabilities related to the warranties)</i>		
Cost of Goods Sold	1,080,000	
Inventory		1,080,000

(To reduce inventory and recognize cost of goods sold)

Difficulty: Medium

Learning Identify the separate performance obligations in the contract.

Section Reference: Identifying Separate Performance Obligations – Step 2.

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex 6-93

What does “breakage” refer to in terms of loyalty points or gift certificates?

Solution 6-93

Often only a percentage of the total value of loyalty points or gift certificates will be redeemed by a customer. The unredeemed amount of loyalty points or gift certificates awarded by a company, is known as breakage.

Difficulty: Easy

Learning Identify the separate performance obligations in the contract.

Section Reference: Identifying Separate Performance Obligations – Step 2

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

Ex 6-94

Explain what upfront fees are, and give three examples.

Solution 6-94

Companies sometimes receive payments from customers before they deliver a product or perform a service which are referred to as upfront fees. Upfront payments generally relate to the initiation, activation, or set-up of a good or service to be provided or performed in the future. In most cases, these upfront payments are non-refundable.

Examples include:

1. Fees paid for membership in a health club or buying club
2. Activation fees for phone, Internet, or cable
3. Gift cards

Difficulty: Easy

Learning Identify the separate performance obligations in the contract.

Section Reference: Identifying Separate Performance Obligations – Step 2.

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 6-95 Performance obligations

Trikonasana Inc. enters into a contract to design and build a bridge connecting a busy downtown core to a shoreline across the way that is home to many commuters. Trikonasana is responsible for overall management of the project and identifies various goods and services to be provided, including engineering, site clearance, foundation, procurement, construction of the structure, and so on.

Instructions

Under IFRS, does Trikonasana have a single performance obligation to the city in this revenue arrangement?

Solution 6-95

The overall management of the bridge construction project and the construction itself are interdependent, and therefore should be accounted for as one performance obligation.

Difficulty: Easy

Learning Objective: Identify the separate performance obligations in the contract.

Section Reference: Identifying Separate Performance Obligations—Step 2

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 6-96 Performance obligations

Island Foods Inc. has a promotional program whereby for every \$ 10 spent in store, customers receive stamps which can later be redeemed for knives and cookware.

Instructions

Under IFRS does Island Foods have a single performance obligation to its customers in this revenue arrangement?

Solution 6-96

For the items customers buy in store, Island Foods has fulfilled its performance obligation. The rights associated with the stamps are essentially giving the customer future items for free and should be treated as separate performance obligations as they provide the customer with a right they would otherwise not be entitled to (i.e., Without the stamps they would need

to pay for such knives and cookware). A portion of the customer's bill is hence advance payment for future goods and services, and the transaction price must be allocated accordingly, between the two separate performance obligations.

Difficulty: Easy

Learning Objective: Identify the separate performance obligations in the contract.

Section Reference: Identifying Separate Performance Obligations—Step 2

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 6-97 Transaction price

Presented below are three revenue recognition situations:

- a) Bliss sells goods to Jusu for \$ 10,000 payment due at delivery.
- b) Bliss sells goods on account to Saanich for \$ 23,000 payment due in 30 days.
- c) Bliss sells goods to Nourish for \$ 50,000 due in two instalments: the first instalment payable in 20 months, and the second payment due 4 months later. The present value of the future payments is \$ 47,000.

Instructions

Indicate the transaction price for each of these transactions and when revenue will be recognized.

Solution 6-97

- a) \$ 10,000 recognized at time of delivery.
- b) \$ 23,000 recognized at time of delivery, less any allowance to account for estimated bad debts.
- c) \$ 47,000 recognized at the time of delivery/ sale. The \$ 3,000 imputed interest income will be recognized with the passage of time at the imputed rate, which discounts the payments (\$ 50K) to the current value of \$ 47K.

Difficulty: Medium

Learning Objective: Determine the transaction price.

Section Reference: Determining the Transaction Price—Step 3

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Exercise 6-98 Allocate transaction price

Periwinkle Company manufactures equipment. Periwinkle's products range from simple automated machinery to complex systems containing numerous components. Unit selling prices range from \$ 140,000 to \$ 1,200,000 and are quoted inclusive of installation. The installation process does NOT involve changes to the features of the equipment to perform specifications. Periwinkle has the following relationship with Rose Inc.

- Rose can purchase equipment from Periwinkle for a price of \$ 200,000 and contracts with Periwinkle to install the equipment. Using market data, Rose determines installation service is estimated to have a fair value of \$ 20,000. The cost of the equipment is \$ 78,000.
- Rose is obligated to pay Periwinkle the \$ 200,000 upon delivery and installation of the equipment.

Periwinkle delivers the equipment on August 1, 2020, and completes the installation of the equipment on October 1, 2020. The equipment has a useful life of 7 years. Assume the equipment and the installations are two distinct performance obligations that should be accounted for separately.

Instructions

- How should the transaction price of \$ 200,000 be allocated among the service obligations?
- Prepare the journal entries for Periwinkle for this revenue arrangement for 2020, assuming Periwinkle receives payment when installation is completed.

Solution 6-98

- Having been provided the market value of the installation, the residual approach is used here, and allocation is as follows:

\$ 20,000	Installation
\$ 180,000	Equipment

- Journal Entries

August 1, 2020: Equipment Delivery

Accounts Receivable	180,000	
Sales Revenue		180,000
Cost of Equipment Sold	78,000	
Equipment Inventory		78,000

October 1, 2020: Equipment Installation

Cash	200,000	
Installation Revenue		20,000
Accounts Receivable		180,000

If there was a cost of labour associated with installation, we would record that here, too; however, this information was not provided in the question.

Difficulty: Medium

Learning Objective: Allocate the transaction price to the separate performance obligations.
 Section Reference: Allocating the Transaction Price to Separate Performance Obligations—
 Step 4

CPA: Communication

CPA: Financial Reporting

Bloomcode: Application

AACSB: Communication

Ex. 6-99 Discounted transaction price

Gabby Inc., is selling tickets to a conference. In addition, Gabby offers an online course. Online courses are often sold separately at a rate of \$ 259 per course.

<u>Item</u>	<u>Stand-alone Selling Price</u>	<u>Price when Bundled</u>
Conference	\$ 60	
Course	<u>\$ 249</u>	
Both		<u>\$ 185</u>
Total	\$ 309	\$ 185

Instructions

How should the discount be allocated to the elements of the revenue arrangement?

Solution 6-99

In this case, the discount applies to the performance obligations related to providing the course. As a result, Gabby allocates the discount solely to the course, as follows:

	<u>Allocated Amounts</u>
Courses	\$ 125
Conference	60

Difficulty: Medium

Learning Objective: Allocate the transaction price to the separate performance obligations.
 Section Reference: Allocating the Transaction Price to Separate Performance Obligations—
 Step 4

CPA: Communication

CPA: Financial Reporting

Bloomcode: Application

AACSB: Communication

Ex. 6-100 Bundled sales

Canucks Inc., a software company sells new accounting software and user support bundled together. The fair value of the software is \$ 1,500 and the fair value of the user support is \$ 500. The user support is valid for a period of 12 months from the date of software purchase. To be able to compete with a competitor's offering, Loon decided to sell the bundle at a discount for \$ 1,800.

During its first month of sales, 100 units of this software bundle were sold at the discounted price, and expenses were \$ 50,000.

Instructions

- Calculate the sale price that should be allocated to each component of the bundle using the adjusted market assessment approach.
- Calculate the sale price that should be allocated to each component of the bundle using the residual approach.
- Assuming that the relative fair value method is used and income tax rate is 30%, calculate the net income applicable to Loon's first month of sales.

Solution 6-100

a) Adjusted Market Assessment Approach:

Software: \$ 1,500 x [\$ 1,800 / (\$ 1,500 + \$ 500)] = ...	\$ 1,350
User Support: \$ 500 x [\$ 1,800 / (\$ 1,500 + \$ 500)] = ...	<u>450</u>
	\$ 1,800

b) Residual approach:

Software: \$ 1,800 – \$ 500.....	\$ 1,300
User Support: \$ 1,800 – \$ 1,300.....	<u>500</u>
	\$ 1,800

c) Net income calculation:

Sales (\$ 1,800 x 100)	\$ 180,000
Less: Expenses.....	(50,000)
User Support Unearned Portion.....	<u>(41,250)</u>
[(\$ 450 x 100) x 11 ÷ 12]	
Income before tax	88,750
Less income tax (30%).....	<u>(26,625)</u>
Net Income	<u>\$ 62,125</u>

Difficulty: Medium

Learning Objective: Allocate the transaction price to the separate performance obligations.

Section Reference: Allocating the Transaction Price to Separate Performance Obligations—Step 4

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 6-101 Contract-based approach

In January 2020, Bruins Construction Corp. contracted to construct a building for \$ 6,000,000. Construction started in early 2020 and was completed in 2021. The following additional information is available:

	<u>2020</u>	<u>2021</u>
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

Bruins uses the percentage-of-completion method.

Instructions

Under the *contract-based* approach,

- How much revenue should Bruins report for 2020 and 2021?
- Prepare all journal entries for 2020 and 2021 for this contract.

Solution 6-101

a)

2020: $[\$ 2,430,000 \div (\$ 2,430,000 + \$ 2,600,000)] \times \$ 6,000,000 = \underline{\$ 2,898,608}$

2021: $[(\$ 2,430,000 + \$ 2,700,000) \div (\$ 2,430,000 + 2,700,000 + \$ 0) \times \$ 6,000,000] - \$ 2,898,608 = \underline{\$ 3,101,392}$

b)

2020:

Contract asset	6,000,000	
Contract liability.....		6,000,000
To record contract rights and obligations—January 2020		

Contract liability.....	2,430,000	
Materials, Cash, Payables etc		2,430,000
To record construction cost—2020		

Cash	2,400,000	
Contract asset		2,400,000
To record collections—2020		

Construction expenses	2,430,000	
Contract liability.....		2,430,000
To recognize revenue and gross profit—2020		

Contract asset	2,898,608	
Revenue from long-term contract.....		2,898,608

2021:

Contract liability	2,700,000	
Materials, Cash, Payables etc.		2,700,000
To record construction cost—2021		
Cash	3,600,000	
Contract asset		3,600,000
To record collections—2021		
Construction expenses	2,700,000	
Contract liability.....		2,700,000
To recognize revenue and gross profit—2021		
Contract asset	3,101,392	
Revenue from long-term contract.....		3,101,392

Difficulty: Medium

Learning Objective: Allocate the transaction price to the separate performance obligations.

Section Reference: Allocating the Transaction Price to Separate Performance Obligations—Step 4

Learning Objective: Understand how to recognize revenue when the company satisfies its performance obligation.

Section Reference: Recognizing Revenue When (or as) Each Performance Obligation Is Satisfied—Step 5

Learning Objective: Apply the percentage-of-completion method for long-term contracts.

Section Reference: Percentage-of-Completion Method

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 6-102 Timing of revenue recognition

Asana Inc. enters into a contract with Modo Company to develop and install a customized enterprise resource planning system (ERP). Progress payments are made upon completion of each stage of the contract. If the contract is terminated, the partly completely ERP will pass to Modo Company. Asana is prohibited from directing the software to another customer (and besides, it is likely too customized to do so, anyway). Asana Inc. prepares its financial statements in accordance with IFRS.

Instructions

At what point should Asana recognize revenue related to its contract with Modo Company?

Solution 6-102

Asana creates an asset with no alternative use because it is prohibited from redirecting the software. In addition, Asana is entitled to payments for performance to date and expects to complete the project. Therefore, Asana concludes that the contract meets the criteria for recognition of revenue over time.

Difficulty: Easy

Learning Objective: Understand how to recognize revenue when the company satisfies its performance obligation.

Section Reference: Recognizing Revenue When (or as) Each Performance Obligation Is Satisfied—Step 5

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 6-103 Timing of revenue recognition/percentage of completion

Crush Inc. provides demolition services. In order to determine the progression of its projects, the company could use several measures, including estimated labour hours, total machine hours, and output of material demolished. A project Crush currently has underway has taken 400 labour hours, 900 machine hours, and 2,000 tons of material output. The estimated total resources required (and resulting outputs) for this project are 1,000 labour hours, 1,400 machine hours and 4,500 tons of materials.

Instructions

Consider the three alternative means of tracking percentage completion. Under each method, calculate the percentage-completion rate for this project.

Solution 6-103

a) Labour Hours

$400 \text{ hours} / 1,000 \text{ hours} = 40\% \text{ complete}$

b) Machine Hours

$900 \text{ hours} / 1,400 \text{ hours} = 64\% \text{ complete}$

c) Material Output

$2,000 \text{ tons} / 4,500 \text{ tons} = 45\% \text{ complete}$

Difficulty: Medium

Learning Objective: Understand how to recognize revenue when the company satisfies its performance obligation.

Section Reference: Recognizing Revenue When (or as) Each Performance Obligation Is Satisfied—Step 5

Learning Objective: Apply the percentage-of-completion method for long-term contracts.

Section Reference: Percentage-of-Completion Method

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 6-104 Percentage-of-completion method

Jets Ltd. contracted to build a high-rise for \$ 6,000,000. Construction began in 2020 and is expected to be completed in 2020. Data for 2020 and 2021 are:

	<u>2020</u>	<u>2021</u>
Costs incurred	\$ 900,000	\$ 1,700,000
Estimated costs to complete	3,600,000	2,400,000

Instructions

Using the percentage-of-completion method and the cost-to-cost basis,

- How much gross profit should be reported for 2020? Show your calculation.
- How much gross profit should be reported for 2021? Show your calculation.
- Prepare the journal entry to record the revenue and gross profit for 2021.

Solution 6-104

- a) \$ 900,000

$$\frac{\text{Costs incurred}}{\text{Estimated total costs}} \times (\$ 6,000,000 - \$ 4,500,000) = \$ 300,000$$

- b) \$ 2,700,000

$$\frac{\text{Costs incurred}}{\text{Estimated total costs}} \times (\$ 6,000,000 - \$ 5,000,000) = \$ 520,000$$

\$ 5,000,000

Less 2020 gross profit (300,000)

Gross profit in 2021 \$ 220,000

- c) Construction in Process (gross profit)..... 220,000
 Construction Expenses 1,700,000
 Revenue from Long-term Contracts..... 1,920,000

Difficulty: Medium

Learning Objective: Understand how to recognize revenue when the company satisfies its performance obligation.

Section Reference: Recognizing Revenue When (or as) Each Performance Obligation Is Satisfied—Step 5

Learning Objective: Apply the percentage-of-completion method for long-term contracts.

Section Reference: Percentage-of-Completion Method

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 6-105 Risks & rewards of ownership

Describe the factors one must consider in determining who has the risk and rewards of ownership and, therefore, whether a sale has occurred at the point of delivery, under the earnings approach.

Solution 6-105

1. Who has possession of the goods?
2. Who has legal title?
3. Who is exposed to risk of loss?
4. Who recognizes the related goods or services as an asset?

Difficulty: Medium

Learning Objective: Analyze and determine whether a company has earned revenues under the earnings approach.

Section Reference: Earnings Approach to Revenue Recognition

CPA: Communication

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 6-106 Earnings approach to revenue recognition

Fabathletics sends an outfit to monthly subscribers each month. If the customer does NOT want the outfit in a given month they can send it back before the last day of that month free of charge in exchange for a store credit. Fab prepares its financial statements in accordance with ASPE.

Instructions

Describe when these transactions should be recognized as sales under the earnings approach.

Solution 6-106

The shipment of the goods signifies Fab has completed their performance obligation in relation to the sale *only* if the customer chooses not to return the item. Thus, after the final day of the month revenues can be recognized. The balance related to any returned goods is considered unearned revenue until the customers redeem it for credits. If Fab has sufficient sales history to estimate the amount of returns it may recognize a proportion of revenue commensurate with past experience.

Difficulty: Easy

Learning Objective: Analyze and determine whether a company has earned revenues under the earnings approach.

Section Reference: Earnings Approach to Revenue Recognition

Learning Objective: Identify other revenue recognition issues.

Section Reference: Other Revenue Recognition Issues

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

Ex. 6-107 Percentage-of-completion method

Oilers Construction 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 \$ 10,000,000. The estimated total costs to complete the project were \$ 8,000,000, and it is expected to take two years.

Instructions

Using the percentage-of-completion method and the cost-to-cost basis,

- Prepare the journal entry to record construction costs of \$ 4,400,000 for the first year.
- Prepare the journal entry to record progress billings of \$ 5,000,000 for the first year.
- Prepare the journal entry to recognize the revenue and gross profit for the first year.

Solution 6-107

% complete = $4,400,000 \div 8,000,000 = 55\%$

a)	Construction in Process.....	4,400,000	
	Materials, Cash, A/P, etc.		4,400,000
b)	Accounts Receivable	5,000,000	
	Billings on Construction in Process.....		5,000,000
c)	Construction Expenses	4,400,000	
	Construction in Process (gross profit).....	1,100,000	
	Revenue from Long-term Contract (55% x \$ 10,000,000).....		5,500,000

Difficulty: Medium

Learning Objective: Analyze and determine whether a company has earned revenues under the earnings approach.

Section Reference: Earnings Approach to Revenue Recognition

Learning Objective: Apply the percentage-of-completion method for long-term contracts.

Section Reference: Percentage-of-Completion Method

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 6-108

Explain what a bill-and-hold sale is and why a customer might engage in such an arrangement.

Solution 6-108

A **bill-and-hold arrangement** is a contract under which an entity bills a customer for a product but the entity retains physical possession of the product until it is transferred to the customer at a point in the future. Bill-and-hold sales result when the buyer is not yet ready to take delivery but does take title and accepts billing. For example, a customer may request that a company enter into such an arrangement because of (1) lack of available space for the product, (2) delays in its production schedule, or (3) more than sufficient inventory in its distribution channel.

Difficulty: Easy

Learning Objective: Identify other revenue recognition issues

Section Reference: Other Revenue Recognition Issues

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex 6-109 Performance obligations and warranties

Kimbo Corporation sold 500 widgets during 2020 at a total price of \$ 1.4 million, with a warranty guarantee that the widgets were free from any defects. The cost of widgets sold is \$ 600,000. The term of the assurance warranty is one year, with an estimated cost of \$ 10,000.

Instructions

What are the journal entries that Kimbo Company should make in 2020 related to the sale and the related warranties?

Solution 6-109

To record the revenue and liabilities related to the warranties:

Cash	1,400,000	
Warranty Liability		10,000

Warranty expenses would be recorded as incurred and the liability reduced accordingly

To reduce inventory and recognize cost of goods sold:

Cost of goods sold	600,000	
Inventory		600,000

Difficulty: Medium

Learning Objective: Identify other revenue recognition issues.

Section Reference: Other Revenue Recognition Issues

CPA: Financial Reporting
Bloomcode: Application
AACSB: Analytic

Exercise 6-110 Revenue recognition

Alpine sells forklifts to Cusco Ltd. Cusco places an order for 50 forklifts to take advantage of a volume discount. Cusco does NOT have storage space to store the forklifts; therefore, they request that Alpine store the forklifts and provide them a delivery schedule. Cusco provides Alpine with insurance coverage for the forklifts and acknowledges that they are taking title to the forklifts immediately. Alpine stores the forklifts in a separate part of the warehouse and specifically identifies them as belonging to Cusco. Alpine invoices Cusco once the paperwork is complete and requires payment within the customary 30-day term.

Instructions

Explain when Alpine can recognize the revenue related to sale of forklifts to Cusco and why.

Solution 6-110

The transaction between Cusco and Alpine meets the criteria for a bill-and-hold sale, and can therefore be recognized as revenue at the time of invoicing. These criteria are:

1. Probability that delivery will be made
2. Item is on hand, identified, and ready for delivery to the buyer
3. The buyer specifically recognizes the deferred delivery instructions
4. The usual payment terms apply.

Alpine has transferred control to Cusco; that is, Alpine has the right to payment for the forklifts and legal title has transferred.

Difficulty: Easy

Learning Objective: Identify other revenue recognition issues.

Section Reference: Other Revenue Recognition Issues

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 6-111 Consignment sale

In 2020, the following transaction occurred between Senators Wholesale Corp. (consignor) and Canadiens Stores (consignee):

On March 2, 2020 Senators shipped merchandise costing \$ 52,000 to Canadiens. Senators paid \$ 4,000 for freight and Canadiens paid \$ 3,000 for advertising (to be reimbursed by Senators). By the end of the third quarter of 2020 (September 30, 2020), Canadiens advised

Senators that all the merchandise has been sold for \$ 70,000, and forwarded the proceeds (net of a 15% commission and the outlay for advertising) to Senators.

Instructions

- Prepare all entries for Canadiens to account for this transaction.
- Prepare all entries for Senators to account for this transaction.

Solution 6-111

a) Canadiens

Receivable from Consignor	3,000	
Cash		3,000
To set up receivable for advertising		
Cash	70,000	
Payable to Consignor		70,000
To record sale		
Payable to Consignor	70,000	
Receivable from Consignor		3,000
Commission Revenue*		10,500
*\$ 70,000 x 15% = \$ 10,500		
Cash		56,500
To record Remittance to consignor		

b) Senators

Inventory on Consignment	52,000	
Merchandise Inventory		52,000
To record Shipment of consigned merchandise		
Inventory on Consignment	4,000	
Cash		4,000
To record Payment of freight costs		
Cash	56,500	
Advertising Expense	3,000	
Commission Expense	10,500	
Revenue from Consignment Sales		70,000
To record Remittance from consignee		
Cost of Goods Sold (52,000 + 4,000)	56,000	
Inventory on Consignment		56,000

To record Cost of sales for consignment sales

Difficulty: Medium

Learning Objective: Identify other revenue recognition issues.

Section Reference: Other Revenue Recognition Issues

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 6-112 Reporting of gross or net revenues

Discuss three factors to consider in determining whether gross or net revenues should be reported on the income statement.

Solution 6-112

Factors to consider:

1. Is the company acting as principal or are they acting as agent or broker? If as principal, this would support reporting gross revenue; if as agent/broker, this would support reporting net revenue.
2. Is the company taking title to the goods being sold? Taking title supports reporting gross revenue.
3. Who has the risks and rewards of ownership of the goods being sold? Having the risks and rewards supports reporting gross revenue.

Difficulty: Easy

Learning Objective: Identify other revenue recognition issues.

Section Reference: Other Revenue Recognition Issues

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

Bloomcode: Application

AACSB: Communication

Ex. 6-113 Presentation & the percentage-of-completion method

Thuxton Inc. began work on a \$ 6,000,000 non-cancellable contract in 2020 to construct a retail building. During 2020, Thuxton incurred costs of \$ 1,500,000 and billed its customers for \$ 1,400,000 (non-refundable), and collected \$ 1,000,000. At December 31, 2020, the estimated future costs to complete the project total \$ 2,500,000.

Instructions

Prepare Thuxton's 2020 journal entries using the percentage-of-completion method.

Solution 6-113

To record the cost of construction:

Contract asset/liability	1,500,000	
Materials, Payables, Cash etc.		1,500,000

To record progress billings:

Accounts receivable	1,400,000	
Contract asset/liability		1,400,000

The debit represents an unconditional right to receive consideration because the billings are non-refundable and the contract non-cancellable.

To record collections:

Cash	1,000,000	
Accounts receivable		1,000,000

To record revenues

Contract asset/liability	2,571,429	
Revenue from long-term contracts		2,571,429

To record construction expenses:

Construction expenses	1,500,000	
Contract asset/liability		1,500,000

Difficulty: Medium

Learning Objective: Describe presentation and disclosure regarding revenue.

Section Reference: Presentation and Disclosure

Learning Objective: Apply the percentage-of-completion method for long-term contracts.

Section Reference: Percentage-of-Completion Method

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 6-114 Percentage-of-completion method

Flames Corp. contracted to build a bridge for \$ 5,000,000. Construction began in 2020 and was completed in 2021. Data relating to the construction are:

	<u>2020</u>	<u>2021</u>
Costs incurred	\$ 1,620,000	\$ 1,400,000
Estimated costs to complete	1,380,000	—

Instructions

Using the percentage-of-completion method and the cost-to-cost basis,

- How much revenue should be reported for 2020? Show your calculation.
- Prepare the journal entry to record progress billings of \$ 1,700,000 during 2020.

- c) Prepare the journal entry to record the revenue and gross profit for 2020.
 d) How much gross profit should be reported for 2021? Show your calculation.

Solution 6-114

- a) \$ 1,620,000
 ————— × \$ 5,000,000 = \$ 2,700,000
 \$ 3,000,000
- b) Accounts Receivable 1,700,000
 Contract Asset/Liability 1,700,000
- c) Construction Expenses 1,620,000
 Contract Asset/Liability 1,080,000
 Revenue from Long-term Contracts..... 2,700,000
- d) Revenue \$ 5,000,000
 Less actual costs (3,020,000)
 Total gross profit..... 1,980,000
 Recognized in 2020 (1,080,000)
 Recognized in 2021 \$ 900,000
- OR**
- Total revenue \$ 5,000,000
 Recognized in 2020 (2,700,000)
 Recognized in 2021 2,300,000
 Actual costs in 2021..... (1,400,000)
 Gross profit in 2021 \$ 900,000

Difficulty: Medium

Learning Objective: Apply the percentage-of-completion method for long-term contracts.

Section Reference: Percentage-of-Completion Method

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 6-115

Explain the advantages and disadvantages of the completed-contract method.

Solution 6-115

The main advantage of the completed-contract method is that reported revenue reflects final results rather than **estimates** of unperformed work. Its major disadvantage is that it does not reflect current performance when the period of a contract extends into more than one accounting period. Although operations may be fairly uniform during the period of the

contract, the company will not report revenue until the year of completion, which distorts earnings.

Difficulty: Easy

Learning Objective: Apply the completed contract method for long-term contracts.

Section Reference: Completed-Contract Method.

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

PROBLEMS

Pr. 6-116 Long-term contract

On January 1, 2020, Charger Corp., a management consulting firm, entered into a contract with Viking Company to provide advisory services over a four-year period. The contract price was \$ 4,000,000 and was to be paid in four equal annual payments at the end of each year. Charger's expenses relating to this contract were \$ 650,000, \$ 730,000, \$ 780,000 and \$ 710,000 for 2020–2023. Collectibility was reasonably assured throughout the duration of the contract and measurement uncertainties were NOT an issue.

Instructions

Using the contract-based revenue recognition model, prepare journal entries for all four years.

Solution 6-116

	2020		2021		2022		2023	
	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
<u>To record contract rights and obligations:</u>								
Contract asset	4,000,000							
Contract liability		4,000,000						
<u>To record contract expenses:</u>								
Contract liability	650,000		730,000		780,000		710,000	

Materials, Cash, Payables etc.	650,000	730,000	780,000	710,000
<u>To record collections:</u>				
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
<u>To recognize revenue and gross profit:</u>				
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

Difficulty: Medium

Learning Objective: Identify the separate performance obligations in the contract.

Section Reference: Identifying Separate Performance Obligations—Step 2

Learning Objective: Determine the transaction price.

Section Reference: Determining the Transaction Price—Step 3

Learning Objective: Allocate the transaction price to the separate performance obligations.

Section Reference: Allocating the Transaction Price to Separate Performance Obligations—Step 4

Learning Objective: Understand how to recognize revenue when the company satisfies its performance obligation.

Section Reference: Recognizing Revenue When (or as) Each Performance Obligation Is Satisfied—Step 5

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 6-117 Long-term construction project accounting

Giants Construction Inc. specializes in the construction of commercial and industrial buildings. The company is experienced in bidding on long-term construction projects of this type, with the typical project lasting from fifteen to twenty-four months. Giants uses the percentage-of-completion method. Progress toward completion is measured on a cost-to-cost basis. Giants began work on a contract at the beginning of 2020. Data for 2020 follow:

Contract price.....	\$ 2,000,000
Estimated costs	
Labour.....	\$ 425,000
Materials and subcontracts	875,000

Indirect costs	<u>200,000</u>	<u>1,500,000</u>
Estimated gross profit.....		<u>\$ 500,000</u>

At the end of 2020, the following was the actual status of the contract:

Progress Billings to date	\$ 1,115,000	
Costs incurred to date		
Labour.....	\$ 207,000	
Materials and subcontracts	519,000	
Indirect costs	<u>75,000</u>	801,000
Latest forecast of total costs		\$ 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

- Calculate the percentage of completion on the contract at the end of 2020.
- Calculate the gross profit that would be reported on this contract for 2020.
- Prepare the journal entry to record the revenue and gross profit for 2020 on Giants' books.
- Indicate the account(s) and the amount(s) that would be shown on Giant's statement of financial position at the end of 2020 related to its construction accounts. Also show how these items would be classified on the statement of financial position. Cash collected during the year was \$ 980,000.
- Assume, instead of \$ 1,500,000, the latest forecast of total costs at the end of 2020 was \$ 2,050,000. How much income (loss) would Giant then report for the year 2020?

Solution 6-117

a) Costs to date	\$ 801,000
Less materials on job site	<u>(51,000)</u>
	<u>\$ 750,000</u>

Costs Incurred to Date
 _____ = Percentage of Completion
 Total Estimated Costs

\$ 750,000
 _____ = 50%
 \$ 1,500,000

b) $50\% \times \$ 2,000,000 =$	\$ 1,000,000
Costs incurred	<u>750,000</u>

Gross profit	<u>\$ 250,000</u>	
c) Construction Expense	750,000	
Contract Asset/Liability.....	250,000	
Revenue from Long-term Project.....		1,000,000
d) <u>Current Asset</u>		
Accounts receivable	\$ 135,000	(\$ 1,115,000 – \$ 980,000)
<u>Current Liability</u>		
Contract Liability (net)	\$ 115,000	(\$ 750,000- \$ 1,115,000 + \$ 1,000,000-\$ 750,000)
e) Total loss reported in 2020		
Contract price	\$ 2,000,000	
Estimated cost to complete	<u>2,050,000</u>	
Amount of loss to be reported	<u>\$ (50,000)</u>	

Difficulty: Medium

Learning Objective: Identify the separate performance obligations in the contract.

Section Reference: Identifying Separate Performance Obligations—Step 2

Learning Objective: Determine the transaction price.

Section Reference: Determining the Transaction Price—Step 3

Learning Objective: Allocate the transaction price to the separate performance obligations.

Section Reference: Allocating the Transaction Price to Separate Performance Obligations—Step 4

Learning Objective: Understand how to recognize revenue when the company satisfies its performance obligation.

Section Reference: Recognizing Revenue When (or as) Each Performance Obligation Is Satisfied—Step 5

Learning Objective: Analyze and determine whether a company has earned revenues under the earnings approach.

Section Reference: Earnings Approach to Revenue Recognition

Learning Objective: Apply the percentage-of-completion method for long-term contracts.

Section Reference: Percentage-of-Completion Method

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 6-118 Accounting for long-term construction contracts

The board of directors of Steelers Construction Corp. 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

Steelers' controller in the preparation of a presentation to be given at the board meeting. The controller provides you with the following information:

1. Steelers commenced doing business on January 1, 2020.
2. Construction activities for the year ended December 31, 2020, were as follows:

Project	Total contract Price	Billings through 12/31/20	Cash collections through 12/31/20
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	<u>480,000</u>	<u>400,000</u>	<u>400,000</u>
	<u>\$ 2,620,000</u>	<u>\$ 1,590,000</u>	<u>\$ 1,395,000</u>

Project	Contract costs incurred through 12/31/20	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	<u>320,000</u>	<u>80,000</u>
	<u>\$ 1,680,000</u>	<u>\$ 750,000</u>

3. Each contract is with a different customer.
4. Any work remaining to be done on the contracts is expected to be completed in 2021.

Instructions

- a) Prepare a schedule by project, calculating the amount of gross profit (or loss) for the 2020 calendar year, 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 to record revenue and gross profit on project B for 2020, assuming that the percentage-of-completion method is used.
- c) Indicate the balances that would appear in the statement of financial position at December 31, 2020 for the following accounts for Project D, 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, if the completed-contract method is used?

Solution 6-118

- a) (1) and (2)

Projects	<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>	<u>E</u>
Contract price	<u>\$ 615,000</u>	<u>\$ 450,000</u>	<u>\$ 475,000</u>	<u>\$ 600,000</u>	<u>\$ 480,000</u>
Contract costs incurred	510,000	130,000	350,000	370,000	320,000
Additional costs to complete	<u>120,000</u>	<u>260,000</u>	<u>-0-</u>	<u>290,000</u>	<u>80,000</u>
Total cost	630,000	390,000	350,000	660,000	400,000
Total gross profit (loss)	<u>\$ (15,000)</u>	<u>\$ 60,000</u>	<u>\$ 125,000</u>	<u>\$ (60,000)</u>	<u>\$ 80,000</u>

The amount reported as gross profit (loss) under the completed-contract method for 2020 is:

Project A	\$ (15,000)
B	-0-
C	125,000
D	(60,000)
E	<u>-0-</u>
	<u>\$ 50,000</u>

The amount reported as gross profit (loss) under the percentage-of-completion method for 2020 is:

Project A	\$ (15,000)	
B	20,000	$\$ 60,000 \times (\$ 130,000 \div \$ 390,000)$
C	125,000	
D	(60,000)	
E	<u>64,000</u>	$\$ 80,000 \times (\$ 320,000 \div \$ 400,000)$
	<u>\$ 134,000</u>	

b) Construction in Process.....	20,000	
Construction Expenses	130,000	
Revenue from Long-term Contracts.....		150,000

c) Billings	\$ 240,000
Cash collections	<u>160,000</u>
Accounts receivable	<u>\$ 80,000</u>
Billings on Construction in Process	\$ 240,000
Costs incurred	\$ 370,000
Loss reported	<u>(60,000)</u>
Construction in process	<u>\$ 310,000</u>

d) The account balances would be the same.

Difficulty: Medium

Learning Objective: Identify the separate performance obligations in the contract.

Section Reference: Identifying Separate Performance Obligations—Step 2

Learning Objective: Determine the transaction price.

Section Reference: Determining the Transaction Price—Step 3

Learning Objective: Allocate the transaction price to the separate performance obligations.

Section Reference: Allocating the Transaction Price to Separate Performance Obligations—Step 4

Learning Objective: Understand how to recognize revenue when the company satisfies its performance obligation.

Section Reference: Recognizing Revenue When (or as) Each Performance Obligation Is Satisfied—Step 5

Learning Objective: Analyze and determine whether a company has earned revenues under the earnings approach.

Section Reference: Earnings Approach to Revenue Recognition

Learning Objective: Apply the percentage-of-completion method for long-term contracts.

Section Reference: Percentage-of-Completion Method

Learning Objective: Apply the completed-contract method for long-term contracts.

Section Reference: Completed-Contract Method

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 6-119 Percentage-of-completion and completed-contract methods

On January 1, 2020, Falcon Construction Ltd. started a construction project for \$ 4,500,000.

Relevant data for 2020 and 2021 are as follows:

	<u>2020</u>	<u>2021</u>
Current year construction costs	\$ 3,300,000	\$ 620,000
Estimated remaining costs to complete	600,000	-0-
Current year billings	3,100,000	1,400,000
Current year collections	3,000,000	1,500,000

Instructions

Calculate the following amounts for each method:

	Completed Contract		Percentage-of-Completion	
	<u>2020</u>	<u>2021</u>	<u>2020</u>	<u>2021</u>
a) Gross Profit	\$	\$	\$	\$
b) Construction in progress				

year-end balance	\$	\$	\$	\$
c) Costs in excess of billings (Billings in excess of costs)	\$	\$	\$	\$

Solution 6-119

	Completed Contract		Percentage-of-Completion	
	<u>2020</u>	<u>2021</u>	<u>2020</u>	<u>2021</u>
a) Gross Profit	-0-	\$ 580,000	\$ 507,692	\$ 72,308
b) Construction in progress year-end balance	\$ 3,300,000	-0-	\$ 3,807,692	-0-
c) Costs in excess of billings (Billings in excess of costs)	\$ 200,000	-0-	\$ 707,692	-0-

Calculations:

$$\$4,500,000 - \$3,300,000 - \$620,000 = \$580,000$$

$$\$3,300,000 - \$3,100,000 = \$200,000$$

$$(\$4,500,000 - \$3,300,000 - \$600,000) \times (\$3,300,000 \div (\$3,300,000 + \$600,000)) = \$507,692$$

$$\$3,300,000 + \$507,692 = \$3,807,692$$

$$\$3,807,692 - \$3,100,000 = \$707,692$$

$$[(\$4,500,000 - \$3,300,000 - \$620,000) \times [(\$3,300,000 + \$620,000) \div (\$3,300,000 + \$620,000)]] - \$507,692 = \$72,308$$

Difficulty: Medium

Learning Objective: Identify the separate performance obligations in the contract.

Section Reference: Identifying Separate Performance Obligations—Step 2

Learning Objective: Determine the transaction price.

Section Reference: Determining the Transaction Price—Step 3

Learning Objective: Allocate the transaction price to the separate performance obligations.

Section Reference: Allocating the Transaction Price to Separate Performance Obligations—Step 4

Learning Objective: Understand how to recognize revenue when the company satisfies its performance obligation.

Section Reference: Recognizing Revenue When (or as) Each Performance Obligation Is Satisfied—Step 5

Learning Objective: Analyze and determine whether a company has earned revenues under the earnings approach.

Section Reference: Earnings Approach to Revenue Recognition

Learning Objective: Apply the percentage-of-completion method for long-term contracts.

Section Reference: Percentage-of-Completion Method

Learning Objective: Apply the completed-contract method for long-term contracts.

Section Reference: Completed-Contract Method

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr.6-120 Percentage-of-completion and completed-contract methods

On June 15, 2020, Lion Construction signed a \$ 360,000 contract to build a small building. Lion estimated that the total cost would be \$ 320,000. Construction started immediately because the required completion date was August 31, 2021. Lion's relevant data relating to this construction project were as follows:

	<u>2020</u>	<u>2021</u>
Actual costs incurred	\$ 120,000	\$ 204,000
Estimated costs to complete	200,000	-0-
Progress billings	112,000	248,000
Collections	110,000	250,000

Instructions

Calculate how much gross profit that Lion should recognize each year, assuming:

<u>Method Used</u>	<u>For 2020</u>	<u>For 2021</u>
a) Completed contract		
b) Percentage-of-completion		

Solution 6-120

<u>Method Used</u>	<u>For 2020</u>	<u>For 2021</u>
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

Difficulty: Medium

Learning Objective: Identify the separate performance obligations in the contract.

Section Reference: Identifying Separate Performance Obligations—Step 2

Learning Objective: Determine the transaction price.

Section Reference: Determining the Transaction Price—Step 3

Learning Objective: Allocate the transaction price to the separate performance obligations.

Section Reference: Allocating the Transaction Price to Separate Performance Obligations—Step 4

Learning Objective: Understand how to recognize revenue when the company satisfies its performance obligation.

Section Reference: Recognizing Revenue When (or as) Each Performance Obligation Is Satisfied—Step 5

Learning Objective: Analyze and determine whether a company has earned revenues under the earnings approach.

Section Reference: Earnings Approach to Revenue Recognition

Learning Objective: Apply the percentage-of-completion method for long-term contracts.

Section Reference: Percentage-of-Completion Method

Learning Objective: Apply the completed-contract method for long-term contracts.

Section Reference: Completed-Contract Method

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 6-121 Completed-contract method

Broncos Construction Ltd. reported the following construction activity in 2020, their first year of operations:

	Total	Billings	Cash	Costs	Estimated
	Contract	through	collections	Incurred	Additional
<u>Contract</u>	<u>Price</u>	<u>12/31/17</u>	<u>12/31/17</u>	<u>12/31/17</u>	<u>Costs to</u>
X	\$ 260,000	\$ 170,000	\$ 155,000	\$ 182,000	\$ 63,000
Y	325,000	130,000	130,000	100,000	247,000
Z	<u>388,000</u>	<u>388,000</u>	<u>316,000</u>	<u>252,000</u>	<u>-0-</u>
	<u>\$ 973,000</u>	<u>\$ 688,000</u>	<u>\$ 601,000</u>	<u>\$ 534,000</u>	<u>\$ 310,000</u>

Each of the above contracts is with a different customer, and any work remaining at December 31, 2020 is expected to be completed in 2021.

Instructions

Prepare a partial income statement and a partial statement of financial position to indicate how the above contract information would be reported. Broncos use the completed-contract method.

Solution 6-121

BRONCOS CONSTRUCTION LTD.
Income Statement
For the Year Ended December 31, 2020

Revenue from long-term contracts (contract Z)	\$ 388,000

Cost of construction (contract Z).....	<u>252,000</u>
Gross profit	\$ 136,000
Provision for loss (contract Y)*	22,000
*Contract costs through 12/31/20	\$ 100,000
Estimated costs to complete	<u>247,000</u>
Total estimated costs.....	347,000
Total contract price.....	<u>325,000</u>
Loss recognized in 2020	<u>\$ 22,000</u>

BRNCOS CONSTRUCTION LTD.
Statement of Financial Position
December 31, 2020

Current assets:

Accounts receivable (\$ 688,000 – \$ 601,000)	\$ 87,000
Inventories	
Construction in process (contract X)	\$ 182,000
Less: Billings	<u>170,000</u>
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

Difficulty: Medium

Learning Objective: Identify the separate performance obligations in the contract.

Section Reference: Identifying Separate Performance Obligations—Step 2

Learning Objective: Determine the transaction price.

Section Reference: Determining the Transaction Price—Step 3

Learning Objective: Allocate the transaction price to the separate performance obligations.

Section Reference: Allocating the Transaction Price to Separate Performance Obligations—Step 4

Learning Objective: Understand how to recognize revenue when the company satisfies its performance obligation.

Section Reference: Recognizing Revenue When (or as) Each Performance Obligation Is Satisfied—Step 5

Learning Objective: Analyze and determine whether a company has earned revenues under the earnings approach.

Section Reference: Earnings Approach to Revenue Recognition

Learning Objective: Apply the completed-contract method for long-term contracts.

Section Reference: Completed-Contract Method

CPA: Financial Reporting

Bloomcode: Application

Pr. 6-122 Consignment sales

On July 2, Cardinal Corp. ships merchandise costing \$ 460,000 on consignment to Dolphin Stores. Cardinal pays the freight of \$ 10,000. Upon sale, Dolphin Stores will receive a 12% commission and a 6% allowance to offset its advertising expenses. At the end of the month, Dolphin notifies Cardinal that 50% of the merchandise has been sold for \$ 560,000.

Instructions

Record the journal entries required by the two companies to account for this consignment.

Solution 6-122

	<u>Cardinal</u>		<u>Dolphin</u>
<u>On shipment:</u>			
Inventory on Consignment	460,000		
Merchandise Inventory		460,000	
<u>Payment of freight:</u>			
Inventory on Consignment	10,000		
Cash		10,000	
<u>Sales of consigned merchandise:</u>			
		Cash	560,000
		Payable to Consignor	560,000
<u>Notification of sales and expenses and remittance of cash:</u>			
Cash	459,200	Payable To Consignor	560,000
Advertising Expense	33,600	Advertising Expense	33,600
Commission Expense	67,200	Commission Revenue	67,200
Revenue from Consignment Sales	560,000	Cash	459,200
Cost of Goods Sold	235,000		
Inventory on Consignment	235,000		
$0.50 \times (460,000 + 10,000) = 235,000$			

$$\$ 560,000 \times 12\% = \$ 67,200$$

$$\$ 560,000 \times 6\% = \$ 33,600$$

$$\$ 560,000 - \$ 33,600 - \$ 67,200 = \$ 459,200$$

Difficulty: Medium

Learning Objective: Identify other revenue recognition issues.

Section Reference: Other Revenue Recognition Issues

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 6-123

Coquel Company has a non-cancellable contract to construct a bridge for an estimated cost of \$ 1,950,000. The contract is to start in July 2020, and the bridge is to be completed in September 2022. The following data pertain to the construction period. Assume that progress billings are non-refundable.

	2020	2021	2022
Costs to date	\$ 360,000	\$ 900,000	\$ 390,000
Estimated costs to complete	1,260,000	380,000	–
Progress billings during the year	305,000	765,000	1,200,000
Cash collected during the year	280,000	760,000	2,000,000

Instructions

Assuming that Coquel Company uses the percentage of completion method prepare the appropriate journal entries.

Solution 6-122

	2020	2021	2022
Contract Asset/Liability	360,000	900,000	390,000
Materials, Payables, Cash, and so on (To record cost of construction)	360,000	900,000	390,000
Accounts Receivable	305,000	765,000	880,000
Contract Asset/Liability (To record progress billings)	305,000	765,000	880,000
Cash	280,000	760,000	910,000
Accounts Receivable	280,000	760,000	910,000

(To record collections)

Contract Asset/Liability	433,334		1,064,836		451,830
Revenue from Long-Term Contracts (To record revenues)		433,334		1,064,836	451,830
Construction Expense	360,000		900,000		390,000
Contract Asset/Liability (To record construction expense)		360,000		900,000	390,000

Difficulty: Medium

Learning Objective: Apply the percentage-of-completion method for long-term contracts.

Section Reference: Percentage-of-Completion Method

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 6-124

Coquel Company has a non-cancellable contract to construct a bridge for an estimated cost of \$ 1,950,000. The contract is to start in July 2020, and the bridge is to be completed in September 2022. The following data pertain to the construction period. Assume that progress billings are non-refundable.

	2020	2021	2022
Costs to date	\$ 360,000	\$ 900,000	\$ 390,000
Estimated costs to complete	1,260,000	380,000	–
Progress billings during the year	305,000	765,000	1,200,000
Cash collected during the year	280,000	760,000	2,000,000

Instructions

- Assuming that Coquel Company uses the completed-contract method prepare the appropriate journal entries.
- Assuming that Coquel Company uses the zero-profit method prepare the appropriate journal entries to recognize revenue over the life of the contract.

Solution 6-124

a)

	2020	2021	2022
Contract Asset/Liability	360,000	900,000	390,000
Materials, Payables, Cash, and so on (To record cost of construction)	360,000	900,000	390,000
Accounts Receivable	305,000	765,000	880,000
Contract Asset/Liability (To record progress billings)	305,000	765,000	880,000
Cash	280,000	760,000	910,000
Accounts Receivable (To record collections)	280,000	760,000	910,000
Contract Asset/Liability			300,000
Construction Expense			1,650,000
Revenue from Long-Term Contracts (To record revenues)			1,950,000

b)

	2020	2021	2022
Construction expense	360,000	900,000	390,000
Contract Asset/Liability (To record construction expense)	360,000	900,000	390,000
Contract Asset/Liability	360,000	900,000	390,000
Revenue from Long-Term Contracts (To record revenues)	360,000	900,000	390,000

Difficulty: Medium

Learning Objective: Apply the completed-contract method for long-term contracts.

Section Reference: Completed-Contract Method

Learning Objective: Apply the zero-profit method for long-term contracts.

Section Reference: Zero-profit Method

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

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CHAPTER 7

CASH AND RECEIVABLES

CHAPTER STUDY OBJECTIVES

1. ***Understand cash and accounts receivable from a business perspective.*** Companies often have a significant amount of accounts receivable, which requires time and effort to manage and control. Companies strive to ensure that their collection policy is restrictive enough to minimize large losses in the form of uncollectible accounts receivable, while not being so restrictive that it interferes with the ability to attract new customers. Typical accounts receivable-related categories include trade receivables, loans receivable, and nontrade receivables (including items like interest receivable and amounts due from officers, and advances to employees).

2. ***Define financial assets, and identify items that are considered cash and cash equivalents and how they are reported.*** Financial assets are a major type of asset, defined as cash, a contractual right to receive cash or another financial asset, an equity holding in another company, or a contractual right to exchange financial instruments under potentially favourable conditions. To be reported as cash, an asset must be readily available to pay current obligations and not have any contractual restrictions that would limit how it can be used in satisfying debts. Cash consists of coins, currency, and available funds on deposit at a bank. Negotiable instruments such as money orders, certified cheques, cashier's cheques, personal cheques, and bank drafts are also viewed as cash. Savings accounts are usually classified as cash. Cash equivalents include highly liquid short-term investments (that is, those maturing three months or less from the date of purchase) that can be exchanged for known amounts of cash and have an insignificant chance of changing in value. Examples include treasury bills, commercial paper, and money-market funds. In certain circumstances, temporary bank overdrafts may be deducted in determining the balance of cash and cash equivalents.

Cash is reported as a current asset in the SFP, with foreign currency balances reported at their Canadian dollar equivalent at the date of the SFP. The reporting of other related items is as follows: (1) Restricted cash: Legally restricted deposits that are held as compensating balances against short-term borrowing are stated separately in current assets. Restricted deposits held against long-term borrowing arrangements are separately classified in non-current assets either in investments or other assets. (2) Bank overdrafts: These are reported in the current liabilities section and may be added to the amount reported as accounts payable. (3) Cash equivalents: This item is often reported together with cash as "cash and cash equivalents."

3. Define receivables and identify the different types of receivables from an accounting perspective. Receivables are claims held against customers and others for money, goods, or services. Most receivables are financial assets. The receivables are described in the following ways: (1) current or non-current; (2) trade or nontrade; and (3) accounts receivable or notes or loans receivable.

4. Account for and explain the accounting issues related to the recognition and measurement of accounts receivable. The entity becomes a party to the contractual provisions of the accounts receivable financial instrument only when it has a legal claim to receive cash or other financial assets. Therefore the timing of recognition of accounts receivable is intertwined with the timing of recognition of revenue, as we discussed in Chapter 6. For most companies, when the sale is recognized, either cash is received (realized) or an account receivable is recognized.

Two issues that may complicate the measurement of accounts receivable are (1) the availability of discounts (trade and cash discounts) and (2) the length of time between the sale and the payment due dates (the interest element). Ideally, receivables should be measured initially at their fair value, which is their present value (discounted value of the cash to be received in the future). Receivables that are created by normal business transactions and are due in the short term are excluded from present value requirements.

5. Account for and explain the accounting issues related to the impairment in value of accounts receivable. Short-term receivables are reported at their net realizable value—the net amount that is expected to be received in cash, which is not necessarily the amount that is legally receivable. Determining net realizable value requires estimating uncollectible receivables and any future returns or allowances and discounts that are expected to be taken. The adjustments to the asset account also affect the income statement amounts of bad debt expense, sales returns and allowances, and sales discounts. The assessment of impairment is usually based on an aged accounts receivable report, with higher percentages of uncollectible accounts shown for older amounts outstanding. Even if a company estimates bad debt expense each period as a percentage of sales, the accounts receivable at the date of the SFP are analyzed to ensure the balance in the allowance account is appropriate.

6. Account for and explain the accounting issues related to the recognition and measurement of notes and loans receivable. The accounting issues for short-term notes receivable are similar to those of accounts receivable. However, because notes always contain an interest element, interest income must be properly recognized. Notes receivable either bear interest on the face amount (interest-bearing) or have an interest element that is the difference between the amount lent and the maturity value (non-interest-bearing). Long-term notes and loans receivable are recognized initially at their fair value (the present value of the future cash flows) and subsequently at their amortized cost.

Transaction costs are capitalized. This requires amortizing any discount if the item was issued at less than its face value, or any premium if it was issued for an amount greater than its face value, using the effective interest method. The straight-line method may be used under ASPE. Amortization of the premium (or discount) results in a reduction of (or increase in) interest income below (or above) the cash amount received.

7. Account for and explain the basic accounting issues related to the derecognition of receivables. To accelerate the receipt of cash from receivables, the owner may transfer the receivables to another entity for cash. The transfer of receivables to a third party for cash may be done in one of two ways: (1) Secured borrowing: The creditor requires the debtor to designate or pledge receivables as security for the loan. (2) Sale (factoring or securitization) of receivables: Factors are finance companies or banks that buy receivables from businesses and then collect the remittances directly from the customers. Securitization is the transfer of receivables to a special purpose entity that is mainly financed by highly rated debt instruments. In many cases, transferors have some continuing involvement with the receivables they sell. For the transfer to be recorded as a sale, IFRS focuses on whether the risks and rewards of ownership have been transferred to the transferee. ASPE focuses on whether the transferor has surrendered control and has continued involvement with the receivables.

8. Explain how receivables and loans are reported and analyzed. Disclosure of receivables requires that (1) valuation accounts be appropriately offset against receivables, (2) the receivables be appropriately classified as current or non-current, and (3) pledged or designated receivables be identified. As financial instruments, specific disclosures are required for receivables so that users can determine their significance to the company's financial position and performance and can assess the nature and extent of associated risks and how these risks are managed and measured. Private entities require less disclosure than those reporting under IFRS. Receivables are analyzed in terms of their turnover and age (number of days outstanding), and in terms of relative changes in the related sales, receivables, and allowance accounts.

9. Identify differences in accounting between IFRS and accounting standards for private enterprises (ASPE), and what changes are expected in the near future. The two sets of standards are very similar, with minor differences relating to what is included in cash equivalents. ASPE does not require use of the effective interest method, whereas IFRS does require it for financial asset investments that are not held for trading purposes. Impairment provisions were recently addressed under IFRS 9, but the changes under IFRS 9 have led to additional differences between IFRS and ASPE.

10. **Explain common techniques for controlling cash (Appendix 7A).** The common techniques that are used to control cash are as follows: (1) Using a variety of bank accounts: A company can vary the number and location of banks and the types of accounts to meet its control objectives. (2) The imprest petty cash system: It may be impractical to require small amounts of various expenses to be paid by cheque, yet some control over them is important. (3) Physical protection of cash balances: Adequate control of receipts and disbursements is part of protecting cash balances. Every effort should be made to minimize the cash on hand in the office. (4) Reconciliation of bank balances: Cash on deposit is not available for counting and is proved by preparing a bank reconciliation.

MULTIPLE CHOICE

Answer	No.	Description
b	1.	Management of accounts receivable
b	2.	Management of accounts receivable
d	3.	Management of accounts receivable
d	4.	Definition of financial asset
a	5.	Identification of cash item
d	6.	Classification of bank overdraft
c	7.	Compensating balance
b	8.	Reporting cash in the statement of financial position
b	9.	Calculation of current net receivables
d	10.	Reporting of nontrade receivables
a	11.	Nontrade receivables
d	12.	Classification of dividends and interest receivable
b	13.	Calculation of current net receivables
b	14.	Standards for recognition and measurement of accounts receivable
c	15.	Trade discounts

- b 16. Classification of Sales Returns and Allowances
- a 17. Non-recognition of interest element
- c 18. Valuation of short-term receivables
- a 19. Valuation of receivables
- c 20. Recording of receivables
- c 21. Recording of receivables when discount is not taken
- d 22. Calculation of net realizable value of accounts receivable
- c 23. Definition of credit risk
- b 24. Classification of Allowance for Doubtful Accounts
- c 25. Write off of receivables
- a 26. Bad debts and the matching concept
- b 27. Direct write off method
- c 28. Effect of write off entry
- d 29. Collection of a previously written off account receivable
- a 30. Relation of bad debts expense to accounts receivable
- b 31. Identification of impaired accounts receivable
- c 32. Recording bad debt expense
- b 33. Calculation of bad debt expense using aging of receivables
- d 34. Calculation of bad debt expense
- c 35. Calculation of bad debt expense
- a 36. Calculation of actual bad debts written off
- b 37. Calculation of Allowance for Doubtful Accounts balance
- c 38. Notes receivable
- d 39. Recording of notes receivable
- a 40. Recording of revenue
- c 41. Straight-line method of amortization
- c 42. Valuation of notes receivable
- b 43. Note issued at less than face value
- a 44. Note issued above face value
- d 45. Present value of note
- a 46. Recording notes receivable at year end
- b 47. Calculation of implicit interest rate for zero-interest-bearing note
- c 48. Recognition of interest income in the first year
- b 49. Recognition of interest income in subsequent year
- b 50. Receivables used as collateral
- d 51. Factoring of receivables
- b 52. Factoring and securitization differences
- a 53. Recording a loss on disposal of receivables
- c 54. Amount owed when receivables are factored
- c 55. Calculation of cash proceeds from transfer of receivables
- c 56. Entry to record collection of assigned receivables
- b 57. Factoring receivables without recourse

- c 58. Factoring receivables with recourse
- d 59. Accounts receivable turnover ratio
- b 60. Liquidity of accounts receivable
- d 61. Requirements for presentation and disclosure under IFRS and ASPE
- d 62. Receivables turnover ratio
- c 63. Treatment of cash and cash equivalents
- a 64. Receivables recognition and measurement
- c *65. Purpose of Cash Over and Short account
- c *66. Bank reconciliation journal entries
- b *67. Treatment of bank error on bank reconciliation
- c *68. Reconciling item on bank reconciliation
- b *69. Cash balance on bank reconciliation
- d *70. Entry to replenish petty cash
- a *71. Calculation of correct cash balance
- b *72. Calculation of correct cash balance
- c *73. Calculation of correct cash balance
- c *74. Calculation of correct cash balance
- a *75. Calculation of correct cash balance

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

EXERCISES

Item	Description
E7-76	Cash management from a business perspective
E7-77	Accounts receivable planning and control
E7-78	Terminology
E7-79	Definitions
E7-80	Credit politics
E7-81	Reporting of cash
E7-82	Reporting of cash and cash equivalents
E7-83	Restricted cash balances
E7-84	Cash versus cash equivalents or short-term investments
E7-85	Classification of accounts receivable
E7-86	Nontrade receivables
E7-87	Sales Returns and Allowances
E7-88	Entries for bad debt expense
E7-89	Allowance for doubtful accounts
E7-90	Entries for bad debt expense
E7-91	Dishonoured note receivable
E7-92	Amortization of discount on note

E7-93	Schedule of note discount amortization
E7-94	Note with fair value not equal to cash consideration
E7-95	Recognition and measurement of long-term notes receivable
E7-96	Notes received for Property, Goods, or Services.
E7-97	Interest rate terminology
E7-98	Zero-interest bearing note
E7-99	Accounts receivable assigned
E7-100	Sales of receivables without recourse
E7-101	Issues with derecognition of accounts receivable
E7-102	Accounts receivable analysis and securitization
E7-103	Presentation and disclosure of receivables
E7-104	ASPE/IFRS differences
E7-105	ASPE/IFRS differences
*E7-106	Reconciliation of cash account
*E7-107	Bank reconciliations
*E7-108	Control of petty cash

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

PROBLEMS

Item	Description
P7-109	Entries for bad debt expense
P7-110	Bad debt expense
P7-111	Amortization of discount under the straight-line and effective interest methods
P7-112	Note with fair value not equal to cash consideration
P7-113	Record note receivable
P7-114	Accounts receivable assigned
P7-115	Factoring accounts receivable
P7-116	Reasons for selling receivables
P7-117	Secured borrowings vs. factoring of receivables
*P7-118	Bank reconciliation

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

MULTIPLE CHOICE

1. Which of the following statements is correct regarding receivables?
 - a) Receivables are written promises of the purchaser to pay for goods or services.
 - b) Receivables are claims held against customers and others for money, goods, or services.

- c) Receivables are non-financial assets.
- d) Receivables that are expected to be collected within a year are classified as non-current.

Answer: b

Difficulty: Easy

Learning Objective: Understand cash and accounts receivable from a business perspective.

Section Reference: Understanding Cash and Accounts Receivable

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

2. Which of the following actions would NOT be considered good management of accounts receivable?

- a) assessing creditworthiness of new or potential customers
- b) very loose or flexible credit terms to encourage sales
- c) offering discounts to encourage faster payment
- d) regular aged receivables analysis

Answer: b

Difficulty: Easy

Learning Objective: Understand cash and accounts receivable from a business perspective.

Section Reference: Understanding Cash and Accounts Receivable

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

3. Which of the following are reasons why companies should monitor accounts receivable levels carefully?

- a) to maximize costs of collection
- b) to encourage prompt payment from their customers
- c) to minimize the stress on working capital and related bank debt
- d) b) and c) only

Answer: d

Difficulty: Easy

Learning Objective: Understand cash and accounts receivable from a business perspective.

Section Reference: Understanding Cash and Accounts Receivable

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

4. Which of the following is NOT a financial asset?

- a) a contractual right to receive cash or other financial asset from another party
- b) an equity instrument of another entity
- c) a contractual right to exchange financial instruments with another party under potentially favourable conditions
- d) a contractual right to pay cash or another financial asset to another party

Answer: d

Difficulty: Easy

Learning Objective: Define financial assets, and identify items that are considered cash and cash equivalents and how they are reported.

Section Reference: Cash

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

5. Which of the following is considered as “cash” for reporting purposes?

- a) money-market chequing accounts
- b) certificates of deposit (CDs)
- c) travel advances to employees
- d) postdated cheques

Answer: a

Difficulty: Easy

Learning Objective: Define financial assets, and identify items that are considered cash and cash equivalents and how they are reported.

Section Reference: Cash

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

6. Bank overdrafts are generally reported as

- a) a current asset.
- b) a contra account.
- c) a non-current asset.
- d) a current liability.

Answer: d

Difficulty: Easy

Learning Objective: Define financial assets, and identify items that are considered cash and cash equivalents and how they are reported.

Section Reference: Cash

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

7. The portion of any demand deposit that a customer keeps as support for its existing or maturing obligations is called
- a) an account receivable.
 - b) a bank overdraft.
 - c) a compensating balance.
 - d) restricted cash.

Answer: c

Difficulty: Easy

Learning Objective: Define financial assets, and identify items that are considered cash and cash equivalents and how they are reported.

Section Reference: Cash

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

8. Grieves Company has the following items at year end:

Cash in bank.....	\$42,000
Petty cash.....	1,500
Short-term paper with maturity of 2 months.....	6,500
Postdated cheques	3,400

Grieves should report cash and cash equivalents of

- a) \$42,000.
- b) \$43,500.
- c) \$50,000.
- d) \$46,600.

Answer: c

Difficulty: Medium

Learning Objective: Define financial assets, and identify items that are considered cash and cash equivalents and how they are reported.

Section Reference: Cash

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$42,000 + \$1,500 + \$6,500 = \$50,000$

9. Brighton Inc. reported the following amounts: Cash in bank—chequing account of \$37,000, Cash on hand of \$1,000, Postdated cheques received totalling \$3,500, and certificates of deposit totalling \$248,000. How much should be reported as cash in the statement of financial position?

- a) \$ 37,000.
- b) \$ 38,000.
- c) \$ 45,000.
- d) \$286,000.

Answer: b

Difficulty: Medium

Learning Objective: Define financial assets, and identify items that are considered cash and cash equivalents and how they are reported.

Section Reference: Cash

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$37,000 + \$1,000 = \$38,000$

10. Because of their special nature, nontrade receivables are generally

- a) reported as cash and cash equivalents.
- b) classified and reported as separate items on the statement of financial position.
- c) classified in a note that is cross referenced to the statement of financial position.
- d) both b) and c) are correct.

Answer: d

Difficulty: Easy

Learning Objective: Define receivables and identify the different types of receivables from an accounting perspective.

Section Reference: Receivables

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

11. Which of the following is not an example of a nontrade receivable?

- a) amounts arising from sale of goods or services
- b) dividends and interest receivable
- c) claims against insurance companies for losses suffered
- d) amounts owing from a purchaser on sale of capital

Answer: a

Difficulty: Easy

Learning Objective: Define receivables and identify the different types of receivables from an accounting perspective.

Section Reference: Receivables

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

12. Dividends and interest receivable would be classified as

- a) loans receivable.
- b) trade receivables.
- c) notes receivable.
- d) nontrade receivables.

Answer: d

Difficulty: Easy

Learning Objective: Define receivables and identify the different types of receivables from an accounting perspective.

Section Reference: Receivables

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

13. On Cairo Corp.'s December 31, 2020 statement of financial position, 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 (Nov. 2020).....	4,000
Selling price of unsold goods sent by Cairo on consignment at 130 percent of cost (not included in Cairo's ending inventory)	29,000
Security deposit on lease of warehouse used for storing some inventories	<u>24,000</u>
Total	<u>\$127,500</u>

At December 31, 2020, the correct total of Cairo's current net receivables was

- a) \$78,000.
- b) \$74,500.
- c) \$70,500.
- d) \$66,500.

Answer: b

Difficulty: Medium

Learning Objective: Define receivables and identify the different types of receivables from an accounting perspective.

Section Reference: Receivables

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$74,000 - \$3,500 + \$4,000 = \$74,500$

14. The general accounting standards for recognition and measurement of accounts receivable include

- a) measuring the receivable initially at amortized cost.
- b) measuring the receivable initially at fair value.
- c) after initial recognition, measuring the receivable at fair value.
- d) not recognizing the receivable until it is paid.

Answer: b

Difficulty: Easy

Learning Objective: Account for and explain the accounting issues related to the recognition and measurement of accounts receivable.

Section Reference: Recognition and Measurement of Accounts Receivable

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

15. Trade discounts are generally NOT used to

- a) avoid frequent changes in catalogues.
- b) quote different prices for different quantities purchased.
- c) encourage faster payment.
- d) hide the true invoice price from competitors.

Answer: c

Difficulty: Easy

Learning Objective: Account for and explain the accounting issues related to the recognition and measurement of accounts receivable.

Section Reference: Recognition and Measurement of Accounts Receivable

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

16. "Sales Returns and Allowances" are reported as

- a) an expense.
- b) a deduction from Sales Revenue.
- c) a deduction from Accounts Receivable.
- d) an addition to Accounts Receivable.

Answer: b

Difficulty: Easy

Learning Objective: Account for and explain the accounting issues related to the recognition and measurement of accounts receivable.

Section Reference: Recognition and Measurement of Accounts Receivable

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

17. The interest element for trade receivables

- a) is usually not recognized because of materiality considerations.
- b) must always be recognized and be accounted for.
- c) is included in the net realizable value of the receivables.
- d) becomes more significant as the time between the sale and payment shortens.

Answer: a

Difficulty: Easy

Learning Objective: Account for and explain the accounting issues related to the recognition and measurement of accounts receivable.

Section Reference: Recognition and Measurement of Accounts Receivable

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

18. Assuming that the ideal measure of short-term receivables in the statement of financial position is the discounted value of the cash to be received in the future, failure to follow this practice usually does NOT make the financial statements 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.

Answer: c

Difficulty: Easy

Learning Objective: Account for and explain the accounting issues related to the recognition and measurement of accounts receivable.

Section Reference: Recognition and Measurement of Accounts Receivable

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

19. Receivables are initially valued based on their _____.

- a) fair value
- b) estimated amount collectible
- c) lower-of-cost-and-market value
- d) historical cost

Answer: a

Difficulty: Easy

Learning Objective: Account for and explain the accounting issues related to the recognition and measurement of accounts receivable.

Section Reference: Recognition and Measurement of Accounts Receivable

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

20. Playtime sold toys listed at \$280 per unit to Jack Inc. for \$252, a trade discount of 10 percent. Jack Inc. in turn sells the toys in the market at \$265. Jenny should record the receivable and related sales revenue (per unit) at

- a) \$280.
- b) \$265.
- c) \$252.
- d) \$227.

Answer: c

Difficulty: Medium

Learning Objective: Account for and explain the accounting issues related to the recognition and measurement of accounts receivable.

Section Reference: Recognition and Measurement of Accounts Receivable

CPA: Financial Reporting

Bloomcode: Application

Feedback: None. \$252 is provided in the question.

AACSB: Analytic

21. Cupcake Corp. has sold goods at terms 2/10, n/30. If the discount is not taken, the amount receivable is \$8,725. The entry to record the sale is

- a) a debit and credit of \$7,852.50 to Accounts Receivable and Sales respectively.
- b) a debit and credit of \$8,550.50 to Accounts Receivable and Sales respectively.
- c) a debit and credit of \$8,725 to Accounts Receivable and Sales respectively.
- d) debits of \$8,550.50 and \$174.50 to Accounts Receivable and "Forfeited Sales Discounts" respectively, and a credit to Sales for the total.

Answer: c

Difficulty: Medium

Learning Objective: Account for and explain the accounting issues related to the recognition and measurement of accounts receivable.

Section Reference: Recognition and Measurement of Accounts Receivable

CPA: Financial Reporting

Bloomcode: Application

22. During the year, Popsicle Inc., which uses the allowance method, made an entry to write off a \$4,000 uncollectible account. Before this entry was posted, the balance in accounts receivable was \$80,000 and the balance in the allowance account was \$7,000. The net realizable value of accounts receivable after the write off entry was

- a) \$80,000.
- b) \$77,000.
- c) \$76,000.
- d) \$73,000.

Answer: d

Difficulty: Hard

Learning Objective: Account for and explain the accounting issues related to the recognition and measurement of accounts receivable.

Section Reference: Recognition and Measurement of Accounts Receivable

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $(\$80,000 - \$4,000) - (\$7,000 - \$4,000) = \$73,000$

23. The likelihood of loss because of the failure of the other party to fully pay the amount owed is called

- a) accounting risk.
- b) bad debts.
- c) credit risk.
- d) currency risk.

Answer: c

Difficulty: Easy

Learning Objective: Account for and explain the accounting issues related to the impairment in value of accounts receivable.

Section Reference: Impairment of Accounts Receivable

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

24. "Allowance for Doubtful Accounts" is a(n)

- a) expense account.
- b) contra account.
- c) liability account.
- d) current asset.

Answer: b

Difficulty: Easy

Learning Objective: Account for and explain the accounting issues related to the impairment in value of accounts receivable.

Section Reference: Impairment of Accounts Receivable

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

25. Using the allowance method, when an account receivable is written off, the account to be debited is

- a) accounts receivable.

- b) bad debts expense.
- c) allowance for doubtful accounts.
- d) cash.

Answer: c

Difficulty: Easy

Learning Objective: Account for and explain the accounting issues related to the impairment in value of accounts receivable.

Section Reference: Impairment of Accounts Receivable

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

26. Which of the following approaches to determine 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

Answer: a

Difficulty: Easy

Learning Objective: Account for and explain the accounting issues related to the impairment in value of accounts receivable.

Section Reference: Impairment of Accounts Receivable

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

27. The direct write off method of accounting for the impairment of receivables

- a) is never acceptable.
- b) is an acceptable method when the effect of not applying the allowance method would be highly immaterial.
- c) is specifically disallowed under IFRS.
- d) usually results in the same net income as the allowance method.

Answer: b

Difficulty: Easy

Learning Objective: Account for and explain the accounting issues related to the impairment in value of accounts receivable.

Section Reference: Impairment of Accounts Receivable

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

28. 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.

Answer: c

Difficulty: Easy

Learning Objective: Account for and explain the accounting issues related to the impairment in value of accounts receivable.

Section Reference: Impairment of Accounts Receivable

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

29. Under the allowance method of recognizing uncollectible accounts, the entry to recognize the collection of a previously written off uncollectible account

- a) increases net income.
- b) has no effect on the allowance for doubtful accounts.
- c) decreases the allowance for doubtful accounts.
- d) increases the allowance for doubtful accounts.

Answer: d

Difficulty: Easy

Learning Objective: Account for and explain the accounting issues related to the impairment in value of accounts receivable.

Section Reference: Impairment of Accounts Receivable

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

30. The advantage of relating a company's bad debt expense to its outstanding accounts receivable is that this approach

- a) gives a reasonably correct valuation of the receivables in the statement of financial position.
- 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.

Answer: a

Difficulty: Easy

Learning Objective: Account for and explain the accounting issues related to the impairment in value of accounts receivable.

Section Reference: Impairment of Accounts Receivable

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

31. What is the single most important indicator used to identify impaired accounts receivable?

- a) the customer's payment history
- b) the age of the accounts
- c) credit reports and references
- d) industry in which the company operates

Answer: b

Difficulty: Easy

Learning Objective: Account for and explain the accounting issues related to the impairment in value of accounts receivable.

Section Reference: Impairment of Accounts Receivable

CPA Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

32. What is the normal journal entry for recording bad debt expense under the allowance method?

- a) debit Allowance for Doubtful Accounts, credit Accounts Receivable
- b) debit Allowance for Doubtful Accounts, credit Bad Debt Expense
- c) debit Bad Debt Expense, credit Allowance for Doubtful Accounts
- d) debit Accounts Receivable, credit Allowance for Doubtful Accounts

Answer: c

Difficulty: Medium

Learning Objective: Account for and explain the accounting issues related to the impairment in value of accounts receivable.

Section Reference: Impairment of Accounts Receivable

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

33. The following information is available for Pirate Company:

Allowance for Doubtful Accounts at December 31, 2020	\$ 7,000
Credit Sales during 2021.....	270,000
Accounts Receivable deemed worthless and written off during 2021	2,800

As a result of a review and aging of Accounts Receivable in early January 2022, however, it has been determined that an Allowance For Doubtful Accounts of \$7,500 is required at December 31, 2021. What amount should Pirate record as bad debt expense for calendar 2021?

- a) \$4,200
- b) \$3,300
- c) \$7,500
- d) \$74,000

Answer: b

Difficulty: Medium

Learning Objective: Account for and explain the accounting issues related to the impairment in value of accounts receivable.

Section Reference: Impairment of Accounts Receivable

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$7,000 - \$2,800 = \$4,200$ unadjusted credit balance

$\$4,200 - \$7,500$ desired balance = $\$3,300$ bad debt expense

34. Lebanon Ltd. prepared an aging of its accounts receivable at December 31, 2020 and determined that the net realizable value of the receivables was \$290,000. Additional information for calendar 2020 follows:

Allowance for doubtful accounts, beginning	\$ 34,000
Uncollectible account written off during year	23,000
Accounts receivable, ending.....	320,000
Uncollectible accounts recovered during year	5,000

For the year ended December 31, 2020, Lebanon's bad debt expense should be

- a) \$20,000.
- b) \$23,000.
- c) \$16,000.
- d) \$14,000.

Answer: d

Difficulty: Medium

Learning Objective: Account for and explain the accounting issues related to the impairment in value of accounts receivable.

Section Reference: Impairment of Accounts Receivable

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: Allowance for Doubtful Accounts balance

$\$34,000 + \$5,000 - \$23,000 = \$16,000$ (before bad debt expense)

$\$320,000 - \$290,000 - \$16,000 = \$14,000$ (bad debt expense)

35. For the year ended December 31, 2020, Ferguson Corp. estimated its allowance for doubtful accounts using the year-end aging of accounts receivable. Additional information for calendar 2020 follows:

Allowance for doubtful accounts, beginning	\$74,000
Estimated uncollectible accounts during 2020	
(1% of credit sales of \$8,000,000)	80,000
Uncollectible accounts written off during year	104,000
Estimated uncollectible accounts per year-end aging	148,000

For the year ended December 31, 2020, Ferguson's bad debt expense should be

- a) \$74,000.
- b) \$104,000.
- c) \$178,000.
- d) \$252,000.

Answer: c

Difficulty: Medium

Learning Objective: Account for and explain the accounting issues related to the impairment in value of accounts receivable.

Section Reference: Impairment of Accounts Receivable

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$148,000 - \$74,000 + \$104,000 = \$178,000$

36. Sudan Ltd.'s allowance for doubtful accounts was \$85,000 at the end of 2020 and \$105,000 at the end of 2019. For the year ended December 31, 2020, Sudan reported bad debt expense of \$18,000 in its income statement. What amount did Sudan debit to allowance for doubtful accounts during 2020 to write off actual bad debts?

- a) \$38,000
- b) \$34,650
- c) \$20,000
- d) \$12,000

Answer: a

Difficulty: Medium

Learning Objective: Account for and explain the accounting issues related to the impairment in value of accounts receivable.

Section Reference: Impairment of Accounts Receivable

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$105,000 + \$18,000 - \$85,000 = \$38,000$

37. The following accounts were included on Mali Co.'s *unadjusted* trial balance at December 31, 2020:

	<u>Debit</u>	<u>Credit</u>
Accounts receivable	\$850,000	
Allowance for doubtful accounts.....	11,000	
Net credit sales		\$2,950,000

Mali estimates that 1.5 % of the gross accounts receivable will become uncollectible. After the proper adjustment at December 31, 2020, the allowance for doubtful accounts should have a credit balance of

- a) \$23,750.
- b) \$12,750.
- c) \$11,000.
- d) \$ 1,750.

Answer: b

Difficulty: Easy

Learning Objective: Account for and explain the accounting issues related to the impairment in value of accounts receivable.

38. Which of the following statements is correct?

- a) There is no interest included in a zero-interest-bearing note.
- b) A long-term note's fair value and present value are always the same.
- c) All notes contain an interest element because of the time value of money.
- d) A note is signed by the payee in favour of the maker.

Answer: c

Difficulty: Easy

Learning Objective: Account for and explain the accounting issues related to the recognition and measurement of notes and loans receivable.

Section Reference: Notes and Loans Receivable

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

39. At the beginning of 2020, Graham Company received a three-year zero-interest-bearing \$5,000 trade note. The market rate for equivalent notes was 10% at that time. Gannon reported this note as a \$5,000 trade note receivable on its 2020 year-end statement of financial position and \$5,000 as sales revenue for 2020. What effect did this accounting for the note have on Gannon's net earnings for 2020, 2021, 2022, and its retained earnings at the end of 2022, respectively?

- a) overstate, overstate, understate, zero
- b) overstate, understate, understate, understate
- c) overstate, overstate, overstate, overstate
- d) None of these answer choices are correct.

Answer: d

Difficulty: Hard

Learning Objective: Account for and explain the accounting issues related to the recognition and measurement of notes and loans receivable.

Section Reference: Notes and Loans Receivable

CPA: Financial Reporting

Bloomcode: Analysis

AACSB: Analytic

Feedback: Answer is none of the options; it should be: overstate, understate, understate, zero.

40. Assume Sentinel Corp., an equipment distributor, sells a piece of machinery with a list price of \$700,000 to Arch Inc. Arch Inc. will pay \$725,000 in one year. Sentinel Corp. normally sells this type of equipment for 80% of list price. How much should be recorded as revenue?

- a) \$560,000

- b) \$580,000
- c) \$700,000
- d) \$725,000

Answer: a

Difficulty: Medium

Learning Objective: Account for and explain the accounting issues related to the recognition and measurement of notes and loans receivable.

Section Reference: Notes and Loans Receivable

CPA: Financial Reporting

Bloomcode: Application

Feedback: $(\$700,000 \times .80) = \$560,000$

AACSB: Analytic

41. The straight-line method of amortization of discounts and premiums for long-term notes

- a) is allowed by both IFRS and ASPE.
- b) reflects the economic reality of the loan.
- c) is only allowed by ASPE.
- d) requires more complicated calculations than the effective interest method.

Answer: c

Difficulty: Easy

Learning Objective: Account for and explain the accounting issues related to the recognition and measurement of notes and loans receivable.

Section Reference: Notes and Loans Receivable

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

42. 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) it must be a zero-interest-bearing note.

Answer: c

Difficulty: Easy

Learning Objective: Account for and explain the accounting issues related to the recognition and measurement of notes and loans receivable.

Section Reference: Notes and Loans Receivable
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

43. If a note receivable was issued at an amount that is *less* than its face value, then
- 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) it must be a zero-interest-bearing note.

Answer: b

Difficulty: Easy
Learning Objective: Account for and explain the accounting issues related to the recognition and measurement of notes and loans receivable.
Section Reference: Notes and Loans Receivable
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

44. If a note receivable was issued at an amount that is *more* than its face value, then
- a) the note was issued at a premium and the note's stated rate was different from the prevailing market rate of interest.
 - b) the note was issued at a premium and the note's stated rate was the same as the prevailing market rate of interest.
 - c) the note was issued at a discount and the note's stated rate was the same as the prevailing market rate of interest.
 - d) the note was issued at a discount and the note's stated rate was different from the prevailing market rate of interest.

Answer: a

Difficulty: Easy
Learning Objective: Account for and explain the accounting issues related to the recognition and measurement of notes and loans receivable.
Section Reference: Notes and Loans Receivable
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

45. When a zero-interest-bearing note is issued, its present value is

- a) zero.
- b) the face value plus interest.
- c) the face value.
- d) the cash paid to the issuer.

Answer: d

Difficulty: Easy

Learning Objective: Account for and explain the accounting issues related to the recognition and measurement of notes and loans receivable.

Section Reference: Notes and Loans Receivable

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

46. On December 31, 2020, Flint Corporation sold for \$100,000 an old machine having an original cost of \$180,000 and a book value of \$80,000. The terms of the sale were as follows:

\$20,000 down payment,

\$40,000 payable on December 31 each of the next two years.

The agreement of sale made no mention of interest; however, 9% would be a fair rate for this type of transaction. What should be the amount of the notes receivable net of the unamortized discount on December 31, 2020, rounded to the nearest dollar?

- a) \$70,364
- b) \$90,364
- c) \$80,000
- d) \$140,728

Answer: a

Difficulty: Medium

Learning Objective: Account for and explain the accounting issues related to the recognition and measurement of notes and loans receivable.

Section Reference: Notes and Loans Receivable

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: The present value of an ordinary annuity of 1 at 9% for 2 years is 1.75911

$\$40,000 \times 1.75911 = \$70,364$.

47. Cookie Ltd. receives a four-year, \$100,000, zero-interest-bearing note. The present value of this note is \$82,270. What is the implicit rate of interest?

- a) 3%

- b) 5%
- c) 7%
- d) 9%

Answer: b

Difficulty: Medium

Learning Objective: Account for and explain the accounting issues related to the recognition and measurement of notes and loans receivable.

Section Reference: Notes and Loans Receivable

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: 4 n, -82,270 PV, 100,000 FV, CPT I = 5%

48. Cookie Ltd. receives a four-year, \$100,000, zero-interest-bearing note. The present value of this note is \$82,270. Assuming the note was issued on January 1, 2020, and the effective interest method is used, the interest income to be recognized for calendar 2020 will be

- a) \$5,000.
- b) \$9,000.46.
- c) \$4,113.50.
- d) \$6,587.31.

Answer: c

Difficulty: Medium

Learning Objective: Account for and explain the accounting issues related to the recognition and measurement of notes and loans receivable.

Section Reference: Notes and Loans Receivable

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$82,270 \times 5\% = \$4,113.50$

49. Cookie Ltd. receives a four-year, \$100,000 zero-interest-bearing note. The present value of this note is \$82,270. Interest income to be recognized for calendar 2021 will be

- a) \$10,000.
- b) \$4,319.18.
- c) \$8,227.00.
- d) \$7,910.75.

Answer: b

Difficulty: Medium

Learning Objective: Account for and explain the accounting issues related to the recognition and measurement of notes and loans receivable.

Section Reference: Notes and Loans Receivable

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $(\$82,270 + \$4,113.50) \times 5\% = \$4,319.18$

50. If receivables are used as collateral in borrowing transactions,

- a) the receivables generally come under the control of the lender.
- b) a liability is reported on the borrower's statement of financial position.
- c) the receivables will be reported as a liability.
- d) the transaction would be reported as a sale.

Answer: b

Difficulty: Easy

Learning Objective: Account for and explain the basic accounting issues related to the derecognition of receivables.

Section Reference: Derecognition of Receivables

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

51. Which of the following is INCORRECT regarding factoring of receivables?

- a) Factoring usually involves a sale to only one company.
- b) The fees are relatively high.
- c) The quality of the receivables may be lower.
- d) The seller usually continues to service the receivables.

Answer: d

Difficulty: Easy

Learning Objective: Account for and explain the basic accounting issues related to the derecognition of receivables.

Section Reference: Derecognition of Receivables

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

52. Which of the following is NOT a difference between factoring and securitization of receivables?

- a) In securitization, many investors are involved, whereas factoring usually involves only one company.
- b) Receivables are derecognized when securitized, but not when factored.
- c) The quality of receivables factored tends to be lower than those securitized.
- d) The seller retains responsibility to collect amounts due when securitized, but not when factored.

Answer: b

Difficulty: Easy

Learning Objective: Account for and explain the basic accounting issues related to the derecognition of receivables.

Section Reference: Derecognition of Receivables

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

Feedback: The opposite is true. Receivables are derecognized when factored, but not when securitized.

Use the following information for questions 42–43.

Braun Company factors \$300,000 of accounts receivable with Schick Factors Inc. on a without recourse basis. The receivables records are transferred to Schick Factors, which takes over full responsibility for collections. Schick assesses a finance charge of 4% and withholds an initial amount equal to 7% of the accounts receivable for returns and allowances.

53. The loss on disposal of receivables recorded by Braun is

- a) \$12,000.
- b) \$21,000.
- c) \$33,000.
- d) \$0.

Answer: a

Difficulty: Medium

Learning Objective: Account for and explain the basic accounting issues related to the derecognition of receivables.

Section Reference: Derecognition of Receivables

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

54. The cash paid by Schick Factors to Braun Company is

- a) \$300,000.
- b) \$288,000.
- c) \$267,000.
- d) \$279,000.

Answer: c

Difficulty: Medium

Learning Objective: Account for and explain the basic accounting issues related to the derecognition of receivables.

Section Reference: Derecognition of Receivables

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

55. Starlight Ltd. assigned \$600,000 of Accounts Receivable to Moonbeam Management as security for a loan of \$580,000. Moonbeam charged a 3% commission on the amount of the loan; the interest rate on the loan was 10%. During the first month, Starlight collected \$320,000 of the assigned accounts, after deducting \$500 of discounts. As well, Starlight accepted returns worth \$2,600 and wrote off assigned accounts totalling \$4,500. The amount of cash Starlight received from Moonbeam at the time of the transfer was

- a) \$378,000.
- b) \$582,000.
- c) \$562,600.
- d) \$280,000.

Answer: c

Difficulty: Medium

Learning Objective: Account for and explain the basic accounting issues related to the derecognition of receivables.

Section Reference: Derecognition of Receivables

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$580,000 \times 97\% = \$562,600$

56. Starlight Ltd. assigned \$600,000 of Accounts Receivable to Moonbeam Management as security for a loan of \$580,000. Moonbeam charged a 3% commission on the amount of the loan; the interest rate on the loan was 10%. During the first month, Starlight collected

\$320,000 of the assigned accounts, after deducting \$500 of discounts. As well, Starlight accepted returns worth \$2,600 and wrote off assigned accounts totalling \$4,500. Entries made by Starlight during the first month would include a

- a) debit to Cash of \$322,600.
- b) debit to Bad Debts Expense of \$4,500.
- c) debit to Allowance for Doubtful Accounts of \$4,500.
- d) debit to Accounts Receivable of \$324,500.

Answer: c

Difficulty: Medium

Learning Objective: Account for and explain the basic accounting issues related to the derecognition of receivables.

Section Reference: Derecognition of Receivables

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

57. On February 1, 2020, Strawberry Corp. factored receivables with a carrying amount of \$250,000 to Shortcake Inc. Shortcake assessed a finance charge of 3% of the receivables and retained 5% of the receivables. Relative to this transaction, you are to determine the amount of loss on disposal to be reported in the income statement of Strawberry Corp. for February. Assume that Strawberry factors the receivables on a *without recourse* basis. The loss to be reported is

- a) \$ 0.
- b) \$7,500.
- c) \$15,000.
- d) \$14,550.

Answer: b

Difficulty: Medium

Learning Objective: Account for and explain the basic accounting issues related to the derecognition of receivables.

Section Reference: Derecognition of Receivables

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$250,000 \times .03 = \$7,500$

58. On February 1, 2020, Strawberry Corp. factored receivables with a carrying amount of \$250,000 to Shortcake Inc. Shortcake assessed a finance charge of 3% of the receivables and

retained 5% of the receivables. Relative to this transaction, you are to determine the amount of loss on disposal to be reported in the income statement of Strawberry Corp. for February. Assume that Strawberry factors the receivables on a *with recourse* basis. The recourse obligation has a fair value of \$1,000. The loss to be reported is

- a) \$17,000.
- b) \$7,000.
- c) \$8,500.
- d) \$1,000.

Answer: c

Difficulty: Medium

Learning Objective: Account for and explain the basic accounting issues related to the derecognition of receivables.

Section Reference: Derecognition of Receivables

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $(\$250,000 \times .03) + \$1,000 = \$8,500$

59. The accounts receivable turnover ratio is calculated by dividing

- a) gross sales by ending net trade receivables.
- b) gross sales by average net trade receivables.
- c) net sales by ending net trade receivables.
- d) net sales by average net trade receivables.

Answer: d

Difficulty: Easy

Learning Objective: Explain how receivables and loans are reported and analyzed.

Section Reference: Presentation, Disclosure, and Analysis of Receivables

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

60. The ratio that is used to assess the liquidity of accounts receivable is the

- a) current ratio.
- b) receivables turnover ratio.
- c) quick ratio.
- d) inventory turnover ratio.

Answer: b

Difficulty: Easy

Learning Objective: Explain how receivables and loans are reported and analyzed.

Section Reference: Presentation, Disclosure, and Analysis of Receivables

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

61. The requirements for presentation and disclosure of receivables under IFRS are different than those required by ASPE. Which of the following statements is true about these disclosures?

- a) More information is required under ASPE than IFRS.
- b) IFRS requires extensive quantitative and qualitative information about all accounts.
- c) Under ASPE, a reconciliation of changes in the allowance account during the period must be reported.
- d) Far less information about risk exposures and fair values is required under ASPE.

Answer: d

Difficulty: Easy

Learning Objective: Explain how receivables and loans are reported and analyzed.

Section Reference: Presentation, Disclosure, and Analysis of Receivables

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

62. Which of the following statements is/are true regarding the receivables turnover ratio?

- a) It is used to assess receivables' liquidity.
- b) It measures the number of times, on average, that receivables are collected during the period.
- c) It is calculated by dividing average sales by gross receivables outstanding during the year.
- d) Both a) and b) are correct.

Answer: d

Difficulty: Easy

Learning Objective: Explain how receivables and loans are reported and analyzed.

Section Reference: Presentation, Disclosure, and Analysis of Receivables

CPA: Financial Reporting

CPA: Management Accounting

Bloomcode: Knowledge

AACSB: Analytic

63. Regarding treatment of cash and cash equivalents under ASPE vs. IFRS, which of the following is NOT correct?

- a) IFRS allows preferred shares acquired close to their maturity date to qualify as a cash equivalent.
- b) Cash equivalents under ASPE may be highly liquid investments readily convertible to cash.
- c) Cash equivalents under ASPE may be investments convertible to unknown amounts of cash with material risk of change and value.
- d) All of these statements are correct.

Answer: c

Difficulty: Easy

Learning Objective: Identify differences in accounting between IFRS and accounting standards for private enterprises (ASPE), and what changes are expected in the near future.

Section Reference: IFRS/ASPE Comparison

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

64. Regarding receivables recognition and measurement, which of the following is true regarding the related IFRS standard?

- a) It requires the effective interest method is used to recognize interest and related premiums or discounts.
- b) It requires the straight-line method is used to recognize interest and related premiums or discounts.
- c) It allows a choice between the effective interest and straight-line methods.
- d) None of these statements is correct.

Answer: a

Difficulty: Easy

Learning Objective: Identify differences in accounting between IFRS and accounting standards for private enterprises (ASPE), and what changes are expected in the near future.

Section Reference: IFRS/ASPE Comparison

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

*65. A Cash Over and Short account is

- a) not generally acceptable under Canadian GAAP.

- b) debited when the sum of the receipts and the cash in the fund is more than the imprest amount.
- c) debited when the sum of the receipts and the cash in the fund is less than the imprest amount.
- d) a contra account to Cash.

Answer: c

Difficulty: Easy

Learning Objective: Explain common techniques for controlling cash.

Section Reference: Methods for Controlling Cash (Appendix 7A)

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

*66. The journal entries related to a bank reconciliation

- a) are taken from the "balance per bank" section only.
- b) may include a credit to Bank Charges Expense for bank service charges.
- c) may include a debit to Accounts Receivable for an NSF cheque.
- d) may include a debit to Accounts Payable for an NSF cheque.

Answer: c

Difficulty: Medium

Learning Objective: Explain common techniques for controlling cash.

Section Reference: Methods for Controlling Cash (Appendix 7A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

*67. When preparing a bank reconciliation, a deposit credited to our account by the bank in error is

- 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.

Answer: b

Difficulty: Medium

Learning Objective: Explain common techniques for controlling cash.

Section Reference: Methods for Controlling Cash (Appendix 7A)

CPA: Financial Reporting
Bloomcode: Application
AACSB: Analytic

*68. Which of the following is NOT a common reconciling item recorded in preparation of a company's bank reconciliation(s)?

- a) deposits in transit
- b) bank charges
- c) cash in other accounts
- d) bank credits

Answer: c

Difficulty: Easy
Learning Objective: Explain common techniques for controlling cash.
Section Reference: Methods for Controlling Cash (Appendix 7A)
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

*69. In preparing its bank reconciliation for the month of April 2020, Henke Inc. has the following information available:

Balance per bank statement, 4/30/20.....	\$34,140
NSF cheque returned with 4/30/20 bank statement	450
Deposits in transit, 4/30/20	5,000
Outstanding cheques, 4/30/20	5,200
Bank service charges for April	20

What should be the correct balance of cash at April 30, 2020?

- a) \$34,370
- b) \$33,940
- c) \$33,490
- d) \$33,470

Answer: b

Difficulty: Medium
Learning Objective: Explain common techniques for controlling cash.
Section Reference: Methods for Controlling Cash (Appendix 7A)
CPA: Financial Reporting
Bloomcode: Application
AACSB: Analytic
Feedback: $\$34,140 + \$5,000 - \$5,200 = \$33,940$

*70. If a petty cash fund is established in the amount of \$550, and contains \$500 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.

Answer: d

Difficulty: Medium

Learning Objective: Explain common techniques for controlling cash.

Section Reference: Methods for Controlling Cash (Appendix 7A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$550 - \$500 = \$50$

*71. If the month-end bank statement shows a balance of \$51,000, outstanding cheques are \$14,000, a deposit of \$3,000 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) \$40,800.
- b) \$51,000.
- c) \$28,800.
- d) \$14,800.

Answer: a

Difficulty: Medium

Learning Objective: Explain common techniques for controlling cash.

Section Reference: Methods for Controlling Cash (Appendix 7A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$51,000 - \$14,000 + \$3,000 + \$800 = \$40,800$

*72. In preparing its bank reconciliation at April 30, 2020, Delta Inc. has the following information available:

Balance per bank statement \$45,700

NSF cheque returned with April bank statement.....	420
Deposits in transit.....	2,500
Outstanding cheques	16,000
Bank service charges for April	25

The correct balance of cash at April 30, 2020 is

- a) \$45,280.
- b) \$32,200.
- c) \$48,200.
- d) \$61,700.

Answer: b

Difficulty: Medium

Learning Objective: Explain common techniques for controlling cash.

Section Reference: Methods for Controlling Cash (Appendix 7A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$45,700 + \$2,500 - \$16,000 = \$32,200$

*73. In preparing its bank reconciliation at May 31, 2020, Kennedy Co. has the following information available:

Balance per bank statement	\$78,000
Deposit in transit.....	15,600
Outstanding cheques	4,200
Note collected by bank in May	7,200

The correct balance of cash at May 31, 2020 is

- a) \$95,600.
- b) \$94,800.
- c) \$89,400.
- d) \$84,000.

Answer: c

Difficulty: Medium

Learning Objective: Explain common techniques for controlling cash.

Section Reference: Methods for Controlling Cash (Appendix 7A)

CPA: Financial Reporting

Bloomcode: Application

Feedback: $\$78,000 + \$15,600 - \$4,200 = \$89,400$

*74. In preparing its September 30 bank reconciliation, Frieda Corp. has the following information available:

Balance per bank statement.....	\$34,510
Deposit in transit	4,650
Customer's cheque returned NSF.....	325
Outstanding cheques	1,925
Bank service charges for September	40

Frieda's correct cash balance at September 30 is

- a) \$36,910.
- b) \$36,870.
- c) \$37,235.
- d) \$34,510.

Answer: c

Difficulty: Medium

Learning Objective: Explain common techniques for controlling cash.

Section Reference: Methods for Controlling Cash (Appendix 7A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$34,510 + \$4,650 - \$1,925 = \$37,235$

*75. Congo Ltd. prepared the following bank reconciliation at March 31:

Balance per bank statement.....	\$37,200
Add: Deposit in transit.....	<u>10,300</u>
.....	47,500
Less: Outstanding cheques	<u>12,600</u>
Correct cash balance per books, March 31	<u>\$34,900</u>

Data per bank statement for the month of April follows:

Deposits	\$47,700
Disbursements.....	49,700

All reconciling items at March 31 cleared the bank in April. Outstanding cheques at April 30 totalled \$5,000. There were no deposits in transit at April 30. What is the correct cash balance per books at April 30?

- a) \$30,200
- b) \$32,900
- c) \$35,200
- d) \$40,500

Answer: a

Difficulty: Medium

Learning Objective: Explain common techniques for controlling cash.

Section Reference: Methods for Controlling Cash (Appendix 7A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$37,200 + \$47,700 - \$49,700 = \$35,200$ (4/30 balance per bank)

$\$35,200 - \$5,000 = \$30,200$

EXERCISES

Ex. 7-76 Cash management from a business perspective

Cite and explain three (3) practices and/or procedures companies engage in to manage their cash balances.

Solution 7-76

Practices and/or procedures companies engage in to manage their cash balances include:

- preparation of cash flow budgets to help anticipate cash needs and minimize borrowing requirements
- preparation of the statement of cash flows to provide insight into the sources and uses of the company's cash balances
- preparation of bank reconciliations to detect any discrepancies between cash movement as per the general ledger and transactions flowing through the company's bank account(s)
- physical controls over cash such as keeping of petty cash, cheques, and banking information under lock and key, and limiting those with access and authorization to the company's bank accounts

Difficulty: Easy

Learning Objective: Understand cash and accounts receivable from a business perspective.

Section Reference: Understanding Cash and Accounts Receivable

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

Ex. 7- 77Accounts receivable planning and control

For many reasons, it is important for management to carefully consider how to manage and control its accounts receivable balances. Explain two (2) reasons why companies must communicate regarding receivables management with their sales team.

Solution 7-77

Reasons why receivables management is important include:

- Overly aggressive sales team might enter into contracts with higher risk customers, resulting in collectibility difficulties
- Discounts offered by salespeople to encourage faster payment of outstanding balances come with an associated cost to the company. The company must consider whether this cost and the additional sale from the customer is in their long-term best interest
- Overall, businesses want to have accurate estimates of anticipated cash on hand to minimize both borrowing requirements and “idle” cash.

Difficulty: Easy

Learning Objective: Understand cash and accounts receivable from a business perspective.

Section Reference: Understanding Cash and Accounts Receivable

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

Ex. 7-78 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 <i>contractual</i> rights to receive cash.	3. _____
4. The reduction from a supplier's list price.	4. _____
5. 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.	5. _____
6. The value at which receivables should be reported.	6. _____

7. The method used to account for the estimated impairment of receivables.	7. _____
8. The approach that specifically recognizes the assets and liabilities when receivables are sold.	8. _____

Solution 7-78

1. compensating balances
2. restricted cash
3. a financial asset
4. a trade discount
5. the straight-line method
6. their net realizable value
7. the allowance method
8. the financial components approach

Difficulty: Easy

Learning Objective: Understand cash and accounts receivable from a business perspective.

Learning Objective: Define financial assets, and identify items that are considered cash and cash equivalents and how they are reported.

Learning Objective: Define receivables and identify the different types of receivables from an accounting perspective.

Learning Objective: Account for and explain the accounting issues related to the recognition and measurement of accounts receivable.

Learning Objective: Account for and explain the accounting issues related to the impairment in value of accounts receivable.

Learning Objective: Account for and explain the accounting issues related to the recognition and measurement of notes and loans receivable.

Learning Objective: Account for and explain the basic accounting issues related to the derecognition of receivables.

Learning Objective: Account for and explain the accounting issues related to the recognition and measurement of notes and loans receivable.

Section Reference: Understanding Cash and Accounts Receivable

Section Reference: Cash

Section Reference: Receivables

Section Reference: Recognition and Measurement of Accounts Receivable

Section Reference: Impairment of Accounts Receivable

Section Reference: Notes and Loans Receivable

Section Reference: Notes and Loans Receivable

Section Reference: Derecognition of Receivables

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

Ex. 7-79 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 7-79

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 a current asset, “cash and cash equivalents,” in the statement of financial position, 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, nontrade, 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 (i.e., 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 aged receivables, with special consideration given to older items. Based on that review, the allowance for

doubtful accounts is then adjusted to reduce the value of gross receivables accordingly. Companies often use a mix of procedures whereby bad debts 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.
6. Receivables are analyzed in terms of their turnover, age, and 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 ASPE).

Difficulty: Easy

Learning Objective: Understand cash and accounts receivable from a business perspective.

Learning Objective: Understand cash and accounts receivable from a business perspective.

Learning Objective: Define financial assets, and identify items that are considered cash and cash equivalents and how they are reported.

Learning Objective: Define receivables and identify the different types of receivables from an accounting perspective.

Learning Objective: Account for and explain the accounting issues related to the recognition and measurement of accounts receivable.

Learning Objective: Account for and explain the accounting issues related to the impairment in value of accounts receivable.

Learning Objective: Account for and explain the accounting issues related to the recognition and measurement of notes and loans receivable.

Learning Objective: Account for and explain the basic accounting issues related to the derecognition of receivables.

Learning Objective: Account for and explain the accounting issues related to the recognition and measurement of notes and loans receivable.

Learning Objective: Explain how receivables and loans are reported and analyzed.

Learning Objective: Identify differences in accounting between IFRS and accounting standards for private enterprises (ASPE), and what changes are expected in the near future.

Section Reference: Understanding Cash and Accounts Receivable

Section Reference: Cash

Section Reference: Receivables

Section Reference: Recognition and Measurement of Accounts Receivable

Section Reference: Impairment of Accounts Receivable

Section Reference: Notes and Loans Receivable

Section Reference: Derecognition of Receivables

Section Reference: Presentation, Disclosure, and Analysis of Receivables

Section Reference: IFRS/ASPE Comparison

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

Ex. 7-80 Credit policies

What are the implications if credit policies are too “tight” or restrictive versus too “loose” or flexible?

Solution 7-80

If credit policies are too “tight,” or restrictive, potential sales could be lost to competitors. On the other hand, if the credit policy is too “loose,” or flexible, an aggressive sales team might enter into contracts with higher-risk customers, resulting in collectibility difficulties.

Difficulty: Easy

Learning Objective: Understand cash and accounts receivable from a business perspective.

Section Reference: Understanding Cash and Accounts Receivable.

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

Ex. 7-81 Reporting of cash

At December 31, 2020, Burkina Ltd.’s general ledger Cash balance was \$24,600. In addition, Burkina held the following items in its safe on December 31:

1. A cheque for \$780 from Zambia Ltd. received December 30, 2020, which was not deposited until January 2, 2021.
2. A cheque from Zanzibar Inc. for \$1,800 that had been deposited on December 20, but was returned NSF on December 29. The cheque was to be re-deposited on January 3, 2021. The original deposit has been included in the December 31 chequebook balance.
3. Coin and currency on hand: \$2,630.

Instructions

Calculate the proper amount to be reported as cash on Burkina’s statement of financial position at December 31, 2020.

Solution 7-81

Cash G/L account \$24,600

Undeposited cheque.....	780
Coin and currency	2,630
Less NSF cheque.....	<u>(1,800)</u>
Cash to be reported.....	<u>\$26,210</u>

Difficulty: Medium

Learning Objective: Define financial assets, and identify items that are considered cash and cash equivalents and how they are reported.

Section Reference: Cash

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 7-82 Reporting of cash and cash equivalents

Lawrence Company has cash in bank of \$22,000, restricted cash in a separate account of \$4,000, and a bank overdraft in an account at another bank of \$2,000. How much cash should Lawrence report on their statement of financial position? Explain.

Solution 7-82

Lawrence should report \$22,000 as cash on their statement of financial position.

The restricted cash of \$4,000 is considered a cash equivalent, or short-term investment because of the restrictions placed upon it.

For a similar reason, the overdraft of \$2,000 available at another bank is not considered cash, as there are likely penalties associated with its use.

Difficulty: Easy

Learning Objective: Define financial assets, and identify items that are considered cash and cash equivalents and how they are reported.

Section Reference: Cash

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

Ex. 7-83 Restricted cash balances

Some lending institutions require customers who borrow money from them to keep minimum cash balances in their chequing or savings accounts. What are these balances called? Explain why they might need to be separately reported on the company's statement of financial position.

Solution 7-83

These balances are called compensating balances. They must be reported separately in current or non-current assets, as appropriate, to ensure that investors are not misled about the amount of cash that is available to meet recurring obligations.

Difficulty: Easy

Learning Objective: Define financial assets, and identify items that are considered cash and cash equivalents and how they are reported.

Section Reference: Cash

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

Ex. 7-84 Cash versus cash equivalents or short-term investments

Explain the difference between cash and cash equivalents or short-term investments and provide two examples of each.

Solution 7-84

Cash consists of coins, currency, and other available funds that are on deposit at a bank. Negotiable instruments such as money orders, certified cheques, cashier's cheques, and bank drafts are also viewed as cash. Money-market funds that give chequing account privileges are usually classified as cash.

It is more appropriate to classify money-market funds, certificates of deposit, and similar types of deposits and "short-term paper" that allow investors to earn interest as **cash equivalents** or **short-term investments** than as cash. The reason is that there are usually restrictions or penalties on these securities if they are converted to cash before maturity. Money-market funds that give chequing account privileges, however, are usually classified as cash.

Difficulty: Easy

Learning Objective: Define financial assets, and identify items that are considered cash and cash equivalents and how they are reported.

Section Reference: Cash

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

Ex. 7-85 Classification of accounts receivable

Trade receivables are amounts owed by customers to whom a company has sold goods or services as part of normal business operations. Briefly explain the difference between open accounts receivable and notes receivable.

Solution 7-85

Open accounts receivable are short-term extensions of credit based on a purchaser's verbal promise to pay for goods and services that have been sold. They are normally collectible between 30 to 60 days, but credit terms may be longer—or shorter—depending on the industry. Notes receivable are written promises to pay a certain amount of money on a specified future date. They may arise from sales of goods and services, or from other transactions.

Difficulty: Easy

Learning Objective: Define receivables and identify the different types of receivables from an accounting perspective.

Section Reference: Receivables

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

Ex. 7-86 Nontrade receivables

Nontrade receivables are created by a variety of transactions and can be written promises either to pay cash or to deliver other assets. Provide three examples of nontrade receivables.

Solution 7-86

Examples of nontrade receivables include the following:

- advances to officers and employees, or to subsidiaries or other companies
- amounts owing from a purchaser on the sale of capital assets or investments where delayed payment terms have been agreed on
- amounts receivable from the government for income taxes paid in excess of the amount owed, GST/HST payments recoverable, investment tax credits, or other tax rebates receivable
- dividends and interest receivable
- claims against insurance companies for losses the company has suffered; against trucking companies or railways for damaged or lost goods; against creditors for returned, damaged, or lost goods; or against customers for returnable items (crates, containers, etc.)

Difficulty: Easy

Learning Objective: Define receivables and identify the different types of receivables from an accounting perspective.

Section Reference: Receivables

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

Ex. 7-87 Sales Returns and Allowances

Assume that Olympia Corporation follows ASPE and estimates that approximately 5% of its \$1.5 million of trade receivables outstanding will be returned or some adjustment will be made to the sales price.

Instructions

- Prepare the entry to show expected sales returns and allowances.
- Explain why it is important to prepare and include this entry in Olympia's financial statements.

Solution 7-87

a)			
Sales Returns and Allowances	75,000		
Allowance for Sales Returns and Allowances		75,000	

* \$1.5 million x 5% = \$75,000

- It is important to prepare and include this entry in Olympia's financial statements because it is material in amount. Leaving out a \$75,000 charge could have a material impact on net income and thus significantly impact the decisions of financial statement stakeholders.

Difficulty: Medium

Learning Objective: Account for and explain the accounting issues related to the recognition and measurement of accounts receivable.

Section Reference: Recognition and Measurement of Accounts Receivable

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 7-88 Entries for bad debt expense

Patagonia Corp.'s unadjusted trial balance included the following:

	<u>Debit</u>	<u>Credit</u>
Accounts receivable	\$140,000	
Allowance for doubtful accounts		\$890
Sales.....		425,000
Sales returns and allowances.....	10,000	

Instructions

Prepare adjusting journal entries assuming that the estimate of uncollectibles is determined by using

- 4% of gross accounts receivable, and
- 1.5% of net sales.

Solution 7-88

a) Bad Debts Expense	4,710	
Allowance for Doubtful Accounts		4,710
 Gross receivables	\$140,000	
Rate	<u>4%</u>	
Total allowance needed	5,600	
Present allowance	<u>(890)</u>	
Adjustment needed	<u>\$ 4,710</u>	
 b) Bad Debts Expense	6,225	
Allowance for Doubtful Accounts		6,225
 Sales	\$425,000	
Less sales returns and allowances	<u>10,000</u>	
Net sales	415,000	
Rate	<u>1.5%</u>	
Bad debts expense	<u>\$ 6,225</u>	

Difficulty: Medium

Learning Objective: Account for and explain the accounting issues related to the impairment in value of accounts receivable.

Section Reference: Impairment of Accounts Receivable

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 7-89 Allowance for doubtful accounts

When a company has a policy of making sales for which credit is extended, it is reasonable to expect a portion of those sales to be uncollectible. As a result of this, a company must recognize bad debt expense. There are basically two methods of recognizing bad debt expense: (1) direct write off method, and (2) allowance method.

Instructions

- Describe fully both the direct write off method and the allowance method of recognizing bad debt expense.
- Discuss the reasons why one of the above methods is preferable to the other, and the reasons why the other method is not usually in accordance with generally accepted accounting principles.

Solution 7-89

- a) There are basically two methods of recognizing bad debt expense: (1) direct write off and (2) allowance.

The direct write off method requires the identification of specific balances that are deemed to be uncollectible before any bad debt expense is recognized. At the time a specific account is deemed uncollectible, the account is removed from accounts receivable and a corresponding amount of bad debt expense is recognized.

The allowance method requires an estimate of bad debt expense for a period of time by reference to the composition of the accounts receivable balance at a specific point in time (aging) or to the overall experience with credit sales over a period of time. Thus, total bad debt expense expected to arise as a result of operations for a specific period is estimated, the valuation account (allowance for doubtful accounts) is appropriately adjusted, and a corresponding amount of bad debt expense is recognized. As specific accounts are identified as uncollectible, the account is written off. It is removed from accounts receivable and a corresponding amount is removed from the valuation account (allowance for doubtful accounts). Net accounts receivable do not change, and there is no charge to bad debt expense when specific accounts are identified as uncollectible and written off using the allowance method.

- b) The allowance method is preferable because it matches the cost of making a credit sale with the revenues generated by the sale in the same period and achieves a proper carrying value for accounts receivable at the end of a period. Since the direct write off method does not recognize the bad debt expense until a specific amount is deemed uncollectible, which may be in a subsequent period, it does not comply with the matching principle and does not achieve a proper carrying value for accounts receivable at the end of a period.

Difficulty: Easy

Learning Objective: Account for and explain the accounting issues related to the impairment in value of accounts receivable.

Section Reference: Impairment of Accounts Receivable

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

Ex. 7-90 Entries for bad debt expense

A trial balance before adjustment included the following:

	<u>Debit</u>	<u>Credit</u>
Accounts receivable	\$120,000	
Allowance for doubtful accounts		\$730
Sales.....		510,000
Sales returns and allowances.....	8,000	

Instructions

Prepare adjusting journal entries assuming that the estimate of uncollectibles is determined by taking

- a) 5% of gross accounts receivable, and
- b) 1% of net sales.

Solution 7-90

a) Bad Debt Expense	5,270	
Allowance for Doubtful Accounts		5,270
Gross receivables	\$120,000	
Rate	<u>5%</u>	
Total allowance needed	6,000	
Present allowance	<u>(730)</u>	
Adjustment needed	<u>\$ 5,270</u>	
b) Bad Debt Expense	5,020	
Allowance for Doubtful Accounts		5,020
Sales	\$510,000	
Sales returns and allowances	<u>8,000</u>	
Net sales	502,000	
Rate	<u>1%</u>	
Bad debt expense	<u>\$ 5,020</u>	

Difficulty: Medium

Learning Objective: Account for and explain the accounting issues related to the impairment in value of accounts receivable.

Section Reference: Impairment of Accounts Receivable

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 7-91 Dishonoured note receivable

On November 1, 2019, Mandrake Corp. and Olivier Ltd. reached an agreement to convert Olivier's outstanding account receivable of \$27,000 into a 3-month, 8% note receivable. On February 1, 2020, Olivier dishonoured the note receivable. Prepare all required journal entries for Mandrake for the above transactions, assuming a December 31 year end and assuming adjusting journal entries are recorded at the end of its fiscal year.

Solution 7-91

2019

Nov 1	Notes Receivable—Olivier Ltd.....	27,000	
	Accounts Receivable—Olivier Ltd.		27,000
	To convert Olivier's account receivable to a 3-month, 8% note receivable		
Dec 31	Interest Receivable.....	360	
	Interest Revenue (\$27,000 x 8% x 2/12)		360
	To record accrued interest—Olivier Ltd.		

2020

Feb 1	Accounts Receivable—Olivier Ltd.	27,540	
	Interest Receivable		360
	Interest Revenue [(\$27,000 x 8% x 1/12) – \$235]		180
	Notes Receivable—Olivier Ltd.		27,000
	To record Olivier Ltd. dishonoured note receivable		

Difficulty: Medium

Learning Objective: Account for and explain the accounting issues related to the impairment in value of accounts receivable.

Section Reference: Impairment of Accounts Receivables

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 7-92 Amortization of discount on note

On December 31, 2017, Green Company finished consultation services and accepted in exchange a promissory note with a face value of \$600,000, a due date of December 31, 2020, and a stated rate of 5%, with interest receivable at the end of each year. The fair value of the services is not readily determinable and the note is not readily marketable. Under the circumstances, the note is considered to have an appropriate imputed rate of interest of 10%.

The following interest factors are provided:

<u>Table Factors for Three Periods</u>	<u>Interest Rate</u>	
	<u>5%</u>	<u>10%</u>
Future Value of 1	1.15763	1.33100
Present Value of 1	.86384	.75132
Future Value of Ordinary Annuity of 1	3.15250	3.31000
Present Value of Ordinary Annuity of 1	2.72325	2.48685

Instructions

Determine the present value of the note.

Solution 7-92

Present value of interest	=	$\$30,000 \times 2.48685$	=	\$ 74,606
Present value of maturity value	=	$\$600,000 \times .75132$	=	<u>450,792</u>
				<u>\$525,398</u>

Difficulty: Medium

Learning Objective: Account for and explain the accounting issues related to the recognition and measurement of notes and loans receivable.

Section Reference: Notes and Loans Receivable

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 7-93 Schedule of note discount amortization

On December 31, 2017, Green Company finished consultation services and accepted in exchange a promissory note with a face value of \$600,000, a due date of December 31, 2020, and a stated rate of 5%, with interest receivable at the end of each year. The fair value of the services is not readily determinable and the note is not readily marketable. Under the circumstances, the note is considered to have an appropriate imputed rate of interest of 10%.

The following interest factors are provided:

<u>Table Factors for Three Periods</u>	<u>Interest Rate</u>	
	<u>5%</u>	<u>10%</u>
Future Value of 1	1.15763	1.33100
Present Value of 1	.86384	.75132
Future Value of Ordinary Annuity of 1	3.15250	3.31000
Present Value of Ordinary Annuity of 1	2.72325	2.48685

Instructions

Prepare a Schedule of Note Discount Amortization for Green Company under the effective interest method. (Round to whole dollars.)

Solution 7-93

Green Company
Schedule of Note Discount Amortization

Effective Interest Method

5% Note Discounted at 10% (Imputed)

<u>Date</u>	Cash Interest (5%)	Effective Interest (10%) Amortized	Discount Balance	Unamortized Discount of Note	Present Value
12/31/17				\$74,606	\$525,394

12/31/18	\$30,000	\$ 52,539	\$22,539	52,067	547,933
12/31/19	30,000	54,793	24,793	27,274	572,726
12/31/20	<u>30,000</u>	<u>57,274*</u>	<u>27,274</u>	0	600,000
	<u>\$90,000</u>	<u>\$164,602</u>	<u>\$74,606</u>		

*\$1 adjustment for rounding.

Difficulty: Medium

Learning Objective: Account for and explain the accounting issues related to the recognition and measurement of notes and loans receivable.

Section Reference: Notes and Loans Receivable

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 7-94 Note with fair value not equal to cash consideration

On January 1, 2020, Cameroon Corp. lent \$50,000 to its CEO, interest-free. The loan is repayable in full in five years. The market rate for similar loans (with similar credit risk) is 4%.

Instructions

- Calculate the present value (fair value) of this loan (round to the nearest dollar). Why is it not the same as the actual cash advanced?
- Prepare the journal entry to record this transaction.

Solution 7-94

- 5 N, 4 I, 50000 FV, CPT PV = \$41,096.

The fair value is less than the actual cash advanced due to the interest component. The present value actually represents the principal portion of the loan.

b) Loan Receivable.....		41,096
Salaries and Wages Expense.....	8,904	
Cash		50,000

Difficulty: Medium

Learning Objective: Account for and explain the accounting issues related to the recognition and measurement of notes and loans receivable.

Section Reference: Notes and Loans Receivable

CPA: Financial Reporting

Bloomcode: Application

Ex. 7-95 Recognition and measurement of long-term notes receivable

Kohl Company lent \$49,587 to Hemingway Inc., accepting Hemingway's 2-year, \$60,000, zero-interest-bearing note. The implied interest rate is 10%. Prepare Kohl's journal entries for the initial transaction, recognition of interest each year, and the collection of \$60,000 at maturity. Kohl Company follows IFRS.

Solution 7-95

Notes Receivable	60,000	
Discount on Notes Receivable		10,413
Cash		49,587
Discount on Notes Receivable ($\$49,587 \times 10\%$)	4,959	
Interest Revenue		4,959
Discount on Notes Receivable ($(\$49,587 + \$4,959) \times 10\%$)	5,454	
Interest Revenue		5,454
Cash	60,000	
Notes Receivable		60,000

Difficulty: Medium

Learning Objective: Account for and explain the accounting issues related to the recognition and measurement of notes and loans receivable.

Section Reference: Notes and Loans Receivable

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 7-96 Notes received for Property, Goods, or Services

Savannah Corp. sold property in exchange for a six-year note that has a maturity value of \$40,250 and no stated interest rate. The property originally cost Savannah \$21,000. Assuming that a market interest rate of 9% is known, prepare the journal entry to record the sale of this property.

Solution 7-96

In this case, the proceeds from the sale are equal to the present value of the note.

This is a non-interest-bearing note, so the only cash flow is the \$40,250 received in 6 period's time: $\$40,250 \times .59627$ (Table A-2) = \$24,000.

The entry to record the sale is:

Notes Receivable	24,000	
Property		21,000
Gain on Sale of Property ($\$24,000 - \$21,000$)		3,000

Difficulty: Medium

Learning Objective: Account for and explain the accounting issues related to the recognition and measurement of notes and loans receivable.

Section Reference: Notes and Loans Receivable

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 7-97 Interest rate terminology

Explain the difference between the following interest rate terms:

Market

Coupon

Effective

Stated

Yield

Face

Solution 7-97

The **stated interest rate**, also referred to as the **face rate** or the **coupon rate**, is the rate that is included as part of the note contract. The effective interest rate, also referred to as the **market rate** or the **yield rate**, is the rate that is used in the market to determine the note's value; that is, the discount rate that is used to determine its present value.

Difficulty: Easy

Learning Objective: Account for and explain the accounting issues related to the recognition and measurement of notes and loans receivable.

Section Reference: Notes and Loans Receivables

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

Ex. 7-98 Zero-interest bearing note

Shepherd Corp. receives a five-year, \$40,000, zero-interest bearing note with a present value of \$34,504.40. Calculate the implicit rate of interest and provide the related journal entry at the date of issuance.

Solution 7-98

$$PVF_{5, ?\%} = \$34,504.40 / \$40,000$$

$$PVF_{5,3\%} = 0.86261$$

Table A-2: Where $n = 5$ and $PVF = 0.86261$, $i = 3\%$

Notes Receivable	34,504.40	
Cash		34,504.40

Difficulty: Medium

Learning Objective: Account for and explain the accounting issues related to the recognition and measurement of notes and loans receivable.

Section Reference: Notes and Loans Receivables

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 7-99 Accounts receivable assigned

Moonbeam Ltd. assigned \$520,000 of their accounts receivable to Sunbright Finance Company, as security for a loan of \$430,000. Sunbright charged a 3.5% commission on the face amount of the loan, and the note bears interest at 9%.

During the first month, Moonbeam collected \$260,000 on assigned accounts. This amount was paid to the finance company along with one month's interest on the note.

Instructions

Prepare the required journal entries on Moonbeam's books related to the transfer of the accounts receivable, the loan, and the payment to the finance company.

Solution 7-99

Cash.....		414,950
Finance Charge (\$430,000 x 3.5%)	15,050	
Notes Payable		430,000
 Cash	260,000	
Accounts Receivable		260,000
 Notes Payable.....	260,000	
Interest Expense (\$430,000 x 9% /12)	3,225	
Cash		263,225

Difficulty: Medium

Learning Objective: Account for and explain the basic accounting issues related to the derecognition of receivables.

Section Reference: Derecognition of Receivables

CPA: Financial Reporting
 Bloomcode: Application
 AACSB: Analytic

Ex. 7-100 Sale of receivables without recourse

Sparwood Manufacturing factored \$240,000 of their accounts receivable to General Factor Corp., on a without recourse basis. The receivables are transferred to General Factor, who takes over the full responsibility of collection. General Factor charged a finance charge of 4% of the dollar value of the receivables, and withheld 5% of the receivable value.

Instructions

- Prepare the general journal entry to reflect this transaction on Sparwood's books.
- Prepare the general journal entry to reflect this transaction on General Factor's books.

Solution 7-100

- Entry on Sparwood's books:

Cash (\$240,000 – \$9,600 – \$12,000)	218,400	
Due from Factor (\$240,000 x 5%).....	12,000	
Loss on Disposal of Receivables (\$240,000 x 4%)	9,600	
Accounts Receivable		240,000

- Entry on General Factor's books:

Accounts Receivable	240,000	
Due to Sparwood (\$240,000 x 5%).....		12,000
Financing Revenue (\$240,000 x 4%)		9,600
Cash		218,400

Difficulty: Medium

Learning Objective: Account for and explain the basic accounting issues related to the derecognition of receivables.

Section Reference: Derecognition of Receivables

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 101 Issues with derecognition of accounts receivable

Consider the standards set out in IFRS 9:

- Briefly summarize the conditions used to indicate whether receivables have been transferred by an entity, supporting treatment as a sale.
- How would your response differ under ASPE?

Solution 7-101

- a) The entity transfers a financial asset, such as accounts receivable, if the entity:
1. transfers the contractual rights to receive cash flows from the accounts receivable; or
 2. retains the contractual rights to receive cash flows from the accounts receivable, but has a contractual obligation to pay the cash flows to one or more recipients.
- Three additional conditions also must be met:
- i) The entity has no obligation to pay amounts to the eventual recipient unless it collects equivalent amounts from the original receivable.
 - ii) The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows.
 - iii) The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay.
- b) Accounting for transfers of receivables under ASPE also focuses on whether a company has retained or given up control of the receivables. Under ASPE, if all three conditions set out in Illustration 7.6 do not apply, the transferring company records the transfer as a secured borrowing. **Only when all three conditions are satisfied** is control over the assets assumed to be given up, and the transaction accounted for as a sale. If accounting for the transaction as a sale is appropriate but there is continuing involvement, the specific asset components retained need to be identified, as well as any liability components that were assumed.

Difficulty: Easy

Learning Objective: Account for and explain the basic accounting issues related to the derecognition of receivables.

Section Reference: Derecognition of Receivables

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

Ex. 7-102 Accounts receivable analysis and securitization

Discuss why adjustments might have to be made and caution has to be exercised when analyzing accounts receivable due to the increased use of securitization transactions.

Solution 7-102

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 statement of financial position 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.

Difficulty: Easy

Learning Objective: Explain how receivables and loans are reported and analyzed.

Section Reference: Presentation, Disclosure, and Analysis of Receivables

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

Ex. 7-103 Presentation and disclosure of receivables

When financial statements are prepared, the presentation of and disclosures related to receivables have to be addressed. What is the objective of these disclosures?

Solution 7-103

The objective of presentation and disclosure of receivables is to allow users to be able to evaluate the significance of these financial assets (the receivables) to the entity's financial position and performance and to allow users to assess the nature and extent of the associated risks.

Difficulty: Easy

Learning Objective: Explain how receivables and loans are reported and analyzed.

Section Reference: Presentation, Disclosure, and Analysis of Receivables

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

Ex. 7-104 ASPE/IFRS Differences

While most requirements set out under ASPE are not likely to change in the short term, what is one area open to change? Explain.

Solution 7-104

One area that is open to change is that of the derecognition (transfer) of receivables. The Accounting Standards Board (AcSB) has indicated that changes may be made to ASPE after the IASB and FASB develop final standards on derecognition of financial assets, and these are now complete. Also, as discussed earlier in this chapter, the IASB has finalized its proposed changes regarding impairment. Although the AcSB issued a "Request for Information" in 2014 as part of its post-implementation review of Section 3856, changes in ASPE are unlikely in the near term.

Difficulty: Easy

Learning Objective: Identify differences in accounting between IFRS and accounting standards for private enterprises (ASPE), and what changes are expected in the near future.

Section Reference: IFRS/ASPE Comparison
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

Ex. 105 ASPE/IFRS Differences

With respect to receivables recognition and measurement, recognition of interest income and amortization of any discounts or premiums, requirements set out under ASPE differ from those under IFRS. Briefly explain the difference in these requirements and the related implications for a company considering which standard to apply.

Solution 7-105

IFRS requires use of the effective interest method for recognizing income, and amortizing discounts and premiums. ASPE does not require use of the effective interest method of recognizing interest income and amortizing any discounts or premiums; therefore, either the straight-line method or the effective interest method may be used.

Implication: The requirements under IFRS require much more administrative time and a greater level of detail in reporting. Preparation of these figures cost time and money to the company; however, the figures reflected are likely a closer approximation to fair value, and, therefore, more accurate. More accurate figures may better inform management decision making depending on the materiality of receivables and the related interest/premium/discount in the context of the overall organization and its operations.

Difficulty: Easy

Learning Objective: Identify differences in accounting between IFRS and accounting standards for private enterprises (ASPE), and what changes are expected in the near future.
Section Reference: IFRS/ASPE Comparison
CPA: Financial Reporting
Bloomcode: Comprehension
AACSB: Analytic

Ex. 7-106 Reconciliation of cash account

Bestway Corp.'s book balance of the cash account shows an unadjusted balance of \$72,000 before reconciliation. The following data was also available:

1. The bank statement does not include a deposit of \$3,100 made on the last day of the month.
2. The bank statement shows a collection of a note receivable by the bank of \$1,400 and a customer's cheque for \$420 was returned because it was NSF.
3. A customer's cheque for \$450 was recorded on the books as \$540.
4. A cheque written for \$185 was recorded as \$851.

Instructions

Calculate the correct balance in the cash account.

Solution 7-106

Unadjusted Cash G/L account	\$72,000
Note receivable collected	1,400
Less NSF cheque.....	(420)
Less error re: deposit \$(540 – \$450)	(90)
Add cheque error (\$851 – \$185)	<u>666</u>
Correct cash balance.....	<u>\$73,556</u>

Difficulty: Medium

Learning Objective: Explain common techniques for controlling cash.

Section Reference: Methods for Controlling Cash (Appendix 7A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 7-107 Bank reconciliations

Benson 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	\$26,746
Add: Deposits in transit	2,100
Deduct: Outstanding cheques.....	<u>(3,800)</u>
Balance per books	<u>\$25,046</u>

Month of April Results

	<u>Per Bank</u>	<u>Per Books</u>
Balance April 30	\$27,995	\$27,355
April deposits	11,784	13,889
April cheques	11,100	10,080
April note collected (not included in April deposits)	3,000	-0-
April bank service charge	35	-0-
April NSF cheque of a customer returned by the bank (recorded by bank as a charge)	900	-0-

Instructions

a) Calculate the following amounts at April 30:

- Deposits in transit

2. Outstanding cheques
- b) What is the April 30 adjusted cash balance? Show all work.

Solution: 7-107

- a) 1. Deposits in transit, \$4,205 [$\$13,889 - (\$11,784 - \$2,100)$]
2. Outstanding cheques, \$2,780 [$\$10,080 - (\$11,100 - \$3,800)$]
- b) Adjusted cash balance at April 30, \$29,420
($\$27,995 + \$4,205 - \$2,780$) OR ($\$27,355 + \$3,000 - \$35 - \$900$)

Difficulty: Medium

Learning Objective: Explain common techniques for controlling cash.

Section Reference: Methods for Controlling Cash (Appendix 7A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 7-108 Control of petty cash

Under an imprest petty cash system, the petty cash custodian has a significant amount of responsibility. Describe two (2) procedures a company could put in place to obtain more complete control over the petty cash fund.

Solution 7-108

Procedures a company could put in place to obtain more complete control over the petty cash fund include:

- Surprise counts from time to time by a superior of the petty cash custodian to determine that the fund is being accounted for satisfactorily.
- Cancelled or mutilation of petty cash receipts after they have been submitted for reimbursement so they cannot be used again.

Difficulty: Easy

Learning Objective: Explain common techniques for controlling cash.

Section Reference: Methods for Controlling Cash (Appendix 7A)

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

PROBLEMS

Pr. 7-109 Entries for bad debt expense

Nairobi Corp.'s unadjusted trial balance includes the following balances:

Dr. Cr.

Accounts receivable	\$150,000	
Allowance for doubtful accounts		\$ 3,500
Sales (all on credit).....		720,000
Sales returns and allowances.....	30,000	

Instructions

- Prepare the entries for estimated bad debts assuming that doubtful accounts are estimated to be (1) 5% of gross accounts receivable and (2) 2% of net sales.
- Assume that all the information above is the same, except that the Allowance for Doubtful Accounts has a *debit* balance of \$3,500 instead of a credit balance.

Solution 7-109

a) (1) Bad Debt Expense	4,000	
Allowance for Doubtful Accounts.....		4,000
 Gross receivables	\$150,000	
Rate.....	<u>5%</u>	
Total allowance needed	7,500	
Present allowance	<u>(3,500)</u>	
Bad debts expense.....	<u>\$ 4,000</u>	
 (2) Bad Debt Expense	13,800	
Allowance for Doubtful Accounts.....		13,800
 Sales	\$720,000	
Sales returns and allowances.....	<u>(30,000)</u>	
Net sales	690,000	
Rate.....	<u>2%</u>	
Bad debts expense.....	<u>\$ 13,800</u>	

- The percentage-of-receivables approach would be affected as follows:

Gross receivables	\$150,000
Rate.....	<u>5%</u>
Total allowance needed	7,500
Present allowance	<u>3,500</u>
Additional amount required	<u>\$ 11,000</u>

The journal entry is therefore as follows:

Bad Debt Expense	11,000	
Allowance for Doubtful Accounts.....		11,000

Note that the balance in the allowance account does not affect calculations for the percentage-of-sales method.

Difficulty: Medium

Learning Objective: Account for and explain the accounting issues related to the impairment in value of accounts receivable.

Section Reference: Impairment of Accounts Receivable

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 7-110 Bad debt expense

The following account balances were found for Jetson Corp. at the beginning of its fiscal year, January 1, 2020:

Accounts Receivable	\$1,240,250
Allowance for Doubtful Accounts	19,220

Sales for the year were \$8,100,000, of which 60% was on credit, and sales returns were \$146,000. Cash collections, excluding recoveries, were \$5,416,000. Jetson had also written off \$62,500, of which half was later recovered and collected. The company's credit and collection manager has estimated that 6% of outstanding accounts receivable are uncollectible.

Instructions

Calculate the bad debt expense for the year and record the appropriate journal entry.

Solution

Bad Debt Expense.....	9,325	
Allowance for Doubtful Accounts		9,325

Accounts receivables (Jan 1)	\$1,240,250
+Credit sales.....	4,860,000 ($\$8,100,000 \times .60$)
- Cash collections	(5,416,000)
- Sales returns	(146,000)
-Write off.....	<u>(62,500)</u>
=Accounts receivables (Dec 31).....	475,750
x Rate @ 6%.....	<u>6%</u>
=Total allowance needed	28,545
-Present allowance	<u>(19,220)</u>
=Bad debts expense.....	<u>\$ 9,325</u>

Difficulty: Medium

Learning Objective: Account for and explain the accounting issues related to the impairment in value of accounts receivable.

Section Reference: Impairment of Accounts Receivable

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 7-111 Amortization of discount under the straight-line and effective interest methods
On January 1, 2020, Ethiopia Corporation receives a four-year, \$50,000, zero-interest-bearing note in payment of goods sold. The present value of the note equals the agreed upon sales price of \$32,936.55. Ethiopia is a privately held company and follows ASPE.

Instructions

- Assuming Ethiopia 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, 2020.
- Assuming Ethiopia 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, 2020.

Solution 7-111

a) Straight-line

Note Receivable	32,936.55	
Sales		32,936.55
To record the sale and issue of the note on Jan 1		
Note Receivable (\$50,000 – \$32,936.55) / 4.....	4,265.86	
Interest Income		4,265.86
To record the interest accrual on Dec 31		

b) Effective Interest

Note Receivable	32,936.55	
Sales		32,936.55
To record the sale and issue of the note on Jan 1		
Note Receivable (\$32,936.55 x 11%).....	3,623.02	
Interest Income		3,623.02
To record the interest accrual on Dec 31		

Implicit rate of interest: 4 N, –32,936.55 PV, 50,000 FV, CPT I = 11%

Difficulty: Medium

Learning Objective: Account for and explain the accounting issues related to the recognition and measurement of notes and loans receivable.

Section Reference: Notes and Loans Receivable

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 7-112 Note with fair value not equal to cash consideration

On January 1, 2020, Tanzania Corp. lent \$50,000 to its CEO, interest-free. However, the loan is repayable in five instalments, each December 31, until paid. The market rate for similar loans (with similar credit risk) is 4%.

Instructions

- Calculate the present value (fair value) of this loan (round to the nearest dollar).
- Prepare the journal entry to record this transaction.

Solution 7-112

- 5 N, 4 I, 10,000 PMT, CPT PV = 44,518.

b) Loan Receivable.....		44,518
Prepaid Interest.....	5,482	
Cash		50,000

Difficulty: Medium

Learning Objective: Account for and explain the accounting issues related to the recognition and measurement of notes and loans receivable.

Section Reference: Notes and Loans Receivable

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 7-113 Record note receivable

On January 1, 2020, Jumpstart Corp. makes a loan to TryStar Company and receives a \$100,000, five-year note bearing interest at 4% semi-annually. The market rate for similar loans (with similar credit risk) is 6%.

Instructions

- Calculate the present value (fair value) of this loan (round to the nearest dollar).
- Prepare the journal entry to record this transaction.

Solution

a) 10 N, 3 I, \$2,000 PMT, FV = \$100,000, CPT PV = \$91,470.

b) Notes Receivable.....	91,470
Cash	91,470

Difficulty: Medium

Learning Objective: Account for and explain the accounting issues related to the recognition and measurement of notes and loans receivable.

Section Reference: Notes and Loans Receivable

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 7-114 Accounts receivable assigned

Prepare journal entries for Tanzania Inc. for:

- Accounts receivable of \$700,000 that were assigned to Chad Finance Co. by Tanzania as security for a loan of \$580,000. Chad charged a 4% commission on the value of the accounts receivable; the interest rate on the note is 11%.
- During the first month, Tanzania collected \$300,000 on assigned accounts. As well, Tanzania wrote off a \$1,100 assigned account as a bad debt.
- Tanzania paid Chad the amount collected plus one month's interest on the note.

Solution 7-114

a) Cash.....	552,000
Finance Charge (\$700,000 x 4%)	28,000
Notes Payable	580,000
b) Cash	300,000
Allowance for Doubtful Accounts	1,100
Accounts Receivable	301,100
c) Notes Payable	300,000
Interest Expense (\$580,000 x 11% / 12)	5,317
Cash	305,317

Difficulty: Medium

Learning Objective: Account for and explain the basic accounting issues related to the derecognition of receivables.

Section Reference: Derecognition of Receivables

CPA: Financial Reporting

Bloomcode: Application
AACSB: Analytic

Pr. 7-115 Factoring accounts receivable

On April 1, Morocco Ltd. factored \$500,000 of accounts receivable with Kenya Finance Corp. on a without recourse basis. Under the arrangement, Morocco was to handle disputes concerning service, and Kenya Finance was to make the collections, handle the sales discounts, and absorb the credit losses. Kenya Finance assessed a finance charge of 5% of the total accounts receivable factored and retained an amount equal to 2% of the total receivables to cover sales discounts.

Instructions

- Prepare the journal entry required on Morocco's books on April 1.
- Prepare the journal entry required on Kenya Finance's books on April 1.
- Instead, assume Morocco factors the \$500,000 of accounts receivable with Kenya Finance on a *with* recourse basis. The recourse provision has a fair value of \$12,000. Prepare the journal entry required on Morocco's books on April 1.

Solution 7-115

a) Cash.....	465,000	
Due from Factor (2% × \$500,000)	10,000	
Loss on Disposal of Receivables (5% × \$500,000)	25,000	
Accounts Receivable		500,000
b) Accounts Receivable	500,000	
Due to Morocco		10,000
Financing Revenue.....		25,000
Cash		465,000
c) Cash	465,000	
Due from Factor	10,000	
Loss on Disposal of Receivables (\$25,000 + \$12,000) .	37,000	
Accounts Receivable		500,000
Recourse Liability.....		12,000

Difficulty: Medium

Learning Objective: Account for and explain the basic accounting issues related to the derecognition of receivables.

Section Reference: Derecognition of Receivables

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 7-116 Reasons for selling receivables

List three reasons why a business might sell its receivables to another party.

Solution 7-116

1. A business may sell its receivables because it needs the cash now and access to normal credit is not available or is too expensive.
2. A business may sell its receivables (instead of borrowing) to avoid violating debt covenant agreements.
3. A business may sell its receivables to avoid billing and collection activities, which are often costly and time-consuming.
4. For competitive reasons, many industries offer sales financing to encourage sales. However, they not be able to finance customers over long periods of time, so will sell or factor the receivables to obtain the cash more quickly.

Difficulty: Medium

Learning Objective: Account for and explain the basic accounting issues related to the derecognition of receivables.

Section Reference: Derecognition of Receivables

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

Pr. 7-117 Secured borrowings vs. factoring of receivables

Explain the difference between secured borrowings and factoring.

Solution 7-117

Secured borrowing is using accounts receivable (or other receivables, such as notes) as collateral to borrow money, usually from a bank. This is common business practice in Canada. The receivables are assigned or pledged as security for the loan. The assignor retains ownership and control of the receivables, thus the receivables remain as an asset on the assignor's statement of financial position; as well, the liability is recorded as with any other liability. As the assigned receivables are collected, the proceeds are used to pay down the loan. Any interest or finance charges paid are expensed.

Factoring receivables is an outright sale to a factor or lender. The factor buys the receivables and deducts a fee upfront, which is recorded as a "Loss on Disposal of Receivables." The receivables are transferred to the factor, who now has ownership and control of them, and the transferor derecognizes them from its books.

Receivables can be sold *without recourse* where the factor assumes the risk of collection and absorbs any bad debts. The factor may also keep a “holdback” (recorded as “Due from Factor” – a current asset) to cover any sales discounts or returns.

On the other hand, receivables are more commonly sold *with recourse* where the risk of bad debts remains with the transferor. In this case, a recourse liability must be recorded, which will increase the loss on disposal.

Difficulty: Medium

Learning Objective: Account for and explain the basic accounting issues related to the derecognition of receivables.

Section Reference: Derecognition of Receivables

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

***Pr. 7-118** Bank reconciliation

Benin Company deposits all receipts daily and makes all payments by cheque. The following information is available from the cash records:

March 31 Bank Reconciliation

Balance per bank	\$35,160
Add: Deposits in transit.....	4,200
Deduct: Outstanding cheques.....	<u>(3,200)</u>
Balance per books.....	<u>\$36,160</u>

Month of April Results

	<u>Per Bank</u>	<u>Per Books</u>
Balance April 30.....	\$38,000	\$42,140
April deposits recorded.....	11,200	17,300
April cheques recorded	12,010	11,320
<i>Items on bank statement but not in books:</i>		
Note collected by bank	5,500	-0-
Bank service charge	50	-0-
Customer's NSF cheque returned by the bank.....	1,800	-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 7-118**

- a) 1. Deposits in transit: \$10,300 ($\$17,300 + \$4,200 - \$11,200$)
2. Outstanding cheques: \$2,510 ($\$11,320 - \$12,010 + \$3,200$)
- b) Adjusted cash balance at April 30: \$45,790 ($\$42,140 + \$5,500 - \$50 - \$1,800$)

Difficulty: Medium

Learning Objective: Explain common techniques for controlling cash.

Section Reference: Methods for Controlling Cash (Appendix 7A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

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CHAPTER 8

INVENTORY

CHAPTER STUDY OBJECTIVES

1. *Understand inventory from a business perspective.* It is important to understand the nature of the various types of businesses that have significant inventory as well as the different types of inventory. Retailers, manufacturers, and wholesalers generally carry significant amounts of inventory. However, different companies have different business models. For example, some manufacturers follow a just-in-time strategy and carry very little inventory on hand. Only one inventory account, Merchandise Inventory, appears in the financial statements of a merchandising concern. A manufacturer normally has three inventory accounts: Raw Materials, Work in Process, and Finished Goods. There may also be an inventory account for factory or manufacturing supplies. Management must manage inventory levels in order to ensure sufficient choice and quantities to meet customer needs yet keep costs to a minimum. The financial statements need to provide information about all of this.

2. *Identify which inventory items should be included in ending inventory.* Differing companies have different types of inventories including such things as securities, land for development, work in progress, and grain. For accounting purposes, inventory is defined as an asset that is held for sale in the ordinary course of business or for the production of such inventory (including raw materials, work in process, and supplies). Special guidance and/or industry practice exists for inventories of financial instruments, biological assets, agricultural products, mineral products, inventories held by producers of agricultural and forest products, and inventories held by commodity broker-traders.

Inventory is included on the statement of financial position of the entity that has substantially all of the risks and rewards of ownership, which is generally the company that has possession and legal title to the goods. Professional judgement must be used to determine whether substantially all of the risks and rewards have passed. For instance, consigned goods remain the property of the consignor. Purchase commitments are generally not recognized unless onerous.

3. *Identify the effects of inventory errors on the financial statements and adjust for them.* If the ending inventory is misstated, (1) the inventory, retained earnings, working capital, and current ratio in the statement of financial position will be incorrect; and (2) the cost of goods

sold and net income in the income statement will be incorrect. If purchases and inventory are misstated, (1) the inventory, accounts payable, and current ratio will be incorrect; and (2) purchases and ending inventory will be incorrect.

4. Determine the components of inventory cost. Inventory costs include all costs of purchase, conversion, and other costs incurred in bringing the inventories to the present location and condition necessary for sale. Such charges include freight charges on goods purchased, other direct costs of acquisition, and labour and other direct production costs incurred in processing the goods up to the time of sale. Manufacturing overhead costs are allocated to inventory based on the normal capacity of the production facilities. Interest and asset retirement costs may be included as part of the cost of inventory in some circumstances.

5. Distinguish between perpetual and periodic inventory systems and account for them. Under a perpetual inventory system, a continuous record of changes in inventory is maintained in the Inventory account. That is, all purchases into and transfers of goods out of the account are recorded directly in the Inventory account as they occur. No such record is kept under a periodic inventory system. Under the periodic system, year-end inventory is determined by a physical count, and the amount of ending inventory and cost of goods sold is based on this count. Even under the perpetual system, an annual count is needed to test the accuracy of the records.

6. Identify and apply GAAP cost formula options and indicate when each cost formula is appropriate. The specific identification method is used to assign costs for items of inventory that are not ordinarily interchangeable or that are produced for specific projects. The weighted average or first-in, first-out cost formula is used to assign costs to other types of inventory. All inventory items that have a similar nature and use to the entity apply the same cost formula.

7. Explain why inventory is measured at the lower of cost and net realizable value, and apply the lower of cost and net realizable value principle. Current assets should not be reported on the statement of financial position at a higher amount than the net cash that is expected to be generated from their use or sale. When this amount is less than “cost,” inventory is written down and the loss in value is recognized in the same period as the decline. Net realizable value is the estimated selling price in the ordinary course of business reduced by the expected costs to complete and sell the goods. Ordinarily, each item’s cost and NRV are compared and the lower value is chosen. However, items that are related to each other and have similar purposes, that are produced and marketed in the same geographical

area, and that cannot be evaluated separately from other items may be grouped and the lower of the group's cost and net realizable value is chosen.

8. Identify inventories that are or may be valued at amounts other than the lower of cost and net realizable value. Inventories of financial instruments, biological assets related to agricultural activity, agricultural produce at the point of harvest and after harvest, inventories held by producers of agricultural and forest products, mineral products, and inventories of commodity broker-traders all may be accounted for at other than the lower of cost and net realizable value.

9. Apply the gross profit method of estimating inventory. Ending inventory is determined by deducting an estimate of cost of goods sold from the actual cost of goods available for sale. Cost of goods sold is estimated by multiplying net sales by the percentage of cost of goods sold to sales. This percentage is derived from the gross profit percent: $100\% - \text{gross profit percentage} = \text{cost of goods sold percentage}$.

10. Identify how inventory should be presented, disclosed and analyzed. ASPE requires disclosure of how cost is determined, inventory that is pledged as security, the amount charged to the income statement as expense in the period, and the inventories' carrying value by category. Additional information is required by IFRS, including details about inventory impairment writedowns and any recoveries, the circumstances responsible for these, and the carrying amounts and reconciliations of items measured at NRV or fair value. Biological assets must be presented separately on the statement of financial position under IFRS. In general, cost of sales is presented on the income statement under both IFRS and ASPE unless expenses are grouped by nature. Common ratios that are used in the management and evaluation of inventory levels are the inventory turnover and a related measure, average days to sell the inventory, often called the average age of inventory. This is useful information because excessive investment in inventory is expensive to carry, yet too little inventory results in lost sales and dissatisfied customers.

11. Identify differences in accounting between IFRS and ASPE, and what changes are expected in the near future. IFRS and ASPE are substantially harmonized. IFRS has specific guidance on the measurement of biological assets, the capitalization of borrowing costs on qualifying assets, and onerous contracts. Asset retirement obligations may be treated differently under IFRS. No major changes are expected in the near future.

12. **Apply the retail method of estimating inventory.** The retail inventory method is based on converting the retail price of ending inventory by a cost-to-retail percentage, which is derived from information in the accounting and supplementary records. To use this method, records must be kept of the costs and retail prices for beginning inventory, net purchases, and abnormal spoilage, as well as the retail amount of net markups, net markdowns, and net sales.

13. **Identify other primary sources of GAAP for inventory.**

MULTIPLE CHOICE

Answer	No.	Description
c	1.	Inventory categories of a manufacturer
a	2.	Inventory categories of a retailer
d	3.	Monitoring of inventory
c	4.	Calculation of cost of goods available for sale
b	5.	Monitoring of inventory
b	6.	Monitoring of inventory
c	7.	Calculate cost of goods available for sale

- d 8. Calculate sales given manufacturing cost information
- d 9. Calculate ending inventory
- c 10. Calculate beginning inventory
- d 11. Calculate total sales from cost information
- d 12. Purchase commitment
- c 13. Calculate accounts payable at year end
- a 14. Calculate accounts payable at year end
- d 15. Calculate accounts payable at year end
- a 16. Calculate cost of sales
- a 17. Loss on purchase commitment
- b 18. Recognition of ownership
- a 19. Classification of goods in transit
- b 20. Classification of goods in transit
- d 21. Classification of goods in transit
- b 22. Goods on consignment
- a 23. Effect of consignment goods on financial statements
- c 24. Effect of consignment goods on financial statements
- c 25. Identify a product financing arrangement
- b 26. Identify ownership under product financing arrangement.
- a 27. Effect of understating inventory on financial statements
- c 28. Definition of onerous contract
- a 29. Material purchase commitments
- a 30. Effect of understating inventory on financial statements
- b 31. Inventory errors
- a 32. Inventory errors
- d 33. Effect of inventory and depreciation errors on income
- a 34. Effect of inventory and depreciation errors on retained earnings
- a 35. Effect of inventory errors on working capital
- a 36. Account for inventory errors
- d 37. Account for inventory errors
- d 38. Effect of understating purchases and ending inventory
- a 39. Effect of inventory errors
- a 40. Effect of inventory errors
- a 41. Purchase commitments
- c 42. Calculate inventoriable cost
- b 43. Calculate unit cost using moving-average method
- c 44. Monitoring of inventory
- d 45. Vendor rebates
- b 46. Identification of product costs
- a 47. Concept of product costs
- c 48. Conversion costs
- d 49. Costs to charge to expense

- b 50. Interest capitalization in manufacturing inventory
- a 51. Classification of factory overhead costs
- d 52. Borrowing costs
- a 53. Concept of standard costs
- c 54. Definition of basket purchase
- b 55. Method to use for basket purchases
- b 56. Cost allocation
- c 57. Borrowing costs
- c 58. Perpetual inventory system characteristics
- b 59. Adjusting entry for inventory shortage
- b 60. Journal entries for periodic inventory system
- a 61. Journal entries for perpetual inventory system
- a 62. Calculate ending inventory using weighted average
- c 63. Calculate ending inventory using moving average
- b 64. Calculate ending inventory using FIFO
- a 65. Calculate ending inventory using average cost
- c 66. Journal entries for perpetual inventory system
- a 67. Periodic inventory system characteristics
- d 68. Accounts used with a periodic system
- c 69. Perpetual inventory system characteristics
- a 70. Computation of net income
- c 71. Perpetual system – moving-average cost
- a 72. Calculate cost of goods sold using FIFO
- d 73. Calculate ending inventory using FIFO
- b 74. Specific identification cost formula characteristics
- a 75. Nature of FIFO valuation of inventory
- c 76. FIFO in periodic vs perpetual system
- a 77. Weighted average cost formula characteristics
- b 78. FIFO cost formula characteristics
- d 79. Objectives underlying inventory standards
- b 80. Inventory costing method
- b 81. Calculate ending inventory balance
- a 82. Adjusting entry to value inventory at NRV
- c 83. Adjusting entry to value inventory at NRV
- a 84. Recognizing a loss due to application of lower of cost and NRV
- c 85. Departure from accounting for inventory at cost
- b 86. Appropriate use of net realizable value
- a 87. Net realizable value
- a 88. “Replacement cost” definition of “market”
- b 89. Definition of net realizable value
- c 90. Appropriate use of net realizable value
- a 91. Valuation of inventory at net realizable value

- c 92. Valuation of inventory
- c 93. Calculation of year-end adjusting entry
- d 94. Valuation of inventory above cost
- c 95. Valuation at fair value less costs to sell
- b 96. Accounting for bearer plants
- a 97. Valuation of inventory at net realizable value
- a 98. Markup on cost equivalent to markup on selling price
- c 99. Estimate ending inventory using gross profit method
- b 100. Estimate ending inventory using gross profit method
- a 101. Estimate ending inventory using gross profit method
- d 102. Estimate cost of inventory destroyed by fire
- d 103. Estimate cost of inventory lost by theft
- d 104. Appropriate use of the gross profit method
- b 105. Appropriate use of the gross profit method
- c 106. Calculation of gross profit percentage
- b 107. Appropriate use of the gross profit method
- d 108. Gross profit method
- b 109. Gross profit method
- b 110. Gross profit method
- c 111. Presentation and disclosure of inventory
- a 112. Inventory disclosure
- a 113. Calculation of inventory turnover ratio
- c 114. Calculation of inventory turnover ratio
- d 115. Calculation of average days to sell inventory
- d 116. Calculate inventory turnover ratio
- c 117. Calculate average inventory
- a *118. Cost-to-retail ratio
- d *119. Basis of cost-to-retail ratio
- a *120. Calculate ending inventory at retail
- b *121. Calculate ending inventory using retail method
- a *122. Calculate ending inventory using retail method
- d *123. Retail inventory method
- d *124. Use of the retail method

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

EXERCISES

Item	Description
E8-125	Inventory management
E8-126	Definitions
E8-127	Inventories from an accounting perspective

E8-128	Accounting definition
E8-129	Items to be included in ending inventory
E8-130	Terminology
E8-131	Impact of accounting errors on financial statement items and ratios
E8-132	Purchases and inventory misstated
E8-133	Vendor rebates
E8-134	Inventory cost flow assumptions
E8-135	Volume rebates
E8-136	Year-end entries to update inventory accounts
E8-137	FIFO cost formula
E8-138	Perpetual FIFO
E8-139	Periodic FIFO
E8-140	Journal entries for perpetual inventory system
E8-141	Inventory overages and shortages
E8-142	FIFO and LIFO inventory methods
E8-143	Average cost formulas
E8-144	Inventory cost flow assumptions
E8-145	Adjustments to lower of cost and NRV
E8-146	Lower of cost and net realizable value (NRV)
E8-147	Lower of cost and net realizable value (NRV)
E8-148	Accounting for biological and agricultural assets
E8-149	Accounting for biological and agricultural assets
E8-150	Bearer plants
E8-151	Gross profit method
E8-152	Gross profit method
E8-153	Gross profit method
E8-154	Gross profit method
E8-155	Gross profit method
E8-160	Inventory presentation and disclosures under IFRS and ASPE
E8-161	Inventory analysis and ratios
E8-162	Interpretation of inventory ratios
E8-163	Inventory presentation and disclosures under IFRS

PROBLEMS

Item	Description
P8-164	Theory (executory vs onerous contract)
P8-165	Inventory cut-off
P8-166	Inventory errors
P8-167	Analysis of errors

- P8-168 Year-end entries to update inventory under periodic system
- P8-169 Gross profit method
- P8-170 Gross profit method
- P8-171 Gross profit method
- P8-172 Retail inventory method
- *P8-173 Retail inventory method
- *P8-174 Retail inventory method

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

MULTIPLE CHOICE

1. A manufacturing company typically maintains the following inventory account(s):
- a) Merchandise Inventory.
 - b) Raw Materials and Work in Process only.
 - c) Raw Materials, Work in Process, and Finished Goods.
 - d) Work in Process and Merchandise Inventory.

Answer: c

Difficulty: Easy

Learning Objective: Understand inventory from a business perspective.

Section Reference: Understanding Inventory

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

2. A hardware retailer typically maintains the following inventory account(s):
- a) Merchandise Inventory.
 - b) Raw Materials and Work in Process only.
 - c) Raw Materials, Work in Process, and Finished Goods.
 - d) Work in Process and Merchandise Inventory.

Answer: a

Difficulty: Easy

Learning Objective: Understand inventory from a business perspective.

Section Reference: Understanding Inventory

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

3. Companies that carry inventories must carefully monitor inventory in order to
- a) have the greatest selection available so customers can always find what they want.
 - b) minimize carrying costs and keep inventory levels high so stockouts never occur.
 - c) keep inventory levels high to maximize profits.
 - d) minimize carrying costs and meet customer demands.

Answer: d

Difficulty: Easy

Learning Objective: Understand inventory from a business perspective.

Section Reference: Understanding Inventory

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

4. The cost of goods available for sale is calculated as
- a) beginning inventory plus ending inventory.
 - b) beginning inventory minus ending inventory.
 - c) beginning inventory plus the cost of goods acquired during the period.
 - d) cost of goods acquired during the period minus ending inventory.

Answer: c

Difficulty: Easy

Learning Objective: Understand inventory from a business perspective.

Section Reference: Understanding Inventory

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

5. A manufacturer that carries very little inventory likely follows the
- a) allowance method.
 - b) just-in-time method.

- c) indirect method.
- d) replacement method.

Answer: b

Difficulty: Easy

Learning Objective: Understand inventory from a business perspective.

Section Reference: Understanding Inventory

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

6. Which of the following items would be inventory for a company like Marriott Hotel Corporation?

- a) hotel rooms
- b) food and beverage stock
- c) cleaning supplies
- d) all of the above

Answer: b

Difficulty: Easy

Learning Objective: Understand inventory from a business perspective.

Section Reference: Understanding Inventory

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

7. The following information is available for Plymouth Ltd. for last year:

Freight-in	\$ 120,000
Purchase returns	183,000
Selling expenses	255,000
Ending inventory	480,000

The cost of goods sold is equal to 200% of selling expenses. What is the cost of goods available for sale?

- a) Cannot be determined from information given.
- b) \$447,000
- c) \$990,000
- d) \$927,000

Answer: c

Difficulty: Medium

Learning Objective: Understand inventory from a business perspective.

Section Reference: Understanding Inventory

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$480,000 + (200\% \times \$255,000) = \$990,000$

8. For calendar 2020, the gross profit of Seymour Corp. was \$135,000; the cost of goods manufactured was \$360,000; the beginning inventories of goods in process and finished goods were \$33,500 and \$57,000, respectively; and the ending inventories of goods in process and finished goods were \$44,000 and \$71,000, respectively. Allan Corp.'s sales for 2020 must have been

- a) \$346,000.
- b) \$552,000.
- c) \$445,000.
- d) \$481,000.

Answer: d

Difficulty: Medium

Learning Objective: Understand inventory from a business perspective.

Section Reference: Understanding Inventory

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$360,000 + \$57,000 - \$71,000 = \$346,000$ (COGS)

$\$346,000 + \$135,000 = \$481,000$

9. Finkler Inc.'s net sales and gross profit were \$335,250 and \$117,750 respectively. Assuming the cost of goods available for sale were \$271,000, what was the cost value of the ending inventory?

- a) \$217,500
- b) \$117,750
- c) \$61,750
- d) \$53,500

Answer: d

Difficulty: Medium

Learning Objective: Understand inventory from a business perspective.

Section Reference: Understanding Inventory

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$271,000 - (\$335,250 - \$235,500) = \$53,500$

10. For last month, Mingi Corp.'s cost of goods sold and ending inventory were \$200,000 and \$300,000 respectively. Assuming Mingi had neither purchases nor returns during the month, what was the cost of its beginning inventory?

- a) \$100,000
- b) \$300,000
- c) \$500,000
- d) Cannot be determined from the information given.

Answer: c

Difficulty: Medium

Learning Objective: Understand inventory from a business perspective.

Section Reference: Understanding Inventory

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$200,000 + \$300,000 = \$500,000$

11. In its first year of operations as a retailer, Riley Ltd. reported a gross profit of \$181,500, total purchases of \$225,000, and an ending inventory of \$90,000. Therefore, Riley's sales in its first year must have been

- a) \$91,500.
- b) \$135,000.
- c) \$315,000.
- d) \$316,500.

Answer: d

Difficulty: Medium

Learning Objective: Understand inventory from a business perspective.

Section Reference: Understanding Inventory

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$181,500 + (\$225,000 - \$90,000) = \$316,500$

12. Under IFRs, liabilities related to non-cancellable purchase commitments are typically recognized

- a) on the date the contract takes effect.
- b) at the time of payment.
- c) when the purchase is recorded in the accounting system.
- d) in the period a decline in market price occurs.

Answer d

Difficulty: Easy

Learning Objective: Identify which inventory items should be included in ending inventory.

Section Reference: Recognition of Physical Goods Included in Inventory

CPA: Financial Reporting

Bloomcode: Knowledge

13. Delaware Corp.'s accounts payable at December 31, 2020, totalled \$450,000 before any necessary year-end adjustments relating to the following:

- 1. On December 27, 2020, Delaware wrote and recorded cheques to creditors totalling \$175,000 causing an overdraft of \$100,000 in Delaware's bank account at December 31, 2020. The cheques were mailed out on January 10, 2021.
- 2. On December 28, 2020, Delaware purchased and received goods for \$100,000, terms 2/10, n/30. Delaware records purchases and accounts payable at net amounts. The invoice was recorded and paid on January 3, 2021.
- 3. Goods shipped FOB destination on December 20, 2020 from a vendor were received on January 2, 2021. The invoice cost was \$65,000.

At December 31, 2020, what amount should Delaware report as total accounts payable?

- a) \$550,000
- b) \$575,000
- c) \$723,000
- d) \$755,500

Answer: c

Difficulty: Medium

Learning Objective: Identify which inventory items should be included in ending inventory.

Section Reference: Recognition of Physical Goods Included in Inventory

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$450,000 + \$175,000 + \$98,000 = \$723,000$

14. The balance in Georgia Corp.'s accounts payable account at December 31, 2020, was \$900,000 before any necessary year-end adjustments relating to the following:

1. Goods were in transit to Georgia from a vendor on December 31, 2020. The invoice cost was \$75,000. The goods were shipped FOB shipping point on December 29, 2020 and were received on January 4, 2021.
2. Goods shipped FOB destination on December 21, 2020 from a vendor were received on January 6, 2021. The invoice cost was \$37,500.
3. On December 27, 2020, Georgia wrote and recorded cheques to creditors totalling \$45,000 that were mailed on January 10, 2021.

At December 31, 2020, what amount should Georgia report as total accounts payable?

- a) \$1,020,000
- b) \$1,012,500
- c) \$975,000
- d) \$945,000

Answer: a

Difficulty: Medium

Learning Objective: Identify which inventory items should be included in ending inventory.

Section Reference: Recognition of Physical Goods Included in Inventory

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$900,000 + \$75,000 + \$45,000 = \$1,020,000$

15. Florida Ltd.'s accounts payable balance at December 31, 2020, was \$300,000 before any necessary year-end adjustments relating to the following:

1. Goods were in transit from a vendor to Florida on December 31, 2020. The invoice price was \$20,000, and the goods were shipped FOB shipping point on December 29, 2020. The goods were received on January 4, 2021.
2. Goods shipped to Florida, FOB shipping point on December 20, 2020, from a vendor were lost in transit. The invoice price was \$12,500. On January 5, 2021, Florida filed a \$12,500 claim against the common carrier.

At December 31, 2020, what amount should Florida report as total accounts payable?

- a) \$300,000
- b) \$312,500
- c) \$320,000
- d) \$332,500

Answer: d

Difficulty: Medium

Learning Objective: Identify which inventory items should be included in ending inventory.

Section Reference: Recognition of Physical Goods Included in Inventory

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$300,000 + \$20,000 + \$12,500 = \$332,500$

16. The following information was derived from the 2020 accounting records of Jersey Co.:

	Jersey's Central Warehouse	Jersey's Goods held by consignees
Beginning inventory	\$260,000	\$28,000
Purchases	475,000	90,000
Freight-in	15,000	
Transportation to consignees		5,000
Freight-out	25,000	8,000
Ending inventory	290,000	20,000

Jersey's 2020 cost of sales was

a) \$563,000.

b) \$558,000.

c) \$488,000.

d) \$460,000.

Answer: a

Difficulty: Medium

Learning Objective: Identify which inventory items should be included in ending inventory.

Section Reference: Recognition of Physical Goods Included in Inventory

Learning Objective: Determine the components of inventory cost.

Section Reference: Measurement of Inventory - Costs Included

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$260,000 + \$28,000 + \$475,000 + \$90,000 + \$15,000 + \$5,000 - \$290,000 - \$20,000 = \$563,000$

17. An estimated loss on purchase commitments is reported

a) under other expenses and losses.

b) as a deduction from purchases.

c) as a current liability.

d) as an extraordinary item.

Answer: a

Difficulty: Easy

Learning Objective: Identify which inventory items should be included in ending inventory.

Section Reference: Recognition of Physical Goods Included in Inventory

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

18. When substantially all risks and rewards of ownership have passed to the purchaser, the purchaser then recognizes an asset. For this recognition, which of the following statements is correct?

- a) The purchaser must have both legal title and possession of the goods.
- b) Legal title and possession do not always pass to the purchaser at the same time.
- c) In practice, recording inventory purchases often takes place when they leave the seller's place of business.
- d) The purchaser must have possession of goods before it has legal title.

Answer: b

Difficulty: Easy

Learning Objective: Identify which inventory items should be included in ending inventory.

Section Reference: Recognition of Physical Goods Included in Inventory

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

19. Goods in transit that are shipped FOB shipping point should be included

- a) in the inventory of the buyer.
- b) in the inventory of the seller.
- c) in the inventory of the shipping company.
- d) in no one's inventory until they arrive at their destination.

Answer: a

Difficulty: Easy

Learning Objective: Identify which inventory items should be included in ending inventory.

Section Reference: Recognition of Physical Goods Included in Inventory

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

20. Goods in transit that are shipped FOB destination should be included

- a) in the inventory of the buyer.
- b) in the inventory of the seller.
- c) in the inventory of the shipping company.
- d) in no one's inventory until they arrive at their destination.

Answer: b

Difficulty: Easy

Learning Objective: Identify which inventory items should be included in ending inventory.

Section Reference: Recognition of Physical Goods Included in Inventory

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

21. Which of the following items should be included in inventory at the statement of financial position date?

- a) goods in transit that were purchased FOB destination
- b) goods received from another company for sale on consignment
- c) goods sold to a customer that are being held for the customer to call for at his or her convenience
- d) goods in transit that were purchased FOB shipping point

Answer: d

Difficulty: Easy

Learning Objective: Identify which inventory items should be included in ending inventory.

Section Reference: Recognition of Physical Goods Included in Inventory

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

22. Which of the following is correct?

- a) Goods on consignment are included in the consignee's inventory.
- b) Goods on consignment are included in the consignor's inventory.
- c) The consignee essentially has the risks and rewards of ownership.
- d) Inventory on consignment is always shown in a separate account.

Answer: b

Difficulty: Easy

Learning Objective: Identify which inventory items should be included in ending inventory.

Section Reference: Recognition of Physical Goods Included in Inventory

CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

23. Wilma received merchandise on consignment from Betty. As at March 31, Wilma had recorded the transaction as a purchase and included the goods in inventory. The effect of this on Wilma's financial statements for March 31 would be

- a) net income was correct and current assets and current liabilities were overstated.
- b) net income, current assets, and current liabilities were overstated.
- c) net income and current liabilities were overstated.
- d) no effect.

Answer: a

Difficulty: Easy
Learning Objective: Identify which inventory items should be included in ending inventory.
Section Reference: Recognition of Physical Goods Included in Inventory
CPA: Financial Reporting
Bloomcode: Comprehension
AACSB: Analytic

24. Fred received merchandise on consignment from Dino. As at January 31, Fred included the goods in inventory, but did NOT record the transaction. The effect of this on Fred's financial statements for January 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, current assets, and retained earnings were overstated.
- d) net income and current assets were overstated and current liabilities were understated.

Answer: c

Difficulty: Easy
Learning Objective: Identify which inventory items should be included in ending inventory.
Section Reference: Recognition of Physical Goods Included in Inventory
CPA: Financial Reporting
Bloomcode: Comprehension
AACSB: Analytic

Use the following information for questions 18–19.

During 2020 Ebert Corp. transferred inventory to Siskel Corp. and agreed to repurchase the merchandise early in 2021. Siskel then used the inventory as collateral to borrow from

Southern Bank, remitting the proceeds to Ebert. In 2021 when Ebert repurchased the inventory, Siskel used the proceeds to repay its bank loan.

25. This transaction is known as a(n)

- a) consignment.
- b) instalment sale.
- c) product financing arrangement.
- d) sale with delayed payment terms.

Answer: c

Difficulty: Easy

Learning Objective: Identify which inventory items should be included in ending inventory.

Section Reference: Recognition of Physical Goods Included in Inventory

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

26. On whose books should the cost of the inventory appear at the December 31, 2020, statement of financial position date?

- a) Siskel Corp.
- b) Ebert Corp.
- c) Southern Bank
- d) Siskel Corp., with Ebert Corp. making appropriate note disclosure of the transaction

Answer: b

Difficulty: Easy

Learning Objective: Identify which inventory items should be included in ending inventory.

Section Reference: Recognition of Physical Goods Included in Inventory

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

27. 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.

Answer: a

Difficulty: Easy

Learning Objective: Identify which inventory items should be included in ending inventory.

Section Reference: Recognition of Physical Goods Included in Inventory

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

28. If the unavoidable costs of completing a purchase commitment are higher than the expected benefits from receiving the contracted goods or services, IFRS requires a loss provision to be recognized. This is known as a(n)

- a) executory contract.
- b) purchase commitment.
- c) onerous contract.
- d) impaired contract.

Answer: c

Difficulty: Easy

Learning Objective: Identify which inventory items should be included in ending inventory.

Section Reference: Recognition of Physical Goods Included in Inventory

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

29. If a material amount of inventory has been ordered through a formal purchase contract at the statement of financial position 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.

Answer: a

Difficulty: Easy

Learning Objective: Identify which inventory items should be included in ending inventory.

Section Reference: Recognition of Physical Goods Included in Inventory

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

30. On December 27, Cloud Corp. accepted delivery of merchandise that it purchased on account. As at December 31, Cloud had recorded the transaction, but did not include the merchandise in its year-end inventory. The effect of this on its December 31 financial statements 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.

Answer: a

Difficulty: Easy

Learning Objective: Identify the effects of inventory errors on the financial statements and adjust for them.

Section Reference: Inventory Errors

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

Use the following information for questions 98–99.

Shanti Inc. is a calendar-year corporation. Its financial statements for the years 2020 and 2019 contained errors as follows:

	2020	2019
Ending inventory	\$6,000 overstated	\$16,000 overstated
Depreciation expense	\$4,000 understated	\$12,000 overstated

31. Assume that the proper correcting entries were made at December 31, 2019. By how much will 2020 income before taxes be overstated or understated?

- a) \$2,000 understated
- b) \$2,000 overstated
- c) \$4,000 overstated
- d) \$10,000 overstated

Answer: b

Difficulty: Medium

Learning Objective: Identify the effects of inventory errors on the financial statements and adjust for them.

Section Reference: Inventory Errors

CPA: Financial Reporting

Bloomcode: Analysis

AACSB: Analytic

Feedback: \$6,000 (O/S EI = U/S COGS = O/S NI) + \$4,000 (U/S Depreciation = O/S NI) = \$10,000 O/S

32. Assume that no correcting entries were made at December 31, 2019. Ignoring income taxes, by how much will retained earnings at December 31, 2020 be overstated or understated?

- a) \$2,000 understated
- b) \$18,000 understated
- c) \$10,000 overstated
- d) \$18,000 overstated

Answer: a

Difficulty: Hard

Learning Objective: Identify the effects of inventory errors on the financial statements and adjust for them.

Section Reference: Inventory Errors

CPA: Financial Reporting

Bloomcode: Analysis

AACSB: Analytic

Feedback: 2019: \$16,000 (O/S EI = U/S COGS = O/S NI) – \$12,000 (O/S Dep = U/S NI) \$4,000 O/S RE at end of 2019

2020: –\$16,000 (O/S BI = O/S COGS = U/S NI) + \$6,000 (O/S EI = U/S COGS = O/S NI) + \$4,000 (U/S Dep = O/S NI) = \$6,000 U/S RE at end of 2020

Together = \$4,000 O/S + \$6,000 U/S = \$2,000 U/S

Use the following information for questions 33–35.

Giselle Ltd. is a calendar-year corporation. Its financial statements for the years 2020 and 2019 contained errors as follows:

	2020	2019
Ending inventory	\$2,000 overstated	\$3,000 overstated
Depreciation expense	\$6,000 understated	\$12,000 overstated

33. Assume that the proper correcting entries were made at December 31, 2019. By how much will 2020 pre-tax income be overstated or understated?

- a) \$2,000 understated
- b) \$2,000 overstated
- c) \$6,000 overstated

d) \$8,000 overstated

Answer: d

Difficulty: Medium

Learning Objective: Identify the effects of inventory errors on the financial statements and adjust for them.

Section Reference: Inventory Errors

CPA: Financial Reporting

Bloomcode: Analysis

AACSB: Analytic

Feedback: $\$2,000 + \$6,000 = \$8,000$

34. Assume that no correcting entries were made at December 31, 2019. Ignoring income taxes, by how much will retained earnings at December 31, 2020 be overstated or understated?

- a) \$4,000 understated
- b) \$6,000 overstated
- c) \$6,000 understated
- d) \$15,000 understated

Answer: a

Difficulty: Medium

Learning Objective: Identify the effects of inventory errors on the financial statements and adjust for them.

Section Reference: Inventory Errors

CPA: Financial Reporting

Bloomcode: Analysis

AACSB: Analytic

Feedback: $\$12,000 - (\$2,000 + \$6,000) = \$4,000$

35. Assume that no correcting entries were made at December 31, 2019, or December 31, 2020 and that no additional errors occurred in 2021. Ignoring income taxes, by how much will working capital, at December 31, 2021 be overstated or understated?

- a) \$0
- b) \$4,000 overstated
- c) \$4,000 understated
- d) \$6,000 understated

Answer: a

Difficulty: Medium

Learning Objective: Identify the effects of inventory errors on the financial statements and adjust for them.

Section Reference: Inventory Errors

CPA: Financial Reporting

Bloomcode: Analysis

AACSB: Analytic

Feedback: The effect of the errors in ending inventories reverse themselves in the following year.

36. For calendar 2020, Gomez Corporation reported pre-tax income of \$70,000. A recount of the company's inventory revealed that 2020 ending inventory was overstated by \$10,000. What is Gomez's corrected pre-tax income for 2020?

- a) \$60,000
- b) \$80,000
- c) \$70,000
- d) \$75,000

Answer: a

Difficulty: Medium

Learning Objective: Identify the effects of inventory errors on the financial statements and adjust for them.

Section Reference: Inventory Errors

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$70,000 - \$10,000 = \$60,000$

37. For calendar 2020, Redfern Corporation reported pre-tax income of \$270,000. You have been made aware that the company's beginning inventory was overstated by \$14,000 and ending inventory was understated by \$9,000. What is Redfern's corrected pre-tax income for 2020?

- a) \$270,000
- b) \$275,000
- c) \$265,000
- d) \$293,000

Answer: d

Difficulty: Medium

Learning Objective: Identify the effects of inventory errors on the financial statements and adjust for them.

Section Reference: Inventory Errors

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$270,000 + \$14,000 + \$9,000 = \$293,000$

38. On June 25, Veranda Corp. accepted delivery of merchandise that it purchased on account. As at June 30, Veranda had NOT recorded the transaction nor included the merchandise in its inventory. The effect of this on Veranda's June 30 statement of financial position 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) assets and liabilities were understated but shareholders' equity was not affected.

Answer: d

Difficulty: Easy

Learning Objective: Identify the effects of inventory errors on the financial statements and adjust for them.

Section Reference: Inventory Errors

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

39. All else being equal, which of the following statements with respect to the impact of inventory errors is NOT correct?

- 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.

Answer: a

Difficulty: Easy

Learning Objective: Identify the effects of inventory errors on the financial statements and adjust for them.

Section Reference: Inventory Errors

CPA: Financial Reporting

Bloomcode: Knowledge

40. In a periodic inventory system, if the beginning inventory is overstated
- a) net income is understated.
 - b) working capital is understated.
 - c) the current ratio is overstated.
 - d) cost of goods sold is understated.

Answer: a

Difficulty: Easy

Learning Objective: Identify the effects of inventory errors on the financial statements and adjust for them.

Section Reference: Inventory Errors

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

41. In a periodic inventory system, if ending inventory is understated,
- a) net income is understated.
 - b) working capital is overstated.
 - c) the current ratio is overstated.
 - d) cost of goods sold is understated.

Answer: a

Difficulty: Easy

Learning Objective: Identify the effects of inventory errors on the financial statements and adjust for them.

Section Reference: Inventory Errors

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

42. The following information was reported by Belleville Inc. for 2020:

Merchandise purchased for resale	\$25,000
Freight-in	1,750
Freight-out	1,000
Purchase returns	500

Based on this data, Belleville's 2020 inventoriable cost was

- a) \$28,250.
- b) \$27,750.
- c) \$26,250.

d) \$25,000.

Answer: c

Difficulty: Medium

Learning Objective: Determine the components of inventory cost.

Section Reference: Measurement of Inventory - Costs Included

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$25,000 + \$1,750 - \$500 = \$26,250$

43. Arizona Inc. uses the perpetual inventory system, and recorded the following data pertaining to raw material X during January 2020:

		Units		
Date		Received	Cost	Issued On Hand
Jan 1	Inventory		\$4.00	3,200
Jan 11	Issue (sold)			1,600 1,600
Jan 22	Purchase	4,000	\$4.70	5,600

The moving-average unit cost of raw material X inventory at January 31, 2020 is

a) \$4.70.

b) \$4.50.

c) \$4.43.

d) \$4.35.

Answer: b

Difficulty: Medium

Learning Objective: Determine the components of inventory cost.

Section Reference: Measurement of Inventory - Costs Included

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $[(3,200 \times \$4) - (1,600 \times \$4) + (4,000 \times \$4.70)] \div 5,600 = \$4.50$

44. The cost of inventory is made up of

a) cost to purchase inventory only.

b) cost of purchase and allocated direct labour only.

c) cost of purchase, allocated direct labour, and allocated overhead.

d) cost of allocated direct labour and allocated overhead only.

Answer c

Difficulty: Easy

Learning Objective: Determine the components of inventory cost.

Section Reference: Measurement of Inventory – Costs Included

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

45. Which of the following is correct regarding vendor rebates?

- a) Vendor rebates are generally recorded as a reduction from sales.
- b) The rebate is never recognized until it is actually received.
- c) If the rebate meets asset recognition criteria, the receivable is allocated to goods sold.
- d) Vendor rebates are generally recorded as a reduction in the purchase cost of inventory.

Answer: d

Difficulty: Easy

Learning Objective: Determine the components of inventory cost.

Section Reference: Measurement of Inventory - Costs Included

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

46. 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) Direct labour costs are usually period costs.

Answer: b

Difficulty: Easy

Learning Objective: Determine the components of inventory cost.

Section Reference: Measurement of Inventory - Costs Included

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

47. 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.

Answer: a

Difficulty: Easy

Learning Objective: Determine the components of inventory cost.

Section Reference: Measurement of Inventory - Costs Included

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

48. Conversion costs include

- a) all materials plus direct labour.
- b) all materials plus variable overhead allocated.
- c) direct labour plus variable and fixed overhead allocated.
- d) direct labour plus fixed overhead allocated.

Answer: c

Difficulty: Easy

Learning Objective: Determine the components of inventory cost.

Section Reference: Measurement of Inventory - Costs Included

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

49. All of the following costs should be charged to expense in the period in which they are incurred EXCEPT for

- a) manufacturing overhead costs for a product manufactured and sold in the same accounting period.
- b) costs that 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.

Answer: d

Difficulty: Easy

Learning Objective: Determine the components of inventory cost.

Section Reference: Measurement of Inventory - Costs Included

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

50. 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) interest on a building mortgage

Answer: b

Difficulty: Easy

Learning Objective: Determine the components of inventory cost.

Section Reference: Measurement of Inventory - Costs Included

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

51. 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.

Answer: a

Difficulty: Easy

Learning Objective: Determine the components of inventory cost.

Section Reference: Measurement of Inventory - Costs Included

CPA: Financial Reporting

Bloomcode: Comprehension

52. Which of the following statements regarding borrowing costs is correct?

- a) Neither ASPE nor IFRS usually require disclosure of these items.
- b) They are usually amortized until the majority of the underlying products have been sold.

- c) They are usually treated as period costs if they are incurred to bring inventories to a condition ready for sale.
- d) If interest is capitalized, ASPE requires this policy and the amount capitalized to be disclosed.

Answer: d

Difficulty: Easy

Learning Objective: Determine the components of inventory cost.

Section Reference: Measurement of Inventory - Costs Included

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

53. 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) When using standard costs, unallocated overhead is capitalized.
- d) Standard costs are always acceptable for reporting purposes.

Answer: a

Difficulty: Easy

Learning Objective: Determine the components of inventory cost.

Section Reference: Measurement of Inventory - Costs Included

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

54. A “basket purchase” is a purchase of

- a) a group of units with *similar* characteristics at a single lump-sum price.
- b) individual units with *similar* characteristics priced individually.
- c) a group of units with *different* characteristics at a single lump-sum price.
- d) individual units with *different* characteristics priced individually.

Answer: c

Difficulty: Easy

Learning Objective: Determine the components of inventory cost.

Section Reference: Measurement of Inventory - Costs Included

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

55. To record a “basket purchase” or to allocate a joint product cost, which method is the most rational?

- a) average cost
- b) relative sales value
- c) fair value
- d) amortized cost

Answer: b

Difficulty: Easy

Learning Objective: Determine the components of inventory cost.

Section Reference: Measurement of Inventory - Costs Included

CPA: Financial Reporting

Bloomcode: Knowledge

56. If two factories produce the exact same product having the same costs, and factory costs are completely allocated to the individual products, the factory operating at 80% capacity (while the other operates at 100% capacity)

- a) would have a lower rate of cost allocation to each unit of production.
- b) would have a higher rate of cost allocation to each unit of production.
- c) would have the same rate of cost allocation to each unit of production as the 100% capacity operation.
- d) would be operating at a loss, because of unused capacity.

Answer: b

Difficulty: Easy

Learning Objective: Determine the components of inventory cost.

Section Reference: Measurement of Inventory - Costs Included

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

57. Borrowing costs

- a) are never included in the costs of inventories.
- b) must only be included in inventory cost if they relate to inventories produced in large quantities and on a repetitive basis.
- c) are capitalized if incurred to finance activities that help bring inventories to a condition available for sale.
- d) none of the above

Answer: c

Difficulty: Easy

Learning Objective: Determine the components of inventory cost.

Section Reference: Measurement of Inventory - Costs Included

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

58. Which of the following does NOT correctly describe a perpetual inventory system?

- a) Cost of goods sold is calculated every time a sale is made.
- b) 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) Assuming a FIFO cost flow, cost of goods sold would equal that calculated by the periodic system.

Answer: c

Difficulty: Easy

Learning Objective: Distinguish between perpetual and periodic inventory systems and account for them.

Section Reference: Measurement and Inventory Accounting Systems

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

59. At the end of its accounting year, Colin Corp.'s physical inventory count indicated that 180,000 units of inventory, costing \$1.75 each, were on hand. The company's perpetual inventory system reported a balance of \$357,600. The year-end adjusting entry is

- a) debit Inventory and credit Loss on Inventory Due to Count, \$42,600.
- b) debit Loss on Inventory Due to Count and credit Inventory, \$42,600.
- c) debit Inventory and credit Loss on Inventory Due to Count, \$92,400.
- d) debit Loss on Inventory Due to Count and credit Inventory, \$92,400.

Answer: b

Difficulty: Medium

Learning Objective: Distinguish between perpetual and periodic inventory systems and account for them.

Section Reference: Measurement and Inventory Accounting Systems

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$357,600 - (180,000 \times \$1.75) = \$42,600$ Loss

Use the following information for questions 110–111.

Windsor Ltd. uses FIFO to cost its inventory. The following information is available for Windsor's inventory of product # 205:

Beginning inventory: 240 units @ \$6.28 per unit

March 1: Purchase of 500 units @ \$7.00 per unit

April 10: Sale of 200 units @ \$10.20 per unit

60. Assuming Windsor uses the periodic inventory system, the entry to account for the March 1 purchase is

- a) debit Inventory and credit Accounts Payable, \$3,500.
- b) debit Purchases and credit Accounts Payable, \$3,500.
- c) debit Accounts Payable and credit Purchases, \$3,500.
- d) debit Accounts Payable and credit Inventory, \$3,500.

Answer: b

Difficulty: Medium

Learning Objective: Distinguish between perpetual and periodic inventory systems and account for them.

Section Reference: Measurement and Inventory Accounting Systems

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: Under the periodic system, a Purchases account is used. $500 \times \$7.00 = \$3,500$

61. Assuming Windsor uses the perpetual inventory system, the entry to account for the March 1 purchase is

- a) debit Inventory and credit Accounts Payable, \$3,500.
- b) debit Purchases and credit Accounts Payable, \$3,500.
- c) debit Accounts Payable and credit Purchases, \$3,500.
- d) debit Accounts Payable and credit Inventory, \$3,500.

Answer: a

Difficulty: Medium

Learning Objective: Distinguish between perpetual and periodic inventory systems and account for them.

Section Reference: Measurement and Inventory Accounting Systems

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: Under the perpetual system, purchases are debited to Inventory. $500 \times \$7.00 = \$3,500$

Use the following information for questions 112–113.

The following information was available from the inventory records of Key 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	<u>(4,200)</u>		
Balance at January 31	<u>1,000</u>		

62. Assuming that Key uses the periodic inventory system, what should the inventory be at January 31, using the weighted-average inventory method, rounded to the nearest dollar?

- a) \$10,237
- b) \$10,260
- c) \$10,360
- d) \$10,505

Answer: a

Difficulty: Medium

Learning Objective: Distinguish between perpetual and periodic inventory systems and account for them.

Section Reference: Measurement and Inventory Accounting Systems

Learning Objective: Identify and apply GAAP cost formula options and indicate when each cost formula is appropriate.

Section Reference: Measurement and Cost Formulas

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $(\$29,310 + \$20,600 + \$28,917) \div (3,000 + 2,000 + 2,700) = \$10.237/\text{unit}$

$\$10.237 \times 1,000 = \$10,237$

63. Assuming that Key uses the perpetual inventory system, what should the inventory be at January 31, using the moving-average inventory method, rounded to the nearest dollar?

- a) \$10,237
- b) \$10,260
- c) \$10,360
- d) \$10,505

Answer: c

Difficulty: Medium

Learning Objective: Distinguish between perpetual and periodic inventory systems and account for them.

Section Reference: Measurement and Inventory Accounting Systems

Learning Objective: Identify and apply GAAP cost formula options and indicate when each cost formula is appropriate.

Section Reference: Measurement and Cost Formulas

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: Avg. on Jan 6: $\$49,910 \div 5,000 = \$9.982/\text{unit}$

Avg. on Jan 26: $\$53,872 \div 5,200 = \$10.36/\text{unit}$

$\$10.36 \times 1,000 = \$10,360$

Use the following information for questions 114–115.

Transactions for Durham Ltd. 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

Durham Ltd. uses the periodic inventory system.

64. The ending inventory on a FIFO basis is

- a) \$2,100.

- b) \$2,065.
- c) \$1,920.
- d) \$1,900.

Answer: b

Difficulty: Medium

Learning Objective: Distinguish between perpetual and periodic inventory systems and account for them.

Section Reference: Measurement and Inventory Accounting Systems

Learning Objective: Identify and apply GAAP cost formula options and indicate when each cost formula is appropriate.

Section Reference: Measurement and Cost Formulas

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: Total GAFS 3,250 units; total sold 2,650 units; EI = 600 units

$$\text{EI} = (250 \times \$3.50) + (350 \times \$3.40) = \$2,065$$

65. The ending inventory on a weighted average cost basis, rounded to the nearest dollar, is

- a) \$1,956.
- b) \$1,970.
- c) \$1,980.
- d) \$1,995.

Answer: a

Difficulty: Medium

Learning Objective: Distinguish between perpetual and periodic inventory systems and account for them.

Section Reference: Measurement and Inventory Accounting Systems

Learning Objective: Identify and apply GAAP cost formula options and indicate when each cost formula is appropriate.

Section Reference: Measurement and Cost Formulas

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

$$\text{Feedback: } \$10,605 \div 3,250 \text{ units} = \$3.26; \$3.26 \times 600 = \$1,956$$

66. Tehran Ltd. uses FIFO to cost its inventory. The following information is available for Tehran's inventory of product # 101:

Beginning inventory: 120 units @ \$3.14 per unit

March 1: Purchase of 250 units @ \$3.50 per unit

April 10: Sale of 100 units @ \$5.10 per unit

Assuming Tehran uses the perpetual inventory system, the second entry to account for the April 10 sale is

- 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 Inventory, \$314.
- d) debit Cost of Goods Sold and credit Purchases, \$314.

Answer: c

Difficulty: Medium

Learning Objective: Distinguish between perpetual and periodic inventory systems and account for them.

Section Reference: Measurement and Inventory Accounting Systems

Learning Objective: Identify and apply GAAP cost formula options and indicate when each cost formula is appropriate.

Section Reference: Measurement and Cost Formulas

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: Under FIFO, the unsold units in beginning inventory are considered to be the first units sold. $100 \times \$3.14 = \$314$

67. Which of the following does NOT correctly describe a periodic inventory system?

- a) Cost of goods sold is calculated every time a sale is made.
- b) Cost of goods sold is a residual amount.
- c) Assuming a FIFO cost flow, cost of goods sold would equal that calculated by the perpetual system.
- d) Inventory and cost of goods sold must be updated at the end of the period.

Answer: a

Difficulty: Easy

Learning Objective: Distinguish between perpetual and periodic inventory systems and account for them.

Section Reference: Measurement and Inventory Accounting Systems

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

68. When using a periodic inventory system,

- a) a Purchases account is not used.
- b) a Cost of Goods Sold account is used.
- c) two entries are required to record a sale.
- d) a Cost of Goods Sold account is not used.

Answer: d

Difficulty: Easy

Learning Objective: Distinguish between perpetual and periodic inventory systems and account for them.

Section Reference: Measurement and Inventory Accounting Systems

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

69. Which of the following is a characteristic of a perpetual inventory system?

- a) Inventory purchases are debited to a Purchases account.
- b) Inventory records are not kept for every item.
- c) Cost of goods sold is recorded with each sale.
- d) Cost of goods sold is determined as the amount of purchases less the change in inventory.

Answer: c

Difficulty: Easy

Learning Objective: Distinguish between perpetual and periodic inventory systems and account for them.

Section Reference: Measurement and Inventory Accounting Systems

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

70. Why are inventories included in the computation of net income?

- a) to determine cost of goods sold
- b) to determine sales revenue
- c) to determine merchandise returns
- d) Inventories are not included in the computation of net income.

Answer: a

Difficulty: Easy

Learning Objective: Distinguish between perpetual and periodic inventory systems and account for them.

Section Reference: Measurement and Inventory Accounting Systems

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

71. When using the moving-average cost formula 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) a new unit cost is calculated both when a sale is made and when a purchase is made.

Answer: c

Difficulty: Easy

Learning Objective: Distinguish between perpetual and periodic inventory systems and account for them.

Section Reference: Measurement and Inventory Accounting Systems

Learning Objective: Identify and apply GAAP cost formula options and indicate when each cost formula is appropriate.

Section Reference: Measurement and Cost Formulas

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

72. data related to an item of inventory:

Inventory, March 1	100 units @ \$8.10
Purchase, March 7	350 units @ \$8.50
Purchase, March 16	70 units @ \$9.10
Inventory, March 31	150 units

If Ritz Ltd. uses FIFO, the value assigned to cost of goods sold is

- a) \$3,105.
- b) \$3,187.
- c) \$2,295.
- d) \$1,369.

Answer: a

Difficulty: Medium

Learning Objective: Identify and apply GAAP cost formula options and indicate when each cost formula is appropriate.

Section Reference: Measurement and Cost Formulas

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $100 + 350 + 70 - 150 = 370$ units sold

$(100 \times \$8.10) + (270 \times \$8.50) = \$3,105$

73. At January 1, 2020, Nevada Ltd. had 150 units of product A on hand, costing \$32 each.

Purchases of product A during January were as follows:

Date	Units	Unit Cost
Jan 10	200	\$33.00
18	250	34.50
28	100	36.00

A physical count on January 31, 2020 shows 200 units of product A on hand. The cost of the inventory at January 31, 2020 under the FIFO cost formula is

- a) \$6,150.
- b) \$6,375.
- c) \$6,600.
- d) \$7,050.

Answer: d

Difficulty: Medium

Learning Objective: Identify and apply GAAP cost formula options and indicate when each cost formula is appropriate.

Section Reference: Measurement and Cost Formulas

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $(100 \times \$36) + (100 \times \$34.50) = \$7,050$

74. Which of the following does NOT correctly describe the specific identification cost formula?

- 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) This method is often used for merchandise with serial numbers such as automobiles.

Answer: b

Difficulty: Easy

Learning Objective: Identify and apply GAAP cost formula options and indicate when each cost formula is appropriate.

Section Reference: Measurement and Cost Formulas

CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

75. An inventory cost formula in which the oldest costs incurred rarely have an effect on the ending inventory valuation is
- a) FIFO.
 - b) moving-average cost.
 - c) LIFO.
 - d) weighted average.

Answer: a

Difficulty: Easy
Learning Objective: Identify and apply GAAP cost formula options and indicate when each cost formula is appropriate.
Section Reference: Measurement and Cost Formulas
CPA: Financial Reporting
Bloomcode: Comprehension
AACSB: Analytic

76. All else being equal, which of the following statements is correct for a company that uses the FIFO costing formula with a perpetual inventory system (compared to a periodic system)?
- 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 both systems.
 - d) The periodic system would not require any additional entries at the end of the period.

Answer: c

Difficulty: Easy
Learning Objective: Identify and apply GAAP cost formula options and indicate when each cost formula is appropriate.
Section Reference: Measurement and Cost Formulas
CPA: Financial Reporting
Bloomcode: Comprehension
AACSB: Analytic

77. Which of the following does NOT correctly describe the weighted average cost formula?
- a) It prices inventory on the basis of the average cost of beginning inventory.
 - b) It prices inventory on the basis of the average cost of goods available for sale during the period.

- c) It takes into account that the volume of goods acquired at each price is different.
- d) It includes the cost of beginning inventory in the calculations.

Answer: a

Difficulty: Easy

Learning Objective: Identify and apply GAAP cost formula options and indicate when each cost formula is appropriate.

Section Reference: Measurement and Cost Formulas

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

78. Which of the following does NOT correctly describe the FIFO cost formula?

- 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 both ASPE and IFRS.

Answer: b

Difficulty: Easy

Learning Objective: Identify and apply GAAP cost formula options and indicate when each cost formula is appropriate.

Section Reference: Measurement and Cost Formulas

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

79. Which of the following statements is INCORRECT regarding the overriding objectives underlying inventory standards?

- a) Report an inventory cost on the statement of financial position that is representative of the inventory's recent cost.
- b) Choose an approach that corresponds as closely as possible to the physical flow of goods.
- c) Use the same method for all inventory assets that have similar economic characteristics.
- d) It is permissible under ASPE to use any inventory method, including LIFO.

Answer: d

Difficulty: Easy

Learning Objective: Identify and apply GAAP cost formula options and indicate when each cost formula is appropriate.

Section Reference: Measurement and Cost Formulas

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

80. The inventory costing method that can be used only for goods that are NOT ordinarily interchangeable is the

- a) LIFO method.
- b) specific identification method.
- c) weighted average cost method.
- d) FIFO method.

Answer: b

Difficulty: Easy

Learning Objective: Identify and apply GAAP cost formula options and indicate when each cost formula is appropriate.

Section Reference: Measurement and Cost Formulas

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

81. The following inventory transactions took place for NPR Corporation for the month of May:

Date	Event	Quantity	Cost/Selling Price
May 1	Beginning Inventory	1,000	\$3.55
May 5	Purchase	6,000	3.10
May 10	Purchase	2,000	3.75
May 15	Sale	3,000	6.00
May 20	Sale	2,000	6.00
May 22	Purchase	5,000	3.45
May 24	Purchase	2,000	3.75
May 25	Sale	7,000	6.00

The ending inventory balance for NPR Corporation, assuming the company uses a perpetual inventory system, and a first-in, first-out (FIFO) cost formula is

- a) \$15,000.
- b) \$14,400.
- c) \$12,850.

d) \$13,800.

Answer: b

Difficulty: Medium

Learning Objective: Identify and apply GAAP cost formula options and indicate when each cost formula is appropriate.

Section Reference: Measurement and Cost Formulas

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $1000 + 6000 + 2000 - 3000 - 2000 + 5000 + 2000 - 7000 = 4000$

$2000 * 3.75 + 2000 * 3.45 = 7500 + 6900 = \$14,400$

Use the following information for questions 82–83.

The following information is available for Anselmo Corporation's inventories:

December 31, 2019:

At cost: \$585,000

At lower of cost and net realizable value (NRV): \$525,000

December 31, 2020:

At cost: \$780,000

At lower of cost and net realizable value (NRV): \$740,000

Anselmo uses a periodic inventory system and an allowance account to adjust its inventory from cost to the lower of cost and NRV.

82. Anselmo's 2019 journal entry to adjust its inventory from cost to the lower of cost and net realizable value (NRV) will include a

- a) debit of \$60,000 to Loss on Inventory Due to Decline in NRV.
- b) credit of \$60,000 to Loss on Inventory Due to Decline in NRV.
- c) debit of \$60,000 to Allowance to Reduce Inventory to NRV.
- d) credit of \$60,000 to Inventory.

Answer: a

Difficulty: Medium

Learning Objective: Explain why inventory is measured at the lower of cost and net realizable value, and apply the lower of cost and net realizable value principle.

Section Reference: Measurement and the Lower of Cost and Net Realizable Value (LC&NRV) Principle

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$585,000 - \$525,000 = \$60,000$

83. Anselmo's 2020 journal entry to adjust its inventory from cost to the lower of cost and net realizable value (NRV) will include a

- a) debit of \$40,000 to Loss on Inventory Due to Decline in NRV.
- b) debit of \$40,000 to Allowance to Reduce Inventory to NRV.
- c) debit of \$20,000 to Allowance to Reduce Inventory to NRV.
- d) credit of \$40,000 to Recovery of Loss Due to Decline in Inventory.

Answer: c

Difficulty: Medium

Learning Objective: Explain why inventory is measured at the lower of cost and market, and apply the lower of cost and net realizable value principle.

Section Reference: Measurement and the Lower of Cost and Net Realizable Value (LC&NRV) Principle

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: Existing balance in allowance account must decrease from \$60,000 to \$40,000. This is accomplished by debiting the allowance account by \$20,000. Then the adjusted inventory will be $\$780,000 - \$40,000 = \$740,000$

84. Washington Distribution Co. has determined its December 31, 2020, 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

Washington records losses that result from applying the lower of cost and net realizable value rule. At December 31, 2020, the loss that Washington should recognize is

- a) \$0.
- b) \$5,000.
- c) \$15,000.
- d) \$25,000.

Answer: a

Difficulty: Medium

Learning Objective: Explain why inventory is measured at the lower of cost and market, and apply the lower of cost and net realizable value principle.

Section Reference: Measurement and the Lower of Cost and Net Realizable Value (LC&NRV)

Principle

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\text{NRV} = \$255,000 - \$10,000 = \$245,000$; $\text{Cost} = \$240,000$; therefore no loss

85. The primary basis of accounting for inventories is cost. A departure from the cost basis of pricing 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) future utility will be less than their cost.
- d) cost will be less than their replacement cost.

Answer: c

Difficulty: Easy

Learning Objective: Explain why inventory is measured at the lower of cost and market, and apply the lower of cost and net realizable value principle.

Section Reference: Measurement and the Lower of Cost and Net Realizable Value (LC&NRV)

Principle

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

86. In no case can "net realizable value" (in the lower of cost and net realizable value 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 a normal profit margin.
- d) estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal, an allowance for a normal profit margin, and an adequate reserve for possible future losses.

Answer: b

Difficulty: Easy

Learning Objective: Explain why inventory is measured at the lower of cost and market, and apply the lower of cost and net realizable value principle.

Section Reference: Measurement and the Lower of Cost and Net Realizable Value (LC&NRV)
Principle
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

87. 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) net realizable value
- b) selling price
- c) historical cost
- d) net realizable value reduced by a normal profit margin

Answer: a

Difficulty: Easy

Learning Objective: Explain why inventory is measured at the lower of cost and market, and apply the lower of cost and net realizable value principle.

Section Reference: Measurement and the Lower of Cost and Net Realizable Value (LC&NRV)
Principle
CPA: Financial Reporting
Bloomcode: Comprehension
AACSB: Analytic

88. The use of a “replacement cost” definition of “market” is based on the assumption that

- a) a decline in an item’s replacement cost results in a decline in its selling price.
- b) prices will fall in the same proportion as input costs fall.
- c) replacement cost is appropriate for all situations.
- d) using “net realizable value less a normal profit margin” will arbitrarily shift profits from one period to another.

Answer: a

Difficulty: Easy

Learning Objective: Explain why inventory is measured at the lower of cost and market, and apply the lower of cost and net realizable value principle.

Section Reference: Measurement and the Lower of Cost and Net Realizable Value (LC&NRV)
Principle
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

89. 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 statement of financial position 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 statement of financial position date.

Answer: b

Difficulty: Easy

Learning Objective: Explain why inventory is measured at the lower of cost and market, and apply the lower of cost and net realizable value principle.

Section Reference: Measurement and the Lower of Cost and Net Realizable Value (LC&NRV) Principle

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

90. Lower of cost and net realizable value

- 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 income tax purposes.

Answer: c

Difficulty: Easy

Learning Objective: Explain why inventory is measured at the lower of cost and market, and apply the lower of cost and net realizable value principle.

Section Reference: Measurement and the Lower of Cost and Net Realizable Value (LC&NRV) Principle

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

91. 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.

Answer: a

Difficulty: Easy

Learning Objective: Explain why inventory is measured at the lower of cost and market, and apply the lower of cost and net realizable value principle.

Section Reference: Measurement and the Lower of Cost and Net Realizable Value (LC&NRV) Principle

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

92. The lower of cost and NRV principle specifies that the comparison is usually applied on

- a) total inventory.
- b) individual categories of inventory.
- c) an item-by-item basis.
- d) major categories of inventory.

Answer: c

Difficulty: Easy

Learning Objective: Explain why inventory is measured at the lower of cost and market, and apply the lower of cost and net realizable value principle.

Section Reference: Measurement and the Lower of Cost and Net Realizable Value (LC&NRV) Principle

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

93. Enviro Corporation had the following items as inventory as at December 31, 2020:

Item No.	Quantity	Unit Cost	NRV
A1	130	\$8.00	\$8.40
B4	190	5.00	4.90
C2	190	12.00	12.90
D3	160	11.00	10.90

Assume that Enviro uses a perpetual inventory system and that none of the inventory items can be grouped together for accounting purposes. The year-end adjusting entry should include a charge to cost of goods sold of

- a) \$223.
- b) \$188.
- c) \$35.

d) \$0.

Answer: c

Difficulty: Medium

Learning Objective: Explain why inventory is measured at the lower of cost and market, and apply the lower of cost and net realizable value principle.

Section Reference: Measurement and the Lower of Cost and Net Realizable Value (LC&NRV) Principle

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

94. 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.

Answer: d

Difficulty: Easy

Learning Objective: Identify inventories that are or may be valued at amounts other than the lower of cost and net realizable value.

Section Reference: Exceptions to Lower of Cost and Net Realizable Value

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

95. Which of the following inventories may NOT be valued at fair value less costs to sell?

- a) grain and livestock futures
- b) biological assets
- c) farm equipment
- d) agricultural produce

Answer: c

Difficulty: Easy

Learning Objective: Identify inventories that are or may be valued at amounts other than the lower of cost and net realizable value.

Section Reference: Exceptions to Lower of Cost and Net Realizable Value

CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

96. Under IFRS, bearer plants used to grow produce including tea bushes, grape vines, and rubber trees are accounted for
- a) as agricultural assets, in accordance with IAS41.
 - b) using the cost or revaluation method.
 - c) as inventory, at cost, in accordance with IAS2.
 - d) as inventory, at fair value less costs to sell, in accordance with IAS2.

Answer: b

Difficulty: Easy
Learning Objective: Identify inventories that are or may be valued at amounts other than the lower of cost and net realizable value.
Section Reference: Exceptions to Lower of Cost and Net Realizable Value
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

97. Under ASPE, agricultural produce, forest products, and mineral products inventories may be accounted for at net realizable value if
- a) there is a well-established industry practice of doing so.
 - b) arbitrary cost allocation would be too costly.
 - c) costs to bring them to market are expected to be minimal.
 - d) the company's financial results appear more favourable by doing so.

Answer: a

Difficulty: Easy
Learning Objective: Identify inventories that are or may be valued at amounts other than the lower of cost and net realizable value.
Section Reference: Exceptions to Lower of Cost and Net Realizable Value
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

98. Rounded to the nearest whole percent, a markup of 35% on cost is equivalent to what percentage of gross profit on selling price?
- a) 26%
 - b) 29%

- c) 40%
- d) 60%

Answer: a

Difficulty: Medium

Learning Objective: Apply the gross profit method of estimating inventory.

Section Reference: Measuring Inventory Using Estimates

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $35\% \div (1 + 35\%) = 26\%$ (rounded)

99. Portland Ltd. estimates the cost of its physical inventory at March 31 for use in its interim financial statements. The rate of markup on cost is 25%. The following account balances are available:

Inventory, March 1	\$200,000
Purchases	168,000
Purchase returns	7,000
Sales during March	350,000

What is the estimated dollar value of the inventory at March 31?

- a) \$18,000
- b) \$175,000
- c) \$81,000
- d) \$368,000

Answer: c

Difficulty: Medium

Learning Objective: Apply the gross profit method of estimating inventory.

Section Reference: Measuring Inventory Using Estimates

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\text{COGS} = \$350,000 \div 1.25 = \$280,000$

$(\$200,000 + \$168,000 - \$7,000) - \$280,000 = \$81,000$

100. On January 1, 2020, the merchandise inventory of Shoesmith Corp. was \$600,000. During 2020, Shoesmith purchased \$1,150,000 of merchandise and recorded sales of \$1,350,000. The gross profit rate on these sales was 35%. What is the estimated dollar value of the inventory at December 31?

- a) \$877,500

- b) \$872,500
- c) \$562,500
- d) \$472,500

Answer: b

Difficulty: Medium

Learning Objective: Apply the gross profit method of estimating inventory.

Section Reference: Measuring Inventory Using Estimates

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\text{COGS} = \$1,350,000 \times 0.65 = \$877,500$

$\$600,000 + \$1,150,000 - \$877,500 = \$872,500$

101. For calendar 2020, cost of goods available for sale for Janus Corp. was \$820,000. The average gross profit rate was 30%. Sales for the year were \$600,000. What is the estimated dollar value of the inventory at December 31?

- a) \$400,000
- b) \$420,000
- c) \$328,000
- d) \$88,000

Answer: a

Difficulty: Medium

Learning Objective: Apply the gross profit method of estimating inventory.

Section Reference: Measuring Inventory Using Estimates

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$820,000 - (\$600,000 \times 0.70) = \$400,000$

102. On April 15 of the current year, a fire destroyed the entire inventory of Nourish, a retail store. The following data are available:

Sales, January 1 through April 15	\$473,000
Inventory, January 1	60,000
Purchases, January 1 through April 15	372,000
Markup on cost	25%

The amount of the inventory loss is estimated to be

- a) \$327,000.
- b) \$67,000.

- c) \$159,250.
- d) \$53,600.

Answer: d

Difficulty: Medium

Learning Objective: Apply the gross profit method of estimating inventory.

Section Reference: Measuring Inventory Using Estimates

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$60,000 + \$372,000 - (\$473,000 \div 1.25) = \$53,600$

103. Tennessee Ltd.'s accounting records reported the following information:

Inventory, Jan 1, 2020	\$ 300,000
Purchases during 2020	1,500,000
Sales during 2020	2,000,000

A physical inventory taken on December 31, 2020, resulted in an ending inventory of \$350,000. Tennessee's gross profit on sales has remained constant at 30% in recent years. Tennessee suspects some inventory may have been taken by a new employee. At December 31, 2020, what is the estimated cost of the missing inventory?

- a) \$400,000
- b) \$100,000
- c) \$75,000
- d) \$50,000

Answer: d

Difficulty: Medium

Learning Objective: Apply the gross profit method of estimating inventory.

Section Reference: Measuring Inventory Using Estimates

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$2,000,000 \times .70 = \$1,400,000$ (COGS)

$\$300,000 + \$1,500,000 - \$1,400,000 - \$350,000 = \$50,000$

104. The gross profit method of inventory valuation is NOT suitable 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) the gross profit percentage applicable to the goods in ending inventory is different from the percentage applicable to the goods sold during the period.

Answer: d

Difficulty: Easy

Learning Objective: Apply the gross profit method of estimating inventory.

Section Reference: Measuring Inventory Using Estimates

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

105. 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) It may be used to provide a rough check on the accuracy of the physical inventory count.

Answer: b

Difficulty: Easy

Learning Objective: Apply the gross profit method of estimating inventory.

Section Reference: Measuring Inventory Using Estimates

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

106. 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.

Answer: c

Difficulty: Easy

Learning Objective: Apply the gross profit method of estimating inventory.

Section Reference: Measuring Inventory Using Estimates

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

107. The gross profit method of inventory valuation

- a) can be used as a substitute for the annual physical count of inventory.
- b) assumes past percentages are appropriate for the current period.
- c) uses markups but not markdowns.
- d) is designed to approximate inventory valuation at the lower of cost and net realizable value.

Answer: b

Difficulty: Easy

Learning Objective: Apply the gross profit method of estimating inventory.

Section Reference: Measuring Inventory Using Estimates

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

108. Which of the following statements with respect to the gross profit method of estimating inventory is NOT correct?

- a) It may be used for interim reporting.
- b) It may be used to estimate ending inventory when inventory has been destroyed.
- c) It uses the interrelationship between the accounts used in the cost of goods sold calculation.
- d) The use of this method eliminates the need for performing an actual inventory count.

Answer: d

Difficulty: Easy

Learning Objective: Apply the gross profit method of estimating inventory.

Section Reference: Measuring Inventory Using Estimates

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

109. Which of the following is NOT a premise upon which the gross profit method of estimating inventory is based?

- a) Beginning inventory plus purchases equals cost of goods available for sale.
- b) The gross profit must be equal to the contribution margin on goods sold.
- c) Goods not included in cost of goods sold must be on hand in ending inventory.
- d) When an estimate of cost of goods sold is deducted from cost of goods available for sale, the result is an estimate of ending inventory.

Answer: b

Difficulty: Easy

Learning Objective: Apply the gross profit method of estimating inventory.

Section Reference: Measuring Inventory Using Estimates

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

110. The gross profit method is normally used

- a) for insurance purposes, in cases where inventory has been destroyed.
- b) for all of these (all of these are examples of how the gross profit method is used).
- c) to provide a rough check on the accuracy of a physical inventory count.
- d) by auditors to estimate a company's inventory for quarterly reporting.

Answer: b

Difficulty: Easy

Learning Objective: Apply the gross profit method of estimating inventory.

Section Reference: Measuring Inventory Using Estimates

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

111. Which of the following statements regarding presentation and disclosure of inventories is INCORRECT?

- a) Major spare parts and standby equipment may be recognized as inventory if they are not expected to provide benefits beyond the current accounting period.
- b) Inventories are one of the most significant assets of manufacturing and merchandising companies.
- c) The classification of inventory seldom requires the exercise of professional judgement.
- d) Minor spare parts and servicing equipment are usually classified as inventory.

Answer: c

Difficulty: Easy

Learning Objective: Identify how inventory should be presented, disclosed and analyzed.

Section Reference: Presentation, Disclosure, and Analysis

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

112. Which of the following is NOT a required inventory disclosure under ASPE?

- a) any portion of foreign exchange gain/loss specifically attributable to inventory items
- b) choice of accounting policies adopted to measure the inventory
- c) carrying amount of inventory pledged as collateral for liabilities
- d) amount of inventory recognized as an expense in the period

Answer: a

Difficulty: Easy

Learning Objective: Identify how inventory should be presented, disclosed and analyzed.

Section Reference: Presentation, Disclosure, and Analysis

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

113. The inventory turnover ratio is calculated as

- a) cost of goods sold divided by average inventory.
- b) average inventory divided by cost of goods sold.
- c) cost of goods sold times average inventory.
- d) average assets divided by cost of goods sold.

Answer: a

Difficulty: Easy

Learning Objective: Identify how inventory should be presented, disclosed, and analyzed.

Section Reference: Presentation, Disclosure, and Analysis

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

114. 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.

Answer: c

Difficulty: Easy

Learning Objective: Identify how inventory should be presented, disclosed, and analyzed.

Section Reference: Presentation, Disclosure, and Analysis

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

115. The average days to sell inventory ratio is calculated as

- a) average inventory divided by inventory turnover.
- b) inventory turnover divided by cost of goods sold.
- c) inventory turnover divided by 365 days.
- d) 365 days divided by inventory turnover.

Answer: d

Difficulty: Easy

Learning Objective: Identify how inventory should be presented, disclosed, and analyzed.

Section Reference: Presentation, Disclosure, and Analysis

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

116. The 2020 financial statements of Barclay Ltd. reported beginning inventory of \$130,000, ending inventory of \$140,000, and cost of goods sold of \$650,000 for the year. To one decimal, Barclay's inventory turnover ratio for 2020 is

- a) 2.9 times.
- b) 3.4 times.
- c) 4.0 times.
- d) 4.8 times.

Answer: d

Difficulty: Medium

Learning Objective: Explain how inventory analysis provides useful information and apply ratio analysis to inventory.

Section Reference: Analysis

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$650,000 \div [(\$130,000 + \$140,000) \div 2] = 4.8 \text{ times}$

117. For 2020, Colorado Corp.'s cost of goods sold was \$562,500 and their sales were \$1,200,000. Assuming an inventory turnover of 3.5 for the year, what was the company's average inventory? (Round to the nearest dollar.)

- a) \$251,786
- b) \$170,682
- c) \$160,714

d) Cannot be determined from the information given.

Answer: c

Difficulty: Medium

Learning Objective: Explain how inventory analysis provides useful information and apply ratio analysis to inventory.

Section Reference: Analysis

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$562,500 \div 3.5 = \$160,714$

****118.** Total merchandise available for sale is \$119,000 at cost and \$148,000 at retail. Net markdowns are \$10,000 and sales are \$50,000. The cost-to-retail ratio (rounded) is

- a) 80%.
- b) 86%.
- c) 82%.
- d) 63%.

Answer: b

Difficulty: Medium

Learning Objective: Apply the retail method of estimating inventory.

Section Reference: Appendix 8A - The Retail Inventory Method of Estimating Inventory Cost

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

***119.** Use the following information for questions *119–*120.

Tang Inc. 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 markups	—	22,000
Net markdowns	—	30,000
Sales	—	585,000

If the ending inventory is to be estimated using the retail method, the calculation of the cost-to-retail ratio should be based on cost and retail of

- a) \$450,000 and \$645,000.
- b) \$567,000 and \$828,000.
- c) \$559,000 and \$795,000.
- d) \$567,000 and \$798,000.

Answer: d

Difficulty: Medium

Learning Objective: Apply the retail method of estimating inventory.

Section Reference: Appendix 8A - The Retail Inventory Method of Estimating Inventory Cost

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: Cost: $\$117,000 + \$442,000 + \$8,000 = \$567,000$.

Retail: $\$183,000 + \$623,000 + \$22,000 - \$30,000 = \$798,000$

*120. The ending inventory at retail should be

- a) \$210,000.
- b) \$216,000.
- c) \$225,000.
- d) \$240,000.

Answer: a

Difficulty: Medium

Learning Objective: Apply the retail method of estimating inventory.

Section Reference: Appendix 8A - The Retail Inventory Method of Estimating Inventory Cost

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$183,000 + \$623,000 - \$3,000 + \$22,000 - \$30,000 - \$585,000 = \$210,000$

*121. Maine 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, 2020, are as follows:

	Cost	Retail
Inventory, July 1/20	\$ 200,000	\$ 360,000
Purchases	1,200,000	1,575,000
Markups, net		175,000
Sales		1,700,000

Estimated normal shoplifting losses	20,000
Markdowns, net	110,000

Maine's estimated inventory at July 31, 2020, using the retail method is

- a) \$210,000.
- b) \$196,000.
- c) \$197,980.
- d) \$185,782.

Answer: b

Difficulty: Medium

Learning Objective: Apply the retail method of estimating inventory.

Section Reference: Appendix 8A - The Retail Inventory Method of Estimating Inventory Cost

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $(\$200,000 + \$1,200,000) \div (\$360,000 + \$1,575,000 + \$175,000 - \$110,000) = 0.7$
 $(\$360,000 + \$1,575,000 + \$175,000 - \$20,000 - \$110,000 - \$1,700,000) \times 0.7 = \$196,000$

122. At December 31, 2020, the following information was available from Hampshire Corp.'s accounting records:

	Cost	Retail
Inventory, Jan 1	\$147,000	\$ 215,000
Purchases	763,000	1,155,000
Additional markups		<u>40,000</u>
Available for sale	<u>\$910,000</u>	<u>\$1,410,000</u>

Sales for the year totalled \$1.1 million. Markdowns amounted to \$10,000. Under the lower of average cost and market method, Hampshire's estimated inventory at December 31, 2020 was

- a) \$188,500.
- b) \$195,000.
- c) \$200,071.
- d) \$205,070.

Answer: b

Difficulty: Medium

Learning Objective: Apply the retail method of estimating inventory.

Section Reference: Appendix 8A - The Retail Inventory Method of Estimating Inventory Cost

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$910,000 \div (\$1,410,000 - \$10,000) = 65.0\%$
 $(\$1,410,000 - \$10,000 - \$1,100,000) \times 65.0\% = \$195,000$

**123. The impact of the retail inventory method upon gross profit can be described as

- a) use of the retail method increases gross profit.
- b) use of the retail inventory method does not impact gross profit.
- c) use of the retail method decreases gross profit.
- d) use of the retail method has an averaging effect for varying rates of gross profit.

Answer: d

Difficulty: Easy

Learning Objective: Apply the retail method of estimating inventory.

Section Reference: Appendix 8A - The Retail Inventory Method of Estimating Inventory Cost

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

*124. The retail inventory method is NOT used

- a) as a control measure to determine inventory shortages.
- b) to allow the calculation of net income without taking a physical inventory count.
- c) to control quantities of merchandise on hand.
- d) to calculate the gross profit percentage.

Answer: d

Difficulty: Easy

Learning Objective: Apply the retail method of estimating inventory.

Section Reference: Appendix 8A - The Retail Inventory Method of Estimating Inventory Cost

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

EXERCISES

Ex. 8-125 Inventory management

Explain why inventory management is referred to as a double-edged sword. What competing interests is management trying to balance in their management of inventories?

Solution 8-125

On one hand, management wants to have a wide variety and sufficient quantities on hand so that customers have the greatest selection and always find what they want in stock. On the other hand, such policies may result in excessive carrying costs (for example, in investment, storage, insurance, taxes, obsolescence, risk of theft, and damage). The higher the levels of inventories held, the higher the costs of looking after them.

Companies must therefore monitor inventory levels carefully to:

Minimize carrying costs and

Meet customer demands

Difficulty: Easy

Learning Objective: Understand inventory from a business perspective.

Section Reference: Understanding Inventory

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

Ex. 8-126 Definitions

Provide clear, concise answers for the following:

1. Identify the inventory categories of a manufacturing company and describe how they are 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 cost flow method?
6. What is the FIFO cost flow method?

Solution 8-126

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 general ledger 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 goods sold is 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 serialized products such as automobiles and major appliances.
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.

Difficulty: Easy

Learning Objective: Understand inventory from a business perspective.

Section Reference: Understanding Inventory

Learning Objective: Identify which inventory items should be included in ending inventory.

Section Reference: Recognition of Physical Goods Included in Inventory

Learning Objective: Distinguish between perpetual and periodic inventory systems and account for them.

Section Reference: Measurement and Inventory Accounting Systems

Learning Objective: Identify and apply GAAP cost formula options and indicate when each cost formula is appropriate.

Section Reference: Measurement and Cost Formulas

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

Ex. 8-127 Inventories from an accounting perspective

Which of the following would be included in inventory?

- a) Cost of jars, to a juice bar
- b) Cost of apples held on the shelves of a grocery store
- c) Cost of an airplane being manufactured
- d) Cost of a courtesy vehicle owned by a car dealership
- e) Cost of wine for a bar/restaurant

Solution 8-127

All except d) should be considered inventory.

Difficulty: Easy

Learning Objective: Identify which inventory items should be included in ending inventory

Section Reference: Recognition of Physical Goods Included in Inventory

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

Ex. 8-128 Accounting definition

Define inventory from an accounting perspective

Solution 8-128

For accounting purposes, inventories are defined as “assets”:

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.

Consistent with the definition of an asset, they represent a future benefit, and are under the control of the entity.

Difficulty: Easy

Learning Objective: Identify which inventory items should be included in ending inventory.

Section Reference: Recognition of Physical Goods Included in Inventory

CPA: Communication
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Communication

Ex. 8-129 Items to be included in ending inventory

During the year, the following transactions took place for Blades Corporation. For each transaction, indicate whether the inventory should be included in Blades' inventory at the end of the year.

- a) On December 31, the last day of the fiscal year, Baldes shipped 1,000 units to one of its customers. The product has not yet been received by the end of the day. Terms were FOB destination point.
- b) Blades shipped some product to a customer, who received the product on December 15. Terms of sale call for payment on January 10 of the following year.
- c) Roller Corporation is holding inventory on consignment for Blades. On December 31, 30% of the inventory is still at Roller's location.
- d) Blades' manager instructed an employee to drive some inventory off-site so it could be considered sold during the fiscal year.

Solution 8-129

- a) should be included
- b) should not be included
- c) should be included
- d) should be included

Difficulty: Easy

Learning Objective: Identify which inventory items should be included in ending inventory.

Section Reference: Recognition of Physical Goods Included in Inventory

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

Ex. 8-130 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 statement of financial position.

2. A contract in which neither party has _____
fulfilled its part of the contract.

3. The costs that are “attached” to Inventory. _____
4. Direct costs and allocated overhead that are incurred to process raw materials into finished goods. _____
5. The predetermined costs to produce one unit of a given item of inventory. _____
6. The purchase of a group of units with different characteristics at a single lump-sum price. _____
7. An inventory estimation method that uses the interrelationships between the accounts used in the calculation of cost of goods sold. _____

Solution 8-130

1. a product financing arrangement
2. executory contract
3. product costs
4. conversion costs
5. standard costs
6. basket purchase
7. the gross profit method

Difficulty: Easy

Learning Objective: Identify which inventory items should be included in ending inventory.

Section Reference: Recognition of Physical Goods Included in Inventory

Learning Objective: Determine the components of inventory cost.

Section Reference: Measurement of Inventory - Costs Included

Learning Objective: Apply the gross profit method of estimating inventory.

Section Reference: Measuring Inventory Using Estimates

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

Ex. 8-131 Impact of accounting errors on financial statement items and ratios

Cayman Corporation makes the following errors during the current year. Each error is an independent case.

Ending inventory is overstated by \$1,120, but purchases are recorded correctly.

Both ending inventory and a purchase on account are understated in the same amount.

Ending inventory is correct, but a purchase on account was not recorded. (Assume the purchase of \$880 was recorded in the following year).

Instructions

Indicate the effect of each error on working capital, the current ratio (assume the current ratio is greater than 1), retained earnings, and net income for the current year and the following year.

Solution 8-131

WC O/S \$1,120

Current Ratio O/S

R/E O/S by \$1,120

NI O/S by \$1,120

Subsequent year NI U/S by \$1,120

WC No effect

Current ratio O/S

R/E No effect

NI No effect

Subsequent year NI no effect

WC O/S by \$880

Current ratio O/S

R/E O/S by \$880

NI O/S by \$880

Subsequent year NI U/S by \$880

Difficulty: Medium

Learning Objective: Identify the effects of inventory errors on the financial statements and adjust for them.

Section Reference: Inventory Errors

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 8-132 Purchases and inventory misstated

Omitting both the purchase of goods and the inventory results in an understated inventory and accounts payable. Net income is not affected. Assuming a company has a current ratio greater than 1, why is it still important to adjust for the error in inventory record keeping.

Solution 8-132

Although total working capital is unchanged, the current ratio is overstated because equal amounts were omitted from inventory and accounts payable. If the company has covenants or other conditions that centre around their level of current assets and current liabilities, it is especially important that they make this adjustment to ensure accuracy of the related figures and ratios.

Difficulty: Easy

Learning Objective: Identify the effects of inventory errors on the financial statements and adjust for them.

Section Reference: Inventory Errors

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

Ex. 8-133 Vendor rebates

Bell Corp. has been purchasing more inventory from Wood Ltd. in recent years. Wood offers Bell a rebate of \$0.14 per unit on each unit purchased if Wood buys more than 80,000 units in a calendar year. Bell has already exceeded this threshold in the first 6 months of 2020, as it has purchased 120,000 units.

Instructions

Prepare the entry that Bell should record if it is preparing semi-annual financial statements assuming that, of the 120,000 units purchased, 40,000 units are still on hand.

Solution 8-133

Rebate receivable	5,600
Inventory	5,600

As the rebate only relates to the 40,000 units that exceeded the threshold, and all these units are in inventory, the entire amount of the rebate is allocated to units in inventory rather than as a reduction of cost of goods sold.

Difficulty: Medium

Learning Objective: Determine the components of inventory cost.

Section Reference: Measurement of Inventory - Costs Included

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex 8-134 Inventory cost flow assumptions

The following inventory transactions took place for NPR Corporation for the month of May:

Date	Event	Quantity	Cost/Selling Price
May 1	Beginning Inventory	1,000	\$3.55
May 5	Purchase	6,000	3.10
May 10	Purchase	2,000	3.75
May 15	Sale	3,000	6.00
May 20	Sale	2,000	6.00
May 22	Purchase	5,000	3.45
May 24	Purchase	2,000	3.75
May 25	Sale	7,000	6.00

Instructions

Calculate the ending inventory balance for NPR Corporation, assuming the company uses a periodic inventory system and the weighted average cost formula.

Solution 8-134

Event	Quantity × Unit Cost	Inventory Amount
Beginning inventory	1,000 × \$3.55 =	\$ 3,550
purchase	6,000 × \$3.10 =	18,600
purchase	2,000 × \$3.75 =	7,500
purchase	5,000 × \$3.45 =	17,250
purchase	<u>2,000</u> × \$3.75 =	<u>7,500</u>
Total	16,000	\$54,400

Weighted Average Cost = \$54,400 / 16000 = \$3.40

Ending Quantity = $1,000 + 6,000 + 2,000 - 3,000 - 2,000 + 5,000 + 2,000 - 7,000 = 4,000$

Ending Inventory Balance = $4,000 \text{ units} \times \$3.40 = \$13,600$

Difficulty: Medium

Learning Objective: Determine the components of inventory cost.

Section Reference: Measurement of Inventory - Costs Included

Learning Objective: Distinguish between perpetual and periodic inventory systems and account for them.

Section Reference: Measurement and Inventory Accounting Systems

Learning Objective: Identify and apply GAAP cost formula options and indicate when each cost formula is appropriate.

Section Reference: Measurement and Cost Formulas

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex 8-135 Volume rebates

Explain when volume rebates are recognized if the “rebate receivable” meets both the definition of an asset and its recognition criteria versus when the rebate is discretionary on the part of the supplier.

Solution 8-135

If the “rebate receivable” meets both the definition of an asset and its recognition criteria, the rebate is recognized before it is received. If the rebate is discretionary on the part of the supplier, no rebate is recognized until it is paid or the supplier becomes obligated to make a payment.

Difficulty: Easy

Learning Objective: Determine the components of inventory cost.

Section Reference: Measurement of Inventory – Costs Included

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

Ex. 8-136 Year-end entries to update inventory accounts

Omaha Corporation uses FIFO and a periodic inventory system. You have been provided with the following information relating to the company's inventory for the year ended December 2020:

Beginning inventory Jan 1	\$24,500
Ending inventory Dec 31	109,080

Total purchases recorded during 2020 130,000

Instructions

Record the journal entry (entries) that are required to bring Omaha's inventory accounts and cost of goods sold up to date for 2020.

Solution 8-136

Ending inventory (Note 1)	109,080	
Cost of goods sold (Note 2)	45,420	
Beginning inventory (Note 3)		24,500
Purchases (Note 4)		130,000

Note 1: To record ending inventory

Note 2: To record cost of goods sold (\$24,500 + \$130,000 – \$109,080)

Note 3: To remove beginning inventory

Note 4: To clear purchases account

Difficulty: Medium

Learning Objective: Distinguish between perpetual and periodic inventory systems and account for them.

Section Reference: Measurement and Inventory Accounting Systems

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 8-137 FIFO cost formula

The Malibu Shop shows the following data related to item Y27:

Inventory, February 1	100 units @ \$7.00
Purchase, February 9	200 units @ \$7.60
Purchase, February 19	150 units @ \$7.90
Inventory, February 28	200 units

Instructions

Using the FIFO cost formula, what value should be assigned to the ending inventory of item Y27?

Solution 8-137

150 @ \$7.90 =	\$1,185
50 @ \$7.60 =	<u>380</u>
	<u>\$1,565</u>

Difficulty: Medium

Learning Objective: Distinguish between perpetual and periodic inventory systems and account for them.

Section Reference: Measurement and Inventory Accounting Systems

Learning Objective: Identify and apply GAAP cost formula options and indicate when each cost formula is appropriate.

Section Reference: Measurement and Cost Formulas

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 8-138 Perpetual FIFO

A record of transactions for the month of May is 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, calculate the ending inventory using FIFO.

Solution 8-138

500 @ \$4.75 =	\$2,375
400 @ \$4.50 =	<u>1,800</u>
	<u>\$4,175</u>

Difficulty: Medium

Learning Objective: Distinguish between perpetual and periodic inventory systems and account for them.

Section Reference: Measurement and Inventory Accounting Systems

Learning Objective: Identify and apply GAAP cost formula options and indicate when each cost formula is appropriate.

Section Reference: Measurement and Cost Formulas

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 8-139 Periodic FIFO

Maine Corporation sells item A as part of its product line, using the periodic system.

Information as to balances on hand, purchases, and sales of item A are given in the following table for the first six months of 2020:

Quantities

Date	Purchased	Sold	Balance	Unit Price of Purchase
January 11	—	—	300	\$5.00
January 24	1,300	—	1,600	5.20
February 8	—	300	1,300	—
March 16	—	560	740	—
June 11	600	—	1,340	5.60

Instructions

Calculate the cost of goods sold for the first six months of 2020 using the FIFO cost formula.

Solution 8-139

300	@ \$5.00 =	\$1,500
<u>560</u>	@ \$5.20 =	<u>2,912</u>
<u>860</u>		<u>\$4,412</u>

Difficulty: Medium

Learning Objective: Distinguish between perpetual and periodic inventory systems and account for them.

Section Reference: Measurement and Inventory Accounting Systems

Learning Objective: Identify and apply GAAP cost formula options and indicate when each cost formula is appropriate.

Section Reference: Measurement and Cost Formulas

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 8-140 Journal entries for perpetual inventory system

Idaho Inc. is a wholesale company selling special parts for the automotive industry. The company uses FIFO and a perpetual inventory system. Its inventory records for part SA-123 show the following transactions for the month of May 2020:

Date	Transaction	Units Purchased	Unit Cost	Units Sold	Unit Selling Price
May 1	Balance	120	\$7.00		
May 10	Purchase	500	\$7.20		
May 15	Sale			(100)	\$12.40
May 21	Sale			(150)	\$12.50
May 23	Purchase	250	\$7.30		

Instructions

Assuming Idaho makes all sales and purchases of inventory on account, prepare the journal entries for each of the above listed transactions.

Solution 8-140May 10

Inventory.....	3,600	
Accounts Payable.....		3,600
To record purchase (500 x \$7.20 = \$3,600)		

May 15

Accounts Receivable.....	1,240	
Sales.....		1,240
To record sale (100 x \$12.40 = \$1,240)		

Cost of goods sold.....	700	
Inventory.....		700
To update inventory and cost of goods sold (100 x \$7.00 (from BI) = \$700)		

May 21

Accounts Receivable.....	1,875	
Sales.....		1,875
To record sale (150 x \$12.50 = \$1,875)		

Cost of goods sold.....	1,076	
Inventory.....		1,076
To update inventory and cost of goods sold (20 x \$7.00 – from BI) + (130 x \$7.20 - from May 10 purch.) = \$1,076		

May 23

Inventory.....	1,825	
Accounts Payable.....		1,825
To record purchase (250 x \$7.30 = \$1,825)		

Difficulty: Medium

Learning Objective: Distinguish between perpetual and periodic inventory systems and account for them.

Section Reference: Measurement and Inventory Accounting Systems

Learning Objective: Identify and apply GAAP cost formula options and indicate when each cost formula is appropriate.

Section Reference: Measurement and Cost Formulas

CPA: Financial Reporting
Bloomcode: Application
AACSB: Analytic

Ex. 8-141 Inventory overages and shortages

Explain how an inventory overage or shortage between the perpetual inventory record and the physical inventory record is adjusted. Is this any different when using a periodic inventory system?

Solution 8-141

When a **perpetual inventory system** is used and there is a difference between the perpetual inventory record and the physical inventory count, a separate entry is needed to adjust the perpetual Inventory account and is usually recognized as an adjustment of Cost of Goods Sold.

In a **periodic inventory system**, there is no separate account to track these inventory losses as there is no up-to-date inventory account that can be compared with the physical count. The amount of any inventory overage or shortage is therefore included in cost of goods sold.

Difficulty: Easy

Learning Objective: Distinguish between perpetual and periodic inventory systems and account for them.

Section Reference: Measurement and Inventory Accounting Systems

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 8-142 FIFO and LIFO inventory methods

During June, the following changes in inventory item 27 took place:

June 1	Balance	1,400 units @ \$24
14	Purchased	800 units @ \$36
24	Purchased	700 units @ \$30
8	Sold	400 units @ \$50
10	Sold	1,000 units @ \$40
29	Sold	500 units @ \$44

Perpetual inventories are maintained.

Instructions

What is the cost of the ending inventory for item 27 under the following methods? (Show calculations.)

- a) FIFO
- b) LIFO

Solution 8-142

$$\begin{array}{rcl} \text{a) } 700 @ \$30 & = & \$21,000 \\ 300 @ \$36 & = & \underline{10,800} \\ & & \underline{\$31,800} \end{array}$$

$$\text{b) } 1,000 @ \$24 = \$24,000$$

Difficulty: Medium

Learning Objective: Identify and apply GAAP cost formula options and indicate when each cost formula is appropriate.

Section Reference: Measurement and Cost Formulas

CPA: Financial Reporting

AACSB: Analytic

Ex. 8-143 Average cost formulas

Distinguish between the weighted average cost formula and the moving-average cost formula.

Solution 8-143

The **weighted average cost formula** takes into account that the volume of goods acquired at each price is different and is used with periodic inventory records. The beginning inventory units and cost are both included in calculating the average cost per unit.

The **moving-average cost formula** is used with perpetual inventory records that are kept in both units and dollars. In this method, a new average unit cost is calculated each time a purchase is made. This is because the cost of goods sold at the updated average cost has to be recognized at the time of the next sale.

Difficulty: Easy

Learning Objective: Identify and apply GAAP cost formula options and indicate when each cost formula is appropriate.

Section Reference: Measurement and Cost Formulas

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 8-144 Inventory cost flow assumptions

Kanga Corp.'s records reported an inventory cost of \$51,400 and a net realizable value of \$48,500 at December 31, 2019. At December 31, 2020, the records indicated a cost of \$67,900 and a net realizable value of \$59,500. All opening inventory had been sold during the year.

Instructions

Assuming that Kanga Corp. uses a perpetual inventory system, prepare the necessary December 31, 2020 entry under the direct method and the indirect method.

Solution 8-144

Direct Method

December 31, 2020

Cost of Goods Sold	8,400	
Inventory		8,400
Inventory \$67,900 – \$59,500 = \$8,400		

Indirect Method

December 31, 2020

Loss on Inventory Due to Decline in NRV	5,500	
Allowance to Reduce Inventory to NRV		5,500
(\$67,900 – \$59,500) \$8,400 less allowance balance from December 31, 2019 of \$2,900		
(\$51,400 – \$48,500) = \$5,500		

Since the opening inventory has been sold, the original cost of \$51,400 has been booked to CGS. Under this method, the original cost is preserved and the write-down is effected through an adjustment to the allowance account.

Difficulty: Medium

Learning Objective: Explain why inventory is measured at the lower of cost and net realizable value, and apply the lower of cost and net realizable value principle.

Section Reference: Measurement and the Lower of Cost and Net Realizable Value (LC&NRV)

Principle

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 8-145 Adjustments to lower of cost and NRV

The controller of Utah Corp. has provided you with the following information relating to its inventory:

Date	Cost	Lower of cost and NRV
Dec 31/17	\$457,000	\$410,000
Dec 31/18	\$615,000	\$555,000

Utah uses the periodic inventory system, and records its inventory at cost. An allowance account is adjusted at the end of each year to adjust the value of the inventory to the lower of cost and NRV.

Instructions

Prepare the journal entries that Utah would have prepared for its 2019 and 2020 year ends, assuming that 2019 was its first year of operations.

Solution 8-145

December 2019:

Loss on Inventory Due to Decline in NRV	47,000	
Allowance to Reduce Inventory to NRV.....		47,000
To set up allowance to decrease inventory from cost to the lower of cost and NRV (\$457,000 – \$410,000 = \$47,000)		

December 2020:

Loss on Inventory Due to Decline in NRV	13,000	
Allowance to Reduce Inventory to NRV.....		13,000
To increase the balance in the allowance account by \$13,000 (\$615,000 – \$47,000) – \$555,000 = \$13,000		
Allowance account now at \$60,000 Cr = difference between cost and NRV		

Difficulty: Medium

Learning Objective: Explain why inventory is measured at the lower of cost and net realizable value, and apply the lower of cost and net realizable value principle.

Section Reference: Measurement and the Lower of Cost and Net Realizable Value (LC&NRV) Principle

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 8-146 Lower of cost and net realizable value (NRV)

Determine the unit value that should be used for inventory costing, using the "lower of cost and NRV" rule.

	A	B	C	D	E	F
Cost	\$2.40	\$2.40	\$2.30	\$2.54	\$2.44	\$2.65
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

Solution 8-146

Case A \$2.40

Case B \$2.40

Case C \$2.25

Case D \$2.45

Case E \$2.44

Case F \$2.50

Difficulty: Medium

Learning Objective: Explain why inventory is measured at the lower of cost and net realizable value, and apply the lower of cost and net realizable value principle.

Section Reference: Measurement and the Lower of Cost and Net Realizable Value (LC&NRV) Principle

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 8-147 Lower of cost and net realizable value (NRV)

The December 31, 2020, inventory of Rhode Inc. consisted of four products, for which certain information is provided below:

		Replacement	Estimated	Expected
Product	Original Cost	Cost	Disposal Cost	Selling Price
A	\$29.00	\$22.00	\$6.50	\$40.00
B	\$44.00	\$40.00	\$8.00	\$48.00
C	\$145.00	\$125.00	\$25.00	\$190.00
D	\$21.00	\$15.80	\$3.00	\$28.00

Instructions

Using the lower of cost and NRV approach applied on an individual-item basis, calculate the inventory valuation that should be reported for each product on December 31, 2020.

Solution 8-147

Product	Net Realizable Value	Cost	Lower of Cost and NRV
A	$\$40.00 - \$6.50 = \$33.50$	\$29.00	\$29.00
B	$\$48.00 - \$8.00 = \$40.00$	\$44.00	\$40.00
C	$\$190.00 - \$25.00 = \$165.00$	\$145.00	\$145.00
D	$\$28.00 - \$3.00 = \$25.00$	\$21.00	\$21.00

Difficulty: Medium

Learning Objective: Explain why inventory is measured at the lower of cost and net realizable value, and apply the lower of cost and net realizable value principle.

Section Reference: Measurement and the Lower of Cost and Net Realizable Value (LC&NRV) Principle

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 8-148 Accounting for biological and agricultural assets

Woods' Apiary began operations on April 1, 2020, with the purchase of 220 hives for \$1,204,000. It has completed the first month of operations and has the following information for its hives at the end of 2020:

Hives

Change in fair value due to growth and price changes	\$(14,000)
Decrease in fair value due to harvest	\$(800)
Honey harvested during April 2020 (at net realizable value)	\$2,500

Instructions

Prepare the journal entries for Woods' bio agricultural assets (beehives) for the month of April 2020.

Solution 8-148

1 April 2020	Biological Assets—Beehives.....	1,204,000	
	Cash.....		1,204,000
	To record purchase of beehives		
April 2020	Unrealized Gain or Loss.....	14,800	
	Biological Assets—Beehives.....		14,800

Difficulty: Medium

Learning Objective: Identify inventories that are or may be valued at amounts other than the lower of cost and net realizable value.

Section Reference: Exceptions to Lower of Cost and Net Realizable Value

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 8-149 Accounting for biological and agricultural assets

Using the information from question 8-148, prepare the journal entry for the honey harvested by Woods during April 2020.

Assume Woods sells the honey harvested at the local market and receives \$3,100. Prepare the summary entry to record the sale of the honey for cash.

Solution 8-149

April 2020	Honey Inventory	2,500	
	Biological Assets—Beehives.....		2,500
	Cash.....	3,100	
	Cost of Goods Sold	2,500	
	Honey Inventory		2,500
	Sales.....		3,100

Difficulty: Medium

Learning Objective: Identify inventories that are or may be valued at amounts other than the lower of cost and net realizable value.

Section Reference: Exceptions to Lower of Cost and Net Realizable Value

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 8-150 Bearer plants

Explain how bearer plants are accounted for and why.

Solution 8-150

Because bearer plants produce saleable products such as tea or grapes each season, they are treated like property, plant, and equipment under IFRS. As such, they are accounted for using the cost or the revaluation method.

Difficulty: Easy

Learning Objective: Identify inventories that are or may be valued at amounts other than the lower of cost and net realizable value.

Section Reference: Exceptions to Lower of Cost and Net Realizable Value

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 8-151 Gross profit method

Logan's Corporation recently suffered a fire in its warehouse. The fire destroyed all of the company's inventory on hand at June 30. The opening inventory on June 1 was \$1,973,500. Logan purchased an additional \$493,000 during June and had sales of \$954,000 for the month at a gross profit of 25%.

Instructions

Using the gross profit method, estimate the value of inventory destroyed in the fire.

Solution 8-151

Beginning inventory at cost.....	\$1,973,500
Purchases (at cost)	<u>493,000</u>
Goods available for sale at cost.....	\$2,466,500
Sales (at selling price)	\$954,000
Less: Gross profit (25%)	<u>238,500</u>
Sales at cost.....	<u>715,500</u>
Estimated inventory destroyed (at cost).....	\$1,751,000

Difficulty: Medium

Learning Objective: Apply the gross profit method of estimating inventory.

Section Reference: Measuring Inventory Using Estimates

CPA: Financial Reporting

Bloomcode: Application

AACSB: Communication

Ex. 8-152 Gross profit method

Ohana Company uses the gross profit method to estimate inventory for monthly reports.

Information follows for the month of November:

Inventory, Nov 1	\$ 978,000
Purchases	691,000
Freight-in	47,000
Sales	1,450,000
Sales returns	67,600
Purchase discounts	14,100

Instructions

- Calculate the estimated inventory at November 30, assuming that the gross profit is 30% of sales.
- Calculate the estimated inventory at November 30, assuming that the markup on cost is 30%.

Solution 8-152

a) Assuming gross profit is 30% of sales:

Inventory, Nov 1 (at cost)	\$978,000
Purchases (gross) (at cost)	691,000
Purchase discounts	(14,100)

Freight-in	47,000
Goods available (at cost)	<u>1,701,900</u>
Sales (at selling price)	\$ 1,450,000
Sales returns (at selling price)	<u>(67,600)</u>
Net sales (at selling price)	1,382,400
Less gross profit (30% of \$1,382,400)	<u>414,720</u>
Estimated cost of goods sold.....	<u>967,680</u>
Estimated inventory, Nov 30 (at cost)	<u>\$734,220</u>

b) Assuming the markup on cost is 30%:

$30\% / (100\% + 30\%) = 23.08\%$ of sales

Inventory, Nov 1 (at cost)	\$ 978,000
Purchases (gross) (at cost)	691,000
Purchase discounts	<u>(14,100)</u>
Freight-in	<u>47,000</u>
Goods available (at cost)	1,701,900
Sales (at selling price)	\$ 1,450,000
Sales returns (at selling price)	<u>(67,600)</u>
Net sales (at selling price)	1,382,400
Less gross profit (23.08% of \$1,382,400)	<u>319,058</u>
Estimated cost of goods sold.....	<u>1,063,342</u>
Estimated inventory, Nov 30 (at cost)	<u>\$ 638,558</u>

Difficulty: Medium

Learning Objective: Apply the gross profit method of estimating inventory.

Section Reference: Measuring Inventory Using Estimates

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 8-153 Gross profit method

An inventory taken the morning after a large theft (March 12) discloses \$27,500 of goods on hand. The following additional data is available from the books:

Inventory on hand, March 1	\$ 42,000
Purchases received, March 1–11	36,000
Sales (goods delivered to customers)	67,500

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 8-153

Beginning inventory	\$ 42,000
Purchases	<u>36,000</u>
Goods available for sale	78,000
Less COGS ($\$67,500 \div 150\%$)	<u>(45,000)</u>
Estimated ending inventory	33,000
Physical inventory still on hand	<u>(27,500)</u>
Theft loss	<u>\$ 5,500</u>

Difficulty: Medium

Learning Objective: Apply the gross profit method of estimating inventory.

Section Reference: Measuring Inventory Using Estimates

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 8-154 Gross profit method

On January 1, Jasper Store had inventory valued at \$124,000. January purchases were \$78,000 and January sales were \$220,000. 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 \$10,000 remained undamaged after the fire.

Instructions

Calculate the amount of the fire loss. Show appropriate titles for all amounts in your presentation.

Solution 8-154

Beginning inventory	\$ 124,000
Purchases	<u>78,000</u>
Goods available for sale	202,000
Less COGS ($\$220,000 \div 125\%$)	<u>(176,000)</u>
Estimated ending inventory	26,000
Cost of undamaged inventory ($\$10,000 \div 125\%$)	<u>(8,000)</u>
Estimated fire loss	<u>\$ 18,000</u>

Difficulty: Medium

Learning Objective: Apply the gross profit method of estimating inventory.

Section Reference: Measuring Inventory Using Estimates

CPA: Financial Reporting
Bloomcode: Application
AACSB: Analytic

Ex. 8-155 Gross profit method

Explain why the gross profit method is not normally acceptable for financial reporting purposes.

Solution 8-155

Because the result is only an estimate, the gross profit method is **not normally acceptable for financial reporting purposes**. A physical inventory is needed as an additional verification that the inventory indicated in the records is actually on hand. Nevertheless, the gross profit method is used to estimate ending inventory for **interim** (monthly and quarterly) **reporting** and for **insurance purposes** (such as fire losses).

Difficulty: Easy

Learning Objective: Apply the gross profit method of estimating inventory.

Section Reference: Measuring Inventory Using Estimates

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 8-156 Inventory presentation and disclosures under IFRS & ASPE

Included in the December 31 trial balance of Watershed Company are the following assets:

Cash	\$201,700	Work in process	\$180,000
Equipment (net)	1,314,000	Receivables (net)	320,000
Prepaid insurance	55,600	Patents	114,000
Raw materials	279,250	Finished goods	212,500

Watershed Company presents its expenses by nature of costs instead of by function.

Instructions

Prepare the current assets section of the December 31 statement of financial position for Watershed Company.

Solution 8-156

WATERSHED COMPANY
Statement of Financial Position (Partial)
December 31

Current Assets		
Cash		\$201,700
Receivables (net)		320,000
Inventories		
Finished goods	\$212,500	
Work in process	180,000	
Raw materials.....	<u>279,250</u>	671,750
Prepaid insurance		<u>55,600</u>
Total current assets		<u>\$1,249,050</u>

Difficulty: Medium

Learning Objective: Identify how inventory should be presented, disclosed, and analyzed.

Section Reference: Presentation, Disclosure, and Analysis

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 8-157 Inventory analysis and ratios

Avery Ltd. began the fiscal year with inventory of \$2,142,560. The company's ending inventory was \$2,241,650, and cost of goods sold for the year was \$14,320,400. Net sales for the year were \$81,877,520.

Instructions

Calculate Avery's inventory turnover and average days to sell inventory. (Use 365 days, round to two decimal places).

Solution 8-157

$$\begin{aligned}
 \text{Inventory turnover} &= \text{Cost of goods sold} / \text{Average inventory} \\
 &= \$14,320,400 / (\$2,142,560 + \$2,241,650) \div 2 \\
 &= \$14,320,400 \div \$2,192,105 \\
 &= 6.53 \text{ times}
 \end{aligned}$$

$$\text{Average days} = 365 \div 6.53 = 55.9 \text{ days}$$

Difficulty: Medium

Learning Objective: Identify how inventory should be presented, disclosed, and analyzed.

Section Reference: Presentation, Disclosure, and Analysis

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 8-158 Interpretation of inventory ratios

Explain the meaning of inventory turnover and average days to sell inventory. What do these ratios say about the company's performance? What additional information would you require to improve your assessment?

Solution 8-158

The inventory turnover ratio measures the average number of times inventory was sold during the period. It helps measure liquidity of the investment in inventory because the faster the turnover, the sooner the company generates cash inflows from this asset. Avery's inventory turns over 6.53 times per year.

The average days to sell inventory is slightly more meaningful and intuitive, and represents the average age of inventory on hand, or, the number of days it takes to sell inventory after it's acquired. Avery's inventory sells an average of about 56 days after it's acquired.

To best interpret these ratios, we need more information about the kind of business it's in. As well, it would be useful to have industry average ratios for Avery, or ratios for competitors, or even Avery itself from prior years, as a basis for comparison. Provided that their inventories do not perish or become technologically obsolete in the turnover period, based on the information known, liquidity of inventory appears to be healthy, and does not raise cause for concern. Generally, companies that are able to keep their inventory at lower levels with higher turnovers than those of their competitors, and still satisfy customer needs, are the most successful.

Difficulty: Medium

Learning Objective: Identify how inventory should be presented, disclosed, and analyzed.

Section Reference: Presentation, Disclosure, and Analysis

CPA: Communication

CPA: Financial Reporting

Bloomcode: Application

AACSB: Communication

Ex. 8-159 Inventory presentation and disclosure under IFRS

Briefly describe the additional disclosures required for inventories under IFRS (as compared to ASPE).

Solution 8-159

Additional disclosures required for inventories under IFRS include:

Carrying amount of inventory carried at fair value less costs to sell.

Details about inventory writedowns and reversals of writedowns, such as information about what led to the reversal of any writedowns.

Additional information for biological assets and agricultural produce at the point of harvest, such as a reconciliation of opening to ending account balance.

IAS 1 requires disclosure of any judgements used in applying accounting policies as well as sources of estimation uncertainty in measuring financial statement elements.

Difficulty: Easy

Learning Objective: Identify how inventory should be presented, disclosed, and analyzed.

Section Reference: Presentation, Disclosure, and Analysis

CPA: Financial Reporting

Bloomcode: Knowledge

PROBLEMS

Pr. 8-160 Theory

What is the difference between an *executory* contract and an *onerous* contract?

Solution 8-160

An executory contract is one where neither party has performed (or fulfilled) its part of the contract. No asset or liability is recognized when the contract takes effect. However, if the amounts are abnormal in relation to the entity's normal business operations or financial position, the contract details should be disclosed in the financial statement notes.

An onerous contract is present if the unavoidable costs of completing the contract are higher than the benefits expected from the contract. IFRS requires the entity to recognize a loss provision (IAS 37). ASPE does not require a loss provision, but normal Canadian practice is to record such a loss/liability.

Difficulty: Easy

Learning Objective: Identify which inventory items should be included in ending inventory.

Section Reference: Recognition of Physical Goods Included in Inventory

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Pr. 8-161 Inventory cut-off

At December 31, 2020, Dakota Corp.'s perpetual inventory showed as \$43,100 in the general ledger. Towards the end of 2020, 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, 2021, costing \$6,000, were included in inventory at December 31, 2020. The sale was recorded in 2021.
2. Units costing \$25,000 received December 30, 2020, were recorded as received on January 2, 2021.
3. Units received during 2020, costing \$4,300 were recorded twice in the general ledger.
4. Units shipped to a customer December 28, 2020, FOB shipping point, which cost \$14,000, were not received by the customer until January 2021. 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, 2020.

Solution 8-161

Inventory per books		\$43,100
Add: Shipment received Dec 30	\$25,000	
Units on hand never recorded	<u>5,600</u>	<u>30,600</u>
		73,700
Deduct: Units recorded twice	4,300	
Units shipped Dec 28	<u>14,000</u>	<u>18,300</u>
Correct inventory, Dec 31		<u>\$55,400</u>

Difficulty: Medium

Learning Objective: Identify which inventory items should be included in ending inventory.

Section Reference: Recognition of Physical Goods Included in Inventory

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 8-162 Inventory errors

An audit of the inventory records of Missouri Inc. identified a number of errors. These errors are summarized in Exhibit A below:

EXHIBIT A			
Year	Net Income Reported	Description of Error	
2016	\$120,000	Overstatement of ending inventory	\$11,000
2017	\$95,000	Understatement of ending inventory	\$1,500
2018	\$99,000	Understatement of ending inventory	\$18,000
2019	\$105,000	Overstatement of ending inventory	\$20,000

2020	\$120,000	Overstatement of ending inventory	\$5,200

Instructions

- a) As financial accountant for Missouri, 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 8-162

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
2016	\$120,000			\$(11,000)		\$109,000
2017	\$95,000	\$11,000			\$1,500	\$107,500
2018	\$99,000		\$(1,500)		\$18,000	\$115,500
2019	\$105,000		\$(18,000)	\$(20,000)		\$67,000
2020	<u>\$120,000</u>	\$20,000		\$(5,200)		<u>\$134,800</u>
	<u>\$539,000</u>					<u>\$533,800</u>

b)

While it is true that inventory errors are self correcting, the (self) correction occurs in the accounting period *following* the error. For Missouri, the overstatement of the 2020 ending inventory reduces corrected 2020 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 2021	<u>5,200</u>	
Total	\$539,000	equal to reported net income

Difficulty: Medium

Learning Objective: Identify the effects of inventory errors on the financial statements and adjust for them.

Section Reference: Inventory Errors

CPA: Communication

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 8-163 Analysis of errors

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 and that all sales and purchases are on credit.

	Accounts		Accounts		Cost of
	Receivable	Inventory	Payable	Sales	Goods Sold
EXAMPLE:					
Goods in rented warehouse were excluded from inventory count.	NE	U	NE	NE	O
1. Goods in transit shipped "FOB 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 "FOB 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 8-163

1.	NE	NE	O	NE	O
2.	NE	O	O	NE	NE
3.	U	O	NE	U	U
4.	U	NE	NE	U	NE

Difficulty: Medium

Learning Objective: Identify the effects of inventory errors on the financial statements and adjust for them.

Section Reference: Inventory Errors

Learning Objective: Distinguish between perpetual and periodic inventory systems and account for them.

Section Reference: Measurement and Inventory Accounting Systems

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 8-164 Year-end entries to update inventory under periodic system

The accountant for the Oswego chain of retail stores is getting ready to prepare the 2020 year-end inventory entries for its periodic inventory system. Her assistant has provided the following information:

Beginning inventory	\$88,000
Inventory purchases during year	900,000
Ending inventory	62,000

Instructions

Record the journal entry(ies) that Oswego's accountant would prepare to bring the inventory and cost of goods sold up to date for 2020.

Solution 8-164

Ending inventory (Note 1)	62,000	
Cost of goods sold (Note 2)	926,000	
Beginning inventory (Note 3).....		88,000
Purchases (Note 4).....		900,000

Note 1: To record ending inventory

Note 2: To record cost of goods sold (\$88,000 + \$900,000 – \$62,000)

Note 3: To remove beginning inventory

Note 4: To clear purchases account

Difficulty: Medium

Learning Objective: Distinguish between perpetual and periodic inventory systems and account for them.

Section Reference: Measurement and Inventory Accounting Systems

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 8-165 Gross profit method

Kiowa Ltd. prepares monthly financial statements. Inventory is counted only at year end; thus, month-end inventories must be estimated. All sales are made on account. The rate of markup on cost is 25%. The following information relates to the month of May:

Accounts receivable, May 1.....	\$31,000
Accounts receivable, May 31.....	37,000
Collections of accounts during May	94,000
Inventory, May 1	47,000
Purchases during May	75,000

Instructions

Calculate the estimated cost of the inventory on May 31.

Solution 8-165

Collections of accounts.....	\$ 94,000
Add accounts receivable, May 31	37,000
Deduct accounts receivable, May 1	<u>(31,000)</u>
Sales during May	<u>\$100,000</u>

Inventory, May 1	\$ 47,000
Purchases during May	<u>75,000</u>
Goods available for sale	122,000
COGS ($\$100,000 \div 125\%$)	<u>(80,000)</u>
Estimated cost of inventory, May 31	<u>\$ 42,000</u>

Difficulty: Medium

Learning Objective: Apply the gross profit method of estimating inventory.

Section Reference: Measuring Inventory Using Estimates

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 8-166 Gross profit method

Select information for Neonplus Corp.'s inventory was available as follows for calendar 2020:

Sales.....	\$540,000
Net purchases.....	380,000
Beginning inventory	75,000

Neonplus' gross profit on sales was 30% last year, its first year of operations. A fire on December 31, 2020, destroyed the entire inventory. Calculate the inventory lost in the fire.

Instructions

- a) Calculate the estimated cost of the inventory.
- b) Prepare entries at December 31, 2020 to close the sales and merchandise accounts.

Solution 8-166

a)

Beginning inventory	\$ 75,000	
Add net purchases.....	<u>380,000</u>	
Cost of goods available	455,000	
Less COGS (\$540,000 x 70%)	<u>(378,000)</u>	
Estimated inventory lost.....	<u>\$ 77,000</u>	

b)

Sales.....	475,000	
Income Summary		475,000
Cost of Goods Sold	378,000	
Fire Loss.....	77,000	
Beginning Inventory.....		75,000
Purchases		380,000

Difficulty: Medium

Learning Objective: Apply the gross profit method of estimating inventory.

Section Reference: Measuring Inventory Using Estimates

CPA: Communication

CPA: Financial Reporting

Bloomcode: Application

AACSB: Communication

Pr. 8-167 Gross profit method

In the early morning of January 1, 2021, Minnesota Corp.'s inventory was destroyed by fire. The following information was available for calendar 2020:

Sales.....	\$950,000
Net purchases.....	600,000
Beginning inventory	110,000

Minnesota's gross profit on sales has averaged 35% for several years.

Instructions

- a) Calculate the estimated cost of the inventory destroyed.

b) Prepare entries at December 31, 2020, to close the sales and merchandise accounts.

Solution 8-167

a)

Beginning inventory.....	\$ 110,000
Add net purchases.....	<u>600,000</u>
Cost of goods available.....	710,000
Less COGS (\$950,000 x 65%)	<u>(617,500)</u>
Estimated inventory lost.....	<u>\$ 92,500</u>

b)

Sales.....	950,000	
Income Summary.....		950,000
Cost of Goods Sold	617,500	
Fire Loss.....	92,500	
Beginning Inventory.....		110,000
Purchases		600,000

Difficulty: Medium

Learning Objective: Apply the gross profit method of estimating inventory.

Section Reference: Measuring Inventory Using Estimates

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 8-168 Retail inventory method

Explain five reasons why the retail inventory method of calculating inventory would be used.

Solution 8-168

The retail inventory method of calculating inventory is used for these reasons:

1. To permit the calculation of net income without a physical count of inventory
2. As a control measure in determining inventory shortages
3. To control quantities of merchandise on hand
4. As a source of information for insurance and tax purposes
5. As a technique for estimating cost in financial statements (as long as the results estimate actual cost)

Difficulty: Easy

Learning Objective: Apply the retail method of estimating inventory.

Section Reference: Appendix 8A - The Retail Inventory Method of Estimating Inventory Cost

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

***Pr. 8-169** Retail inventory method

California Corp. is preparing the financial statements at its fiscal year end, January 31, 2020.

The following information is available:

	At Cost	At Retail
Inventory, February 1, 2019	\$ 83,400	\$ 103,400
Markdowns		47,000
Markups		71,000
Markdown cancellations.....		22,000
Markup 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 at January 31, 2020, 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, e.g., 62.34%.

***Solution 8-169**

	At Cost	At Retail
Beginning inventory	\$ 83,400	\$103,400
Purchases	\$241,200	\$294,300
Less purchase returns	5,150	6,700
Totals	<u>\$319,450</u>	391,000
Add markups (net) (\$71,000 – \$9,000)		<u>62,000</u>
Totals		453,000
Deduct markdowns (net) (\$47,000 – \$22,000)		<u>25,000</u>
Sales price of goods available		428,000
Sales less sales returns (\$329,000 – \$9,000)		<u>320,000</u>
Ending inventory at retail		<u>\$108,000</u>

Ending inventory at cost:

Ratio of cost to retail = $\$319,450 \div \$428,000 = 74.64\%$

$\$108,000 \times 74.64\% = \$80,611$

\$ 80,611

Difficulty: Medium

Learning Objective: Apply the retail method of estimating inventory.

Section Reference: Appendix 8A - The Retail Inventory Method of Estimating Inventory Cost

CPA: Communication

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

***Pr. 8-170** Retail inventory method

The records of Little Hawaii 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

Additional markups, \$3,800; markup cancellations, \$400; net markdowns, \$1,300

Sales during May, \$46,700

Instructions

Calculate the estimated inventory at May 31 under the retail inventory method. (Carry the cost ratio to two decimal places, e.g., 62.34%.) Show your calculations in good form and label all amounts.

***Solution 8-170**

	Cost	Retail	Ratio
Inventory, May 1	\$10,150	\$14,500	
Purchases	31,550	42,900	
Freight-in	2,000		
Net markups		3,400	
Net markdowns	<u>0</u>	<u>(1,300)</u>	
	<u>\$43,700</u>	59,500	73.45%
Sales		<u>(46,700)</u>	
Inventory, May 31		<u>\$12,800</u>	

Estimated inventory, May 31 ($\$12,800 \times 73.45\%$) = \$9,401.60

Difficulty: Medium

Learning Objective: Apply the retail method of estimating inventory.

Section Reference: Appendix 8A - The Retail Inventory Method of Estimating Inventory Cost

CPA: Financial Reporting

Bloomcode: Application
AACSB: Analytic

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CHAPTER 9

INVESTMENTS

CHAPTER STUDY OBJECTIVES

1. *Understand the nature of and basic accounting for investments, including which types of companies have significant investments.* This chapter deals with investments in basic debt and equity instruments of other companies. Debt instruments such as bonds generally carry contractual rights to receive principal and interest payments. Equity instruments such as shares may carry contractual rights to receive dividends (depending on the type of share) and may also carry voting rights and/or rights to receive residual assets upon windup of a company. Care must be taken to determine exactly what rights the investments entitle the holder to as this will help determine the accounting. Not all companies carry significant investments. It depends on the business model. Examples of types of companies that generally carry significant investments are financial institutions, insurance companies, and pension funds. There are three basic models for accounting for investments: the cost/amortized cost model, the FV-NI model, and the FV-OCI model

2. *Explain and apply the cost/amortized cost model of accounting for investments.* At acquisition, the cost of the investment is recognized as its fair value plus transaction costs. If the investment is a debt instrument, any premium or discount is amortized to interest income. Holding gains are recognized only when realized, as are holding losses, unless the investment is impaired. The investment is reported at its cost or amortized cost as either a current asset or a long-term investment, depending on its maturity and management's intention to hold it. ASPE uses this model for most investments excluding equity investments where an active market exists for trading the shares and derivatives. IFRS 9 uses this model for debt instruments where the entity's business model is to hold the investments to maturity.

3. *Explain and apply the fair value through net income model of accounting for investments.* At acquisition, the investment is recognized at its fair value, with transaction costs being expensed. At each reporting date, the investment is revalued to its current fair value, with holding gains and losses recognized in net income. Dividend and interest income is also recognized in net income. If the investment is not held for trading purposes, any interest income is reported separately and is adjusted for discount or premium amortization. If held for trading or other current purposes, the investment is reported as a current asset. ASPE uses this for equity instruments where there is an active market and derivatives. IFRS 9

uses this model for all investments not accounted for under the cost/amortized cost model or the FV-OCI model. ASPE and IFRS both allow any investment to be accounted for using FV-NI under the fair value option.

4. Explain and apply the fair value through other comprehensive income model of accounting for investments. At acquisition, the investment is recognized at fair value plus transaction costs. At each reporting date, the investment is revalued to its current fair value, with the holding gains or losses reported in other comprehensive income. On disposal, the accumulated holding gains or losses are either recycled to net income (debt securities) or transferred directly to retained earnings (equity securities). Investments are reported as current or long-term assets, depending on marketability and management intent. ASPE does not allow this method. IFRS 9 allows this method for certain equity investments and debt securities where the business model is achieved by both holding to maturity and selling (depending on the investment and circumstances).

5. Explain and apply the incurred loss, expected loss, and fair value loss impairment models. The three impairment loss models differ in the timing of the recognition of impairment losses and the discount rate used. Under the incurred loss approach, a triggering event is required before a loss is recognized and measured, and the revised cash flows are discounted using either the historical or a current market rate. Under the expected loss approach, no triggering event is required, and revised cash flows and impairment losses are determined on a continual basis. The discount rate is the historical/original rate. Using the fair value loss model, the asset is written down to fair value taking into account market information (refer back to Chapters 2 and 3). ASPE and IFRS use the incurred loss model for all cost/amortized cost investments, although the post-impairment carrying values are measured differently. IFRS 9 uses the expected loss model for all cost/amortized cost investments as well as FV-OCI debt securities. Under IFRS 9, impairment losses on FV-OCI equity investments are not recognized in net income. Where the FV-NI model is used, there is no need to specifically assess impairment because the investment is continually revalued to fair value and any gains or losses are booked to income.

6. Explain the concept of significant influence and apply the equity method. Significant influence is the ability to have an effect on strategic decisions made by an investee's board of directors, but not enough to control those decisions. The equity method, sometimes referred to as one-line consolidation, is used because income is recognized by the investor as it is earned. The investor's income statement will reflect the performance of the investee company. Under this method, the investment account is adjusted for all changes in the investee's book value and for the amortization of any purchase discrepancy. IFRS requires use of the equity method for its associates (investees a company can significantly influence).

ASPE provides a policy choice: either the equity method or the cost method, except that associates with a quoted price in an active market cannot be accounted for at cost. Instead, the FV–NI model can be used.

7. Explain the concept of control and when consolidation is appropriate. Control relates to the ability to direct the strategic decisions of another entity and to generate returns for your own benefit or loss. When one company controls another, it controls all the net assets of that entity and is responsible for all its revenues and expenses. Therefore, all of the subsidiary's assets and liabilities, and revenues and expenses, are reported by the parent investor on a line-by-line basis in consolidated financial statements. The interests of the noncontrolling shareholders in the subsidiary company are reported separately as noncontrolling interest. Under IFRS, all subsidiaries are consolidated. ASPE, on the other hand, allows consolidation or a choice of the equity or cost method. Investments in companies with shares traded in an active market cannot be reported using the cost method, but may use FV–NI.

8. Explain how investments are presented and disclosed in the financial statements, noting how this facilitates analysis. The objectives of disclosure are to provide information so users can assess the significance of the financial asset investments to the entity's financial position and performance, the extent of risks to which the company is exposed as a result, and how those risks are managed. As a result, the investments are identified on the statement of financial position according to how they are classified for accounting purposes, with the income statement reporting information on the returns by method of classification. Extensive disclosure is required, particularly under IFRS, on the entity's risk exposures and how it manages those risks.

9. Identify differences in accounting between IFRS and ASPE, and what changes are expected in the near future. The differences are noted in Illustrations 9-7, 9-19 9-11, 9-12 and 9-13. There are significant differences, partly because ASPE has adopted a more simplified approach.

MULTIPLE CHOICE

Answer	No.	Description
c	1.	Debt securities
b	2.	Investment in debt instruments
c	3.	Equity instruments
d	4.	Definition of equity security
b	5.	Accounting for investments
a	6.	Valuation of debt instruments
a	7.	Transaction costs
a	8.	Motivation for debt investment
c	9.	Measurement of investments
d	10.	Cost model for debt securities
a	11.	Holding gains under cost model
c	12.	Equity investments and the cost model
b	13.	Recognition of interest for bond investment
b	14.	Amortization of premium or discount
a	15.	Recording amortization of bond discount
b	16.	Accounting for investments in associates
b	17.	Amortization of premium or discount
c	18.	Accrued interest treatment
b	19.	Acquisition of long-term investment in bonds
a	20.	Recording purchase of bonds
c	21.	Carrying value of long-term investment in bonds – cost model
d	22.	Carrying value of long-term investment in bonds – cost model
a	23.	Calculation of income from long-term investment in bonds
b	24.	Calculation of income from long-term investment in bonds
c	25.	Determine gain on disposal of bond investment
c	26.	Cost model of accounting for share investment
b	27.	Recognition of interest income from bond
d	28.	Calculation of bond discount to be amortized
d	29.	Carrying value of long-term investment in bonds
b	30.	Net carrying value of bonds
a	31.	FV–NI model
a	32.	FV–NI model
c	33.	Holding gains with FV–NI model
d	34.	FV–NI model and transaction costs
c	35.	Accounting method for investment
d	36.	Temporary investments in equity securities
a	37.	Year-end adjustments for FV–NI investment
c	38.	Accounting for fair value adjustments
d	39.	Valuation of marketable equity securities

- b 40. Valuation of marketable equity securities
- b 41. Application of cost model to an investment
- b 42. Unrealized gains and losses with FV-OCI
- c 43. Classification of comprehensive income
- c 44. FV-OCI with recycling
- b 45. Inclusions in OCI
- d 46. Accumulated other comprehensive income
- a 47. The concept of “recycling”
- a 48. Accounting method for investment
- d 49. Recognition of investment disposals
- b 50. Accounting for fair value adjustments
- a 51. Accounting for impairment losses
- c 52. Indications for potential impairment
- d 53. Impairment – incurred loss model
- b 54. Impairment – expected loss model
- c 55. Impairment – fair value loss model
- c 56. Amortized cost of a bond
- a 57. Accounting for a controlling interest
- a 58. Equity investments and significant influence
- b 59. Conditions for using the equity method
- a 60. Significant influence
- d 61. Degree of control
- a 62. Recording of dividends received under the equity method
- c 63. Recognition of earnings of investee using the equity method
- c 64. Effect of using the cost method in error
- c 65. Accounting for investments in associates
- c 66. Accounting for investments in associates
- d 67. Investor paying more than book value
- b 68. Equity investments traded in active market
- a 69. Equity method of accounting for share investment
- b 70. Equity method of accounting for share investment
- c 71. Equity method of accounting for share investment
- b 72. Equity method of accounting for share investment
- b 73. Equity method of accounting for share investment
- a 74. Balance of investment account using the equity method
- c 75. Investment income recognized under the equity method
- c 76. Balance of investment account using the equity method
- b 77. Balance of investment account using the equity method
- c 78. Investment income recognized using the equity method
- c 79. Investment income recognized under the equity method
- a 80. Balance of investment account using the equity method
- c 81. Sale of share investment

- d 82. Calculate acquisition price of an investment in associate
- c 83. Implications of control
- a 84. Investing in subsidiaries
- d 85. Accounting for subsidiary
- b 86. Reporting model for control
- a 87. Description of investee corporation
- d 88. Classification as current assets
- b 89. Objectives of disclosure requirements
- b 90. Disclosures for private entities
- a 91. Consolidation under IFRS and ASPE
- c 92. Reporting of equity method
- d 93. Financial disclosures regarding acquisitions
- c 94. Differences in disclosure for IFRS and ASPE
- c 95. Transaction costs under IFRS and ASPE
- d 96. Treatment of interest and dividend income under IFRS and ASPE

EXERCISES

Item	Description
E9-97	Investment in debt securities at a discount
E9-98	Shares acquired on margin
E9-99	Fair value of bonds
E9-100	Cost/amortized cost model – ASPE versus IFRS 9
E9-101	Investment in shares of other entities – cost model
E9-102	Motivation for investments
E9-103	Types of companies that have investments
E9-104	Types of companies that have investments
E9-105	Application of cost/amortized cost method
E9-106	Investment in debt securities at a premium
E9-107	Investment in debt securities at a premium
E9-108	Investments in debt securities
E9-109	Cost and equity methods
E9-110	Fair value through net income method
E9-111	Cost and equity methods
E9-112	Fair value through other comprehensive income investments – entries
E9-113	Significant influence
E9-114	Accounting for investment under APSE
E9-115	Significant influence
E9-116	Investment in equity securities
E9-117	True-false questions
E9-118	Accounting entries for acquisition
E9-119	Accounting entries for acquisition

PROBLEMS

Item	Description
P9-120	Transaction costs
P9-121	Accounting for bonds – amortized cost model
P9-122	Accounting for debt investments purchased at a discount – FV–NI model
P9-123	Temporary investments – FV–NI model
P9-124	Year-end adjustments for temporary investments
P9-125	Accounting for debt investment purchased at premium – FV–NI model
P9-126	Accounting for investments – FV–NI model
P9-127	Long-term investment – FV–NI model
P9-128	Equity method (ASPE)
P9-129	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) government treasury bills

Answer: c

Difficulty: Easy

Learning Objective: Understand the nature of and basic accounting for investments, including which types of companies have significant investments.

Section Reference: Understanding Investments

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

2. 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) subsidiary.

Answer: b

Difficulty: Easy

Learning Objective: Understand the nature of and basic accounting for investments, including which types of companies have significant investments.

Section Reference: Understanding Investments

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

3. Which of the following is NOT an equity instrument?

- a) common shares

- b) preferred shares
- c) convertible bonds
- d) put options

Answer: c

Difficulty: Easy

Learning Objective: Understand the nature of and basic accounting for investments, including which types of companies have significant investments.

Section Reference: Understanding Investments

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

4. Any contract that is evidence of a residual interest in an entity's assets is called a(n)
- a) debt security.
 - b) liability.
 - c) derivative.
 - d) equity security.

Answer: d

Difficulty: Easy

Learning Objective: Understand the nature of and basic accounting for investments, including which types of companies have significant investments.

Section Reference: Understanding Investments

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

5. How investments are accounted for does NOT usually depend on
- a) the type of investment.
 - b) whether the investments are bought on margin.
 - c) management intent.
 - d) company strategy.

Answer: b

Difficulty: Easy

Learning Objective: Understand the nature of and basic accounting for investments, including which types of companies have significant investments.

Section Reference: Understanding Investments

CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

6. The price of a debt instrument is quoted as a percentage of its
- a) face or par value.
 - b) fair market value.
 - c) book value.
 - d) present value.

Answer: a

Difficulty: Easy
Learning Objective: Understand the nature of and basic accounting for investments, including which types of companies have significant investments.
Section Reference: Understanding Investments
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

7. Generally, transaction costs are
- a) capitalized when investments are accounted for using a cost-based model.
 - b) capitalized when investments are accounted for using a fair value model.
 - c) always expensed.
 - d) never expensed.

Answer: a

Difficulty: Easy
Learning Objective: Understand the nature of and basic accounting for investments, including which types of companies have significant investments.
Section Reference: Understanding Investments
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

8. Which of the following is NOT a motivation for investment in debt and equity instruments issued by other companies?
- a) to assist those companies in meeting financial obligations
 - b) the returns provided by the investments
 - c) to have a special relationship, with a supplier, for example
 - d) to exercise influence or control over the operations of the investee

Answer: a

Difficulty: Easy

Learning Objective: Understand the nature of and basic accounting for investments, including which types of companies have significant investments.

Section Reference: Understanding Investments

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

9. When it comes to measuring investments, which of the following statements is true?

- a) Companies are required to measure at cost/amortized cost.
- b) Companies are required to measure at fair value.
- c) Both cost/amortized cost and fair value are permitted in appropriate circumstances.
- d) The company may report using whichever method best aligns with their financial reporting objectives.

Answer: c

Difficulty: Easy

Learning Objective: Understand the nature of and basic accounting for investments, including which types of companies have significant investments.

Section Reference: Understanding Investments

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

10. When the cost model is applied to an investment in debt securities, such as bonds, it is referred to as the

- a) equity method.
- b) fair value through net income model.
- c) fair value through other comprehensive income model.
- d) amortized cost model.

Answer: d

Difficulty: Easy

Learning Objective: Explain and apply the cost/amortized cost model of accounting for investments.

Section Reference: Measurement - Cost/Amortized Cost Model

CPA: Financial Reporting

Bloomcode: Knowledge
AACSB: Analytic

11. 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) not recognized at all.

Answer: a

Difficulty: Easy

Learning Objective: Explain and apply the cost/amortized cost model of accounting for investments.

Section Reference: Measurement - Cost/Amortized Cost Model

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

12. Equity investments that are accounted for under the cost model will result in
- a) recognition of dividend income only when actually received.
 - b) expensing transaction costs when incurred.
 - c) recognition of a gain or loss in net income at disposal.
 - d) recognition of a gain or loss in other comprehensive income at disposal.

Answer: c

Difficulty: Easy

Learning Objective: Explain and apply the cost/amortized cost model of accounting for investments.

Section Reference: Measurement - Cost/Amortized Cost Model

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

13. To calculate the amount of interest to recognize each period for a bond investment (unless it held for trading purposes),
- a) ASPE requires the use of the effective-interest method.
 - b) IFRS requires the use of the effective-interest method.
 - c) IFRS allows the use of either the effective-interest or the straight-line method.
 - d) ASPE requires the use of the straight-line method.

Answer: b

Difficulty: Easy

Learning Objective: Explain and apply the cost/amortized cost model of accounting for investments.

Section Reference: Measurement - Cost/Amortized Cost Model

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

14. 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) treated as a transaction cost.

Answer: b

Difficulty: Easy

Learning Objective: Explain and apply the cost/amortized cost model of accounting for investments.

Section Reference: Measurement - Cost/Amortized Cost Model

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

15. 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 "Gain from Discount."
 - c) debit to Interest Income.
 - d) credit to the investment account.

Answer: a

Difficulty: Medium

Learning Objective: Explain and apply the cost/amortized cost model of accounting for investments.

Section Reference: Measurement - Cost/Amortized Cost Model

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

16. Under ASPE, for accounting for investments in associates,
- a) the cost method must be used for all such investments.
 - b) the fair value method can be used for shares quoted in an active market.
 - c) the investor may use the cost method for one investment and the fair value for another.
 - d) the fair value method must be used for all such investments.

Answer: b

Difficulty: Easy

Learning Objective: Explain and apply the cost/amortized cost model of accounting for investments.

Section Reference: Measurement - Cost/Amortized Cost Model

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

17. In practice, under the cost/amortized cost method and ASPE, any discount or premium on a bond investment is
- a) required to be recognized and reported separately, and amortized using the effective-interest rate method.
 - b) not recognized or reported separately; amortized using either the straight-line or effective-interest method.
 - c) not recognized or reported separately; amortized using the effective-interest method.
 - d) required to be recognized and reported separately, and amortized using the straight-line method.

Answer: b

Difficulty: Easy

Learning Objective: Explain and apply the cost/amortized cost model of accounting for investments.

Section Reference: Measurement - Cost/Amortized Cost Model

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

18. An interest-bearing investment is sold mid-way through the year. At the time of sale, how is the accrued interest typically treated?
- a) The seller forfeits the right to any interest payment, and loses on the investment sale.
 - b) The original issuer (investee) must settle the interest owing before the sale can be completed.

- c) The purchaser pays the seller an amount equal to the accrued interest since the last payment date.
- d) At the next interest payment date, the original issuer (investee) splits the interest payments amongst anyone who held the investment over the period.

Answer: c

Difficulty: Easy

Learning Objective: Explain and apply the cost/amortized cost model of accounting for investments.

Section Reference: Measurement - Cost/Amortized Cost Model

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

19. On August 1, 2020, Franklin Inc. acquired \$ 120,000 (face value) 10% bonds of Machu Corporation at 102 plus accrued interest. The bonds were dated May 1, 2020, and mature on April 30, 2023, with interest payable each October 31 and April 30. The bonds will be held to maturity. Assuming the amortized cost model is used, the entry to record the purchase of the bonds on August 1, 2020 is

a) Bond Investment at Amortized Cost.....	125,400	
Cash.....		125,400
b) Bond Investment at Amortized Cost.....	122,400	
Interest Income	3,000	
Cash.....		125,400
c) Bond Investment at Amortized Cost.....	125,400	
Interest Income		3,000
Cash.....		122,400
d) Bond Investment at Amortized Cost	120,000	
Premium on Bonds.....	5,400	
Cash.....		125,400

Answer: b

Difficulty: Medium

Learning Objective: Explain and apply the cost/amortized cost model of accounting for investments.

Section Reference: Measurement - Cost/Amortized Cost Model

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: Dr. Bond Investment at Amortized Cost: $\$ 120,000 \times 1.02 = \$ 122,400$

Dr. Interest Income: $\$ 120,000 \times .10\% \times 3 \div 12 = \$ 3,000$

Cr. Cash: \$ 122,400 + \$ 3,000 = \$ 125,400

20. On August 1, 2020, Peterson Corp. acquired 20, \$ 1,000, 8% bonds at 95 plus accrued interest. The bonds were dated May 1, 2020, and mature on April 30, 2020, with interest paid semi-annually on October 31 and April 30. The bonds will be held to maturity. Assuming the amortized cost model is used, the entry to record the purchase of the bonds on August 1, 2020 is

a) Bond Investment at Amortized Cost.....	9,500	
Interest Income	200	
Cash.....		9,700
b) Bond Investment at Amortized Cost.....	9,700	
Cash.....		9,700
c) Bond Investment at Amortized Cost.....	9,500	
Interest Receivable	200	
Cash.....		9,700
d) Bond Investment at Amortized Cost.....	10,000	
Interest Income	200	
Discount on Debt Securities.....		500
Cash.....		9,700

Answer: a

Difficulty: Medium

Learning Objective: Explain and apply the cost/amortized cost model of accounting for investments.

Section Reference: Measurement - Cost/Amortized Cost Model

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: Dr. Bond Investment at Amortized Cost: $10 \times \$ 1,000 \times .95 = \$ 9,500$

Dr. Interest Income: $\$ 10,000 \times 8\% \times 3 \div 12 = \$ 200$

Cr. Cash: $\$ 9,500 + \$ 200 = \$ 9,700$

21. On October 1, 2020, Barrick Corp. purchased 800, \$ 1,000, 9% bonds for \$ 792,000, which included \$ 12,000 accrued interest. The bonds, which mature on February 1, 2029, pay interest semi-annually on February 1 and August 1. The bonds will be held to maturity. Barrick uses the straight-line method of amortization. The bonds, which are accounted for under the amortized cost model, should be reported in the December 31, 2020 balance sheet at a carrying value of

- a) \$ 792,240.
- b) \$ 780,000.
- c) \$ 780,600.

d) \$ 792,000.

Answer: c

Difficulty: Hard

Learning Objective: Explain and apply the cost/amortized cost model of accounting for investments.

Section Reference: Measurement - Cost/Amortized Cost Model

CPA: Finance

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 780,000 + (\$ 20,000 \times 3 \div 100) = \$ 780,600$

22. On November 1, 2020, Jepson Ltd. purchased 300 of the \$ 1,000 face value, 9% bonds of Carly Corp., for \$ 316,000, which included accrued interest of \$ 4,500. The bonds, which mature on January 1, 2025, pay interest semi-annually on March 1 and September 1. The bonds will be held to maturity. Assuming that Jepson uses the straight-line method of amortization and that the bonds are accounted for under the amortized cost method, the carrying value of the bonds should be shown on Jepson's December 31, 2020, statement of financial position at

a) \$ 316,000.

b) \$ 300,000.

c) \$ 311,500.

d) \$ 311,040.

Answer: d

Difficulty: Hard

Learning Objective: Explain and apply the cost/amortized cost model of accounting for investments.

Section Reference: Measurement - Cost/Amortized Cost Model

CPA: Finance

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 316,000 - \$ 4,500 = \$ 311,500$

$\$ 311,500 - (\$ 11,500 \times 2 \div 50) = \$ 311,040$

23. On November 1, 2020, Fluck Corp. purchased 10-year, 9%, bonds with a face value of \$ 360,000, for \$ 324,000. An additional \$ 10,800 was paid for the accrued interest, which is paid semi-annually on January 1 and July 1. The bonds mature on July 1, 2027 and will be held to maturity. Fluck uses the straight-line method of amortization and the amortized cost method

for these bonds. Ignoring income taxes, the amount to be reported in Fluck's 2020 income statement as a result of this investment is

- a) \$ 6,300.
- b) \$ 6,000.
- c) \$ 5,400.
- d) \$ 4,800.

Answer: a

Difficulty: Medium

Learning Objective: Explain and apply the cost/amortized cost model of accounting for investments.

Section Reference: Measurement - Cost/Amortized Cost Model

CPA: Finance

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $(\$ 360,000 \times .045) - \$ 10,800 + (\$ 36,000 \times 2 \div 80) = \$ 6,300$

24. On October 1, 2020, Berlin Corp. purchased 250, \$ 1,000, 9% bonds for \$ 260,000. An additional \$ 7,500 was paid for the accrued interest, which is paid semi-annually on December 1 and June 1. The bonds mature on December 1, 2024 and will be held to maturity. Berlin uses the straight-line method of amortization and the amortized cost model for these bonds. Ignoring income taxes, the amount to be reported in Berlin's 2020 income statement as a result of this investment is

- a) \$ 3,750.
- b) \$ 5,025.
- c) \$ 5,625.
- d) \$ 6,225.

Answer: b

Difficulty: Medium

Learning Objective: Explain and apply the cost/amortized cost model of accounting for investments.

Section Reference: Measurement - Cost/Amortized Cost Model

CPA: Finance

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $(\$ 250,000 \times .09 \times 3 \div 12) - (\$ 10,000 \times 3 \div 50) = \$ 5,025$

25. During 2020, Brandon Inc. purchased 2,000, \$ 1,000, 9% bonds. The bonds mature on March 1, 2025, and pay interest on March 1 and September 1. The carrying value of the bonds at December 31, 2020 was \$ 1,960,000. On September 1, 2021, after the semi-annual interest was received, Brandon sold half of these bonds for \$ 988,000. Brandon uses straight-line amortization and has accounted for the bonds under the amortized cost model. The gain on the sale is
- a) \$ 11,200.
 - b) \$ 8,000.
 - c) \$ 4,800.
 - d) \$ 0.

Answer: c

Difficulty: Medium

Learning Objective: Explain and apply the cost/amortized cost model of accounting for investments.

Section Reference: Measurement - Cost/Amortized Cost Model

CPA: Finance

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: Discount amortization: $\$ 40,000 \times 8 \div 50 = \$ 6,400$

$(\$ 1,960,000 + \$ 6,400) \div 2 = \$ 983,200$; $\$ 983,200 - \$ 988,000 = \$ 4,800$ gain

26. On January 2, 2020, Fidel Corp. purchased 200 of the 1,000 outstanding common shares of Rindu Ltd. for \$ 60,000. During 2020, Rindu declared total cash dividends of \$ 10,000 and reported net income for the year of \$ 40,000. If Fidel uses the cost model to account for its investment in Rindu, Fidel's Investment in Rindu Ltd. account at December 31, 2020 should be
- a) \$ 68,000.
 - b) \$ 66,000.
 - c) \$ 60,000.
 - d) \$ 58,000.

Answer: c

Difficulty: Medium

Learning Objective: Explain and apply the cost/amortized cost model of accounting for investments.

Section Reference: Measurement - Cost/Amortized Cost Model

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: \$ 60,000, acquisition cost

Use the following information for questions 27–28.

On July 1, 2020, Harry Ltd. purchased \$ 200,000 (par value) of Prince's 8% bonds. Because the market rate was 9%, Harry purchased them for \$ 186,992. The bonds pay interest semi-annually on December 31 and June 30. Harry uses the amortized cost model and the effective-interest method to recognize interest income on bond investments.

27. Rounding values to the nearest dollar (if necessary), the entry to recognize receipt of the first interest payment on December 31, 2020 will include a

- a) debit to Cash of \$ 9,000.
- b) credit to Interest Income of \$ 8,415.
- c) debit to Cash of \$ 8,415.
- d) credit to Interest Income of \$ 8,000.

Answer: b

Difficulty: Medium

Learning Objective: Explain and apply the cost/amortized cost model of accounting for investments.

Section Reference: Measurement - Cost/Amortized Cost Model

CPA: Finance

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: Interest income = \$ 186,992 x 9% x 6 ÷ 12 = \$ 8,415 rounded

28. Rounding values to the nearest dollar (if necessary), the bond discount to be amortized on December 31, 2020 is

- a) \$ 8,415.
- b) \$ 8,000.
- c) \$ 7,585.
- d) \$ 415.

Answer: d

Difficulty: Medium

Learning Objective: Explain and apply the cost/amortized cost model of accounting for investments.

Section Reference: Measurement - Cost/Amortized Cost Model

CPA: Finance

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: Cash received \$ 8,000; interest income \$ 8,415; discount amortized \$ 415

29. On October 1, 2020, Moray Ltd. purchased 500 of the \$ 1,000 face value, 8% bonds of Eel Ltd. for \$ 585,000, including accrued interest of \$ 10,000. The bonds, which mature on January 1, 2027, pay interest semi-annually on January 1 and July 1. Moray used the straight-line method of amortization and appropriately recorded the bonds as long-term. On Moray's December 31, 2021 balance sheet, the carrying value of the bonds would be

- a) \$ 575,000.
- b) \$ 570,000.
- c) \$ 568,000.
- d) \$ 560,000.

Answer: d

Difficulty: Medium

Learning Objective: Explain and apply the cost/amortized cost model of accounting for investments.

Section Reference: Measurement - Cost/Amortized Cost Model

CPA: Finance

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 585,000 - \$ 10,000 = \$ 575,000$

15

$\$ 575,000 - (\$ 75,000 \times \frac{15}{75}) = \$ 560,000$

75

30. On January 1, 2020 Limoyo Corporation purchased 600 of \$ 1,000 face value, 8% bonds of Leon Company, for \$ 553,668, to yield 10%. The bonds, which mature on January 1, 2025, pay interest semi-annually on January 1 and July 1. Assuming that Limoyo uses the straight-line method of amortization and that the bonds are accounted for under the amortized cost method, the net carrying value of the bonds should be shown on Limoyo's December 31, 2020, statement of financial position at

- a) \$ 557,351.
- b) \$ 562,934.
- c) \$ 600,000.
- d) \$ 553,668.

Answer: b

Difficulty: Medium

Learning Objective: Explain and apply the cost/amortized cost model of accounting for investments.

Section Reference: Measurement – Cost/ Amortized Cost Model

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: Calculation: $(\$ 600,000 - \$ 553,668) / 10 = \$ 4,633.20$ = semi-annual amortization

Value after 2 amortization periods = $\$ 553,668 + (\$ 4,633.20 \times 2) = \$ 562,934$

31. The fair value through net income (FV–NI) model is sometimes referred to as
- a) the fair value through profit or loss (FVTPL).
 - b) held for trading.
 - c) discontinued operations.
 - d) available for sale.

Answer: a

Difficulty: Easy

Learning Objective: Explain and apply the fair value through net income model of accounting for investments.

Section Reference: Measurement - Fair Value through Net Income (FV–NI) Model

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

32. Regarding the reporting of investment income under the FV–NI method, for companies reporting in accordance with ASPE, which of the following statements is true?
- a) Interest income must be separated from net gains or losses recognized on financial instruments.
 - b) Holding gains and losses are always tracked separately from interest and dividend income.
 - c) Interest income must be separated from dividends recognized on financial instruments.
 - d) None of these are true.

Answer: a

Difficulty: Easy

Learning Objective: Explain and apply the fair value through net income model of accounting for investments.

Section Reference: Measurement - Fair Value through Net Income (FV–NI) Model

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

33. Under the fair value through net income model, holding gains are

- a) recognized in other comprehensive income only.
- b) recognized in either net income or other comprehensive income.
- c) recognized in net income only.
- d) ignored.

Answer: c

Difficulty: Easy

Learning Objective: Explain and apply the fair value through net income model of accounting for investments.

Section Reference: Measurement - Fair Value through Net Income (FV–NI) Model

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

34. The fair value through net income model requires that

- a) investments are measured at fair value.
- b) transaction costs are expensed.
- c) investments are measured at fair value and transaction costs are capitalized.
- d) investments are measured at fair value and transaction costs are expensed.

Answer: d

Difficulty: Easy

Learning Objective: Explain and apply the fair value through net income model of accounting for investments.

Section Reference: Measurement - Fair Value through Net Income (FV–NI) Model

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

35. In January 2020, Haddock Ltd. had purchased an investment for \$ 150,000. By December 31, 2020, the fair market value of that investment had increased by \$ 20,000. Assuming this gain was included in the company's 2020 net income, which accounting method did Haddock use to account for this investment?

- a) cost
- b) fair value through other comprehensive income (FV–OCI)
- c) fair value through net income (FV–NI)
- d) equity

Answer: c

Difficulty: Medium

Learning Objective: Explain and apply the fair value through net income model of accounting for investments.

Section Reference: Measurement - Fair Value through Net Income (FV-NI) Model

CPA: Financial Reporting

Bloomcode: Analysis

AACSB: Analytic

36. On its December 31, 2020, balance sheet, Red Corp. reported a short-term investment in equity securities, under the fair value through net income model, at \$ 330,000. At December 31, 2021, the fair value of the securities was \$ 350,000. What should Red report on its 2021 income statement as a result of the increase in fair value of the investments during 2021?

- a) \$ 0.
- b) loss on investments of \$ 20,000.
- c) unrealized gain of \$ 20,000.
- d) investment income of \$ 20,000.

Answer: d

Difficulty: Medium

Learning Objective: Explain and apply the fair value through net income model of accounting for investments.

Section Reference: Measurement - Fair Value through Net Income (FV-NI) Model

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: \$ 350,000 – \$ 330,000 = \$ 20,000

37. George Inc. owns bonds that are accounted for under the fair value through net income model. On December 31, 2020, the bonds have a carrying value of \$ 124,365. The fair value at that date is \$ 123,000. The entry to record the year-end adjustment is

- a) Investment Income or Loss 1,365
 FV-NI Investments..... 1,365
- b) Unrealized Gain or Loss OCI 1,365
 FV-NI Investments..... 1,365
- c) FV-NI Investments..... 1,365
 Investment Income or Loss..... 1,365
- d) No adjustment is required.

Answer: a

Difficulty: Medium

Learning Objective: Explain and apply the fair value through net income model of accounting for investments.

Section Reference: Measurement - Fair Value through Net Income (FV-NI) Model

CPA: Finance

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$124,365 - \$123,000 = \$1,365$ unrealized holding loss

38. At December 31, 2020, Silicon Corp.'s stock investment portfolio, which is being accounted for by the fair value through net income (FV-NI) model, shows a general ledger balance of \$ 318,600. It is determined that the fair value of the securities is actually \$ 326,200. The entry to adjust the portfolio to fair value will include a

- a) debit to Investment Income or Loss of \$ 7,600.
- b) credit to Cash of \$ 7,600.
- c) debit to FV-NI Investments of \$ 7,600.
- d) credit to FV-NI Investments of \$ 7,600.

Answer: c

Difficulty: Medium

Learning Objective: Explain and apply the fair value through net income model of accounting for investments.

Section Reference: Measurement - Fair Value through Net Income (FV-NI) Model

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$326,200 - \$318,600 = \$7,600$ increase to investment account

39. Masma Corp. began operations in 2020. An analysis of Masma's equity securities portfolio acquired in 2020 shows the following totals at the end of the year. Masma accounts for these investments using the fair value through net income (FV-NI) model.

Total cost	\$ 182,400
Total fair market value	153,600

Based on this information, what amount should Masma report in its 2020 income statement for "Investment Income or Loss"?

- a) \$ 12,800 loss
- b) \$ 16,000 gain
- c) \$ 28,800 gain
- d) \$ 28,800 loss

Answer: d

Difficulty: Medium

Learning Objective: Explain and apply the fair value through net income model of accounting for investments.

Section Reference: Measurement - Fair Value through Net Income (FV-NI) Model

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$153,600 - \$182,400 = \$28,800$ loss

40. At December 31, 2020, Platinum Corp. has the following equity securities (no significant influence) that were purchased earlier in 2020, its first year of operation:

	<u>Cost</u>	<u>Market</u>
Security A	\$ 50,000	\$ 51,875
B	<u>70,000</u>	<u>77,500</u>
Totals	<u>\$ 120,000</u>	<u>\$ 129,375</u>

If the investments are being accounted for under the fair value through net income (FV-NI) model, the total book value of the investment accounts should

- a) be decreased by \$ 9,375.
- b) be increased by \$ 9,375.
- c) be decreased by \$ 20,000.
- d) remain unchanged.

Answer: b

Difficulty: Medium

Learning Objective: Explain and apply the fair value through net income model of accounting for investments.

Section Reference: Measurement - Fair Value through Net Income (FV-NI) Model

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$129,375 - \$120,000 = \$9,375$ gain

41. Application of the cost model to the investment one company makes in another entity's shares is straightforward and includes all of the following EXCEPT

- a) recognize the cost of the investment at the fair value of shares acquired.
- b) unless impaired, report the investment at its fair value at each balance sheet date.
- c) recognize dividend income when the entity has a claim to the dividend.

d) when the shares are disposed of, derecognize them and report a gain or loss on disposal in net income.

Answer: b

Difficulty: Easy

Learning Objective: Explain and apply the fair value through other comprehensive income model of accounting for investments.

Section Reference: Measurement - Fair Value through Other Comprehensive Income (FV-OCI) Model

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

42. Under the fair value through other comprehensive income model, unrealized gains and losses are

- a) recognized in net income.
- b) recognized in other comprehensive income.
- c) recognized in either net income or other comprehensive income.
- d) ignored.

Answer: b

Difficulty: Easy

Learning Objective: Explain and apply the fair value through other comprehensive income model of accounting for investments.

Section Reference: Measurement - Fair Value through Other Comprehensive Income (FV-OCI) Model

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

43. Accumulated comprehensive income is included as part of

- a) retained earnings.
- b) net income.
- c) shareholders' equity.
- d) unearned revenue.

Answer: c

Difficulty: Easy

Learning Objective: Explain and apply the fair value through other comprehensive income model of accounting for investments.

Section Reference: Measurement - Fair Value through Other Comprehensive Income (FV-OCI) Model

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

44. Under the fair value through other comprehensive income model, with recycling, previously unrealized holding gains and/or losses to the date of disposal are

- a) ignored.
- b) transferred to retained earnings.
- c) transferred to net income.
- d) transferred to "Unrealized Gain or Loss – OCI."

Answer: c

Difficulty: Easy

Learning Objective: Explain and apply the fair value through other comprehensive income model of accounting for investments.

Section Reference: Measurement - Fair Value through Other Comprehensive Income (FV-OCI) Model

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

45. Other comprehensive income does NOT include

- a) comprehensive income.
- b) net income.
- c) unrealized gains resulting from the application of the fair value through other comprehensive income model.
- d) unrealized losses resulting from the application of the fair value through other comprehensive income model.

Answer: b

Difficulty: Easy

Learning Objective: Explain and apply the fair value through other comprehensive income model of accounting for investments.

Section Reference: Measurement - Fair Value through Other Comprehensive Income (FV-OCI) Model

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

46. Accumulated other comprehensive income includes

- a) current year's net income.
- b) all previous debits to other comprehensive income.
- c) all previous credits to other comprehensive income.
- d) all previous debits and credits to other comprehensive income.

Answer: d

Difficulty: Easy

Learning Objective: Explain and apply the fair value through other comprehensive income model of accounting for investments.

Section Reference: Measurement - Fair Value through Other Comprehensive Income (FV-OCI) Model

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

47. 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) should be used in the fair value through net income model.
- d) should not be used in the fair value through other comprehensive income model.

Answer: a

Difficulty: Easy

Learning Objective: Explain and apply the fair value through other comprehensive income model of accounting for investments.

Section Reference: Measurement - Fair Value through Other Comprehensive Income (FV-OCI) Model

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

48. Salmon Corporation purchased an investment in 2020 (an equity investment without significant influence). The purchase price of \$ 94,000 included transaction costs of \$ 1,000. Assuming the transaction costs were capitalized and Salmon follows IFRS, which accounting method did Salmon use to account for this investment?

- a) amortized cost

- b) fair value through net income (FV-NI)
- c) fair value through other comprehensive income (FV-OCI)
- d) equity

Answer: a

Difficulty: Medium

Learning Objective: Explain and apply the fair value through other comprehensive income model of accounting for investments.

Section Reference: Measurement - Fair Value through Other Comprehensive Income (FV-OCI) Model

CPA: Financial Reporting

Bloomcode: Analysis

AACSB: Analytic

49. Realized gains and losses on investment disposals are recognized in net income for all investment instruments EXCEPT those classified as

- a) FV-NI.
- b) FV-OCI with recycling.
- c) cost/amortized cost.
- d) FV-OCI without recycling.

Answer: d

Difficulty: Easy

Learning Objective: Explain and apply the fair value through other comprehensive income model of accounting for investments.

Section Reference: Measurement - Fair Value through Other Comprehensive Income (FV-OCI) Model

Learning Objective: Explain the concept of significant influence and apply the equity method.

Section Reference: Strategic Investments - Investments in Associates

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

50. At December 31, 2020, Swift Current Inc. has the following portfolio of common shares in which it does not have significant influence:

	<u>Cost</u>	<u>Fair Value</u>
Apple Corp.	\$ 100,000	\$ 120,000
Chester Inc.	200,000	205,000
Dooley Ltd.	<u>300,000</u>	<u>500,000</u>
	<u>\$ 600,000</u>	<u>\$ 825,000</u>

Assuming Swift Current uses the fair value through other comprehensive income (FV-OCI) model to account for this portfolio of investments, the most informative entry to record the year-end adjustment is

a) FV-OCI Investments	225,000	
Unrealized Gain or Loss-OCI.....		225,000
b) FV-OCI Investment in Apple Corp.....	20,000	
FV-OCI Investment in Chester Inc.....	5,000	
FV-OCI Investment in Dooley Ltd.	200,000	
Unrealized Gain or Loss-OCI on Apple Corp.		20,000
Unrealized Gain or Loss-OCI on Chester Inc.		5,000
Unrealized Gain or Loss-OCI on Dooley Ltd.		200,000
c) Unrealized Gain or Loss-OCI on Apple Corp.	20,000	
Unrealized Gain or Loss-OCI on Chester Inc.	5,000	
Unrealized Gain or Loss-OCI on Dooley Ltd.....	200,000	
FV-OCI Investment in Apple Corp.....		20,000
FV-OCI Investment in Chester Inc.....		5,000
FV-OCI Investment in Dooley Ltd.		200,000
d) Unrealized Gain or Loss-OCI.....	225,000	
FV-OCI Investments		225,000

Answer: b

Difficulty: Medium

Learning Objective: Explain and apply the fair value through other comprehensive income model of accounting for investments.

Section Reference: Measurement - Fair Value through Other Comprehensive Income (FV-OCI) Model

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: \$ 120,000 – \$ 100,000 = \$ 20,000 gain for Apple

\$ 205,000 – \$ 200,000 = \$ 5,000 gain for Chester

\$ 500,000 – \$ 300,000 = \$ 200,000 gain for Dooley

51. Accounting of impairment losses is required for investments that are measured using the

a) cost/amortized cost model.

b) FV-NI model.

c) FV-OCI model.

d) All of these (all of these models require a method of accounting for impairment).

Answer: a

Difficulty: Easy

Learning Objective: Explain and apply the incurred loss, expected loss, and fair value loss impairment models.

Section Reference: Measurement - Impairment Models

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

52. Which of the following situations would NOT necessarily 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) The issuing entity has temporarily halted dividend payments in order to retain cash for future expansion.
- d) The issuing entity is undergoing a major reorganization.

Answer: c

Difficulty: Medium

Learning Objective: Explain and apply the incurred loss, expected loss, and fair value loss impairment models.

Section Reference: Measurement - Impairment Models

CPA: Financial Reporting

Bloomcode: Analysis

AACSB: Analytic

53. Assuming the revised amount and timing of cash flows for an investment can be reasonably determined, the incurred loss impairment model uses which discount rate?

- a) the investor's internal rate of return
- b) the historical interest rate
- c) the current market rate
- d) either the historical rate or the current market rate

Answer: d

Difficulty: Easy

Learning Objective: Explain and apply the incurred loss, expected loss, and fair value loss impairment models.

Section Reference: Measurement - Impairment Models

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

54. Assuming the revised amount and timing of cash flows for an investment can be reasonably determined, the expected loss impairment model uses which discount rate?

- a) the investor's internal rate of return
- b) the historical interest rate
- c) the current market rate
- d) either the historical rate or the current market rate

Answer: b

Difficulty: Easy

Learning Objective: Explain and apply the incurred loss, expected loss, and fair value loss impairment models.

Section Reference: Measurement - Impairment Models

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

55. The fair value loss impairment model

- a) is used for all investments that are not accounted for as FV-NI.
- b) requires a separate impairment test.
- c) calculates the impairment loss as the difference between the asset's fair value and its current carrying amount.
- d) calculates the impairment loss as the difference between the asset's original cost and its current carrying amount.

Answer: c

Difficulty: Easy

Learning Objective: Explain and apply the incurred loss, expected loss, and fair value loss impairment models.

Section Reference: Measurement - Impairment Models

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

56. On November 1, 2020, Mack Co. purchased a 5-year, 8% bond with a face value of \$ 200,000. The purchase price of \$ 184,556 was consistent with a 10% yield. Interest is payable semi-annually on January 1 and July 1. The bonds mature on January 1, 2022. The amortized cost of the bond on the maturity date is

- a) \$ 185,556.
- b) \$ 195,000.
- c) \$ 200,000.

d) \$ 190,000.

Answer: c

Difficulty: Medium

Learning Objective: Explain and apply the incurred loss, expected loss, and fair value loss impairment models.

Section Reference: Measurement - Impairment Models

CPA: Finance

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

57. When one corporation has a controlling interest in another corporation whose shares are not actively traded, under ASPE, the investment is accounted for using

- a) either the consolidation method or the equity method or the cost method.
- b) the consolidation method.
- c) either the consolidation method or the equity method.
- d) either the consolidation method or the equity method or the cost method or the FV-OCI method.

Answer: a

Difficulty: Easy

Learning Objective: Explain the concept of significant influence and apply the equity method.

Section Reference: Strategic Investments - Investments in Associates

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

58. 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.

Answer: a

Difficulty: Easy

Learning Objective: Explain the concept of significant influence and apply the equity method.

Section Reference: Strategic Investments - Investments in Associates

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

59. 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.

Answer: b

Difficulty: Easy

Learning Objective: Explain the concept of significant influence and apply the equity method.

Section Reference: Strategic Investments - Investments in Associates

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

60. An investor who owns 15% of an entity's voting shares can

- a) potentially have influence over the investee if the shares are widely held.
- b) always be assumed to have little or no influence over the investee.
- c) be assumed to be using the cost model.
- d) be assumed to always use the equity method.

Answer: a

Difficulty: Easy

Learning Objective: Explain the concept of significant influence and apply the equity method.

Section Reference: Strategic Investments - Investments in Associates

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

61. An investor who owns 11% of an entity's voting shares

- a) must use the equity method.
- b) would be likely to prepare consolidated statements.
- c) may have significant influence over the investee if the shares are closely held.
- d) may have significant influence over the investee if the shares are widely held.

Answer: d

Difficulty: Easy

Learning Objective: Explain the concept of significant influence and apply the equity method.

Section Reference: Strategic Investments - Investments in Associates

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

62. Olde Corp. accounts for its investment in the common shares of Young Inc. under the equity method. Olde Corp. should 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.

Answer: a

Difficulty: Medium

Learning Objective: Explain the concept of significant influence and apply the equity method.

Section Reference: Strategic Investments - Investments in Associates

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

63. 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) earnings are reported by the investee in its financial statements.
- d) investee pays a dividend.

Answer: c

Difficulty: Easy

Learning Objective: Explain the concept of significant influence and apply the equity method.

Section Reference: Strategic Investments - Investments in Associates

CPA: Financial Reporting

Bloomcode: Application

Bloomcode: Knowledge

AACSB: Analytic

64. Jabba Inc. owns 35% of Hutt Corp., and has significant influence over Hutt. During the calendar year 2020, Hutt reported net income of \$ 300,000 and paid dividends of \$ 30,000.

Jabba mistakenly recorded these transactions using the cost method rather than the equity method of accounting. What effect would this have on Jabba's investment account, net income, and retained earnings, respectively?

- a) understate, overstate, overstate
- b) overstate, understate, understate
- c) understate, understate, understate
- d) overstate, overstate, overstate

Answer: c

Difficulty: Hard

Learning Objective: Explain the concept of significant influence and apply the equity method.

Section Reference: Strategic Investments - Investments in Associates

CPA: Financial Reporting

Bloomcode: Evaluation

AACSB: Analytic

65. When an investor is using the equity method and receives dividends from the investee, the journal entry will include a

- a) credit to Dividend Revenue.
- b) credit to Retained Earnings.
- c) credit to the Investment account.
- d) debit to the Investment account.

Answer: c

Difficulty: Medium

Learning Objective: Explain the concept of significant influence and apply the equity method.

Section Reference: Strategic Investments - Investments in Associates

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

66. When an investor is using the equity method and the investee reports a net loss, the journal entry will include a

- a) debit to the Investment account.
- b) debit to Retained Earnings.
- c) credit to the Investment account.
- d) credit to Investment Income or Loss.

Answer: c

Difficulty: Medium

Learning Objective: Explain the concept of significant influence and apply the equity method.

Section Reference: Strategic Investments - Investments in Associates

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

67. When an investor, using the equity method, pays more than its share of the investee's book value, the difference is

- a) ignored.
- b) accounted for on the investor's books by a debit to Goodwill.
- c) accounted for on the investee's books by a debit to Goodwill.
- d) requires that the investor's Investment account and any investment income from the associate be adjusted over time.

Answer: d

Difficulty: Medium

Learning Objective: Explain the concept of significant influence and apply the equity method.

Section Reference: Strategic Investments - Investments in Associates

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

68. Current IFRS rules for equity investments that are traded in an active market require that they

- a) can 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) cannot be accounted for under the fair value through net income model.

Answer: b

Difficulty: Easy

Learning Objective: Explain the concept of significant influence and apply the equity method.

Section Reference: Strategic Investments - Investments in Associates

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

Use the following information for questions 69–72.

The summarized balance sheets of Thunder Bay Corp. and Fort William Corp. at December 31, 2020, are as follows:

THUNDER BAY CORP.
Balance Sheet
December 31, 2020

Assets	<u>\$ 400,000</u>
Liabilities	\$ 50,000
Common shares	200,000
Retained earnings	<u>150,000</u>
Total equities.....	<u>\$ 400,000</u>

FORT WILLIAM CORP.
Balance Sheet
December 31, 2020

Assets	<u>\$ 300,000</u>
Liabilities	\$ 75,000
Common shares	185,000
Retained earnings	<u>40,000</u>
Total equities.....	<u>\$ 300,000</u>

69. If Thunder Bay acquired a 20% interest in Fort William on December 31, 2020, for \$ 65,000 and the equity method of accounting for the investment were used, the amount of the debit to Investment in Fort William Corp. would have been

- a) \$ 65,000.
- b) \$ 60,000.
- c) \$ 45,000.
- d) \$ 37,000.

Answer: a

Difficulty: Medium

Learning Objective: Explain the concept of significant influence and apply the equity method.

Section Reference: Strategic Investments - Investments in Associates

CPA: Finance

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: \$ 65,000, acquisition cost

70. If Thunder Bay acquired a 30% interest in Fort William on December 31, 2020, for \$ 75,000 and the equity method of accounting for the investment were used, the amount of the debit to Investment in Fort William Corp. would have been

- a) \$ 90,000.
- b) \$ 75,000.
- c) \$ 67,500.
- d) \$ 60,000.

Answer: b

Difficulty: Medium

Learning Objective: Explain the concept of significant influence and apply the equity method.

Section Reference: Strategic Investments - Investments in Associates

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: \$ 75,000, acquisition cost

71. If Thunder Bay acquired a 20% interest in Fort William on December 31, 2020, for \$ 45,000, and during 2021 Fort William reported net income of \$ 25,000 and paid a total cash dividend of \$ 10,000, applying the equity method would give a debit balance in the Investment in Fort William Corp. account at the end of 2021 of

- a) \$ 37,000.
- b) \$ 45,000.
- c) \$ 48,000.
- d) \$ 50,000.

Answer: c

Difficulty: Medium

Learning Objective: Explain the concept of significant influence and apply the equity method.

Section Reference: Strategic Investments - Investments in Associates

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 45,000 + (\$ 25,000 \times .2) - (\$ 10,000 \times .2) = \$ 48,000$

72. If Thunder Bay acquired a 30% interest in Fort William on December 31, 2020, for \$ 67,500 and during 2021 Fort William reported net income of \$ 25,000 and paid a total cash dividend of \$ 30,000, applying the equity method would give a debit balance in the Investment in Fort William Corp. account at the end of 2021 of

- a) \$ 67,500.

- b) \$ 66,000.
- c) \$ 62,500.
- d) \$ 58,500.

Answer: b

Difficulty: Medium

Learning Objective: Explain the concept of significant influence and apply the equity method.

Section Reference: Strategic Investments - Investments in Associates

CPA: Finance

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 67,500 + (\$ 25,000 \times .3) - (\$ 30,000 \times .3) = \$ 66,000$

73. On January 2, 2020, Fidel Corp. purchased 200 of the 1,000 outstanding common shares of Rindu Ltd. for \$ 60,000. During 2020, Rindu declared total cash dividends of \$ 10,000 and reported net income for the year of \$ 40,000. If Fidel uses the equity method of accounting for its investment in Rindu, Fidel's Investment in Rindu Ltd. account at December 31, 2020 should be

- a) \$ 68,000.
- b) \$ 66,000.
- c) \$ 60,000.
- d) \$ 58,000.

Answer: b

Difficulty: Medium

Learning Objective: Explain the concept of significant influence and apply the equity method.

Section Reference: Strategic Investments - Investments in Associates

CPA: Finance

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 60,000 + (\$ 40,000 \times .2) - (\$ 10,000 \times .2) = \$ 66,000$

Use the following information for questions 88–89.

During calendar 2020, Davel Corp. reported net income of \$ 45,000 and paid total cash dividends of \$ 15,000. Ryan Inc. owns 2,250 of the 7,500 outstanding shares of Davel and exercises significant influence.

74. What amount should Ryan show in the investment account at December 31, 2020 if the beginning of the year balance in the account was \$ 60,000?

- a) \$ 69,000
- b) \$ 73,500
- c) \$ 60,000
- d) \$ 90,000

Answer: a

Difficulty: Medium

Learning Objective: Explain the concept of significant influence and apply the equity method.

Section Reference: Strategic Investments - Investments in Associates

CPA: Financial Reporting

Bloomcode: Application

Feedback: $\$ 60,000 + (\$ 45,000 \times .3) - (\$ 15,000 \times .3) = \$ 69,000$

AACSB: Analytic

75. How much income from its investment in Davel should Ryan report in 2020?

- a) \$ 45,000
- b) \$ 15,000
- c) \$ 13,500
- d) \$ 22,500

Answer: c

Difficulty: Medium

Learning Objective: Explain the concept of significant influence and apply the equity method.

Section Reference: Strategic Investments - Investments in Associates

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 45,000 \times .3 = \$ 13,500$

76. On December 31, 2020, Ryan Corp. acquired a 40% interest in Gosling Corp. for \$ 315,000. During 2021, Gosling reported net income of \$ 200,000 and paid total cash dividends of \$ 50,000. Assuming Ryan uses the equity method, at December 31, 2021, the balance in the investment account should be

- a) \$ 395,000.
- b) \$ 295,000.
- c) \$ 375,000.
- d) \$ 255,000.

Answer: c

Difficulty: Medium

Learning Objective: Explain the concept of significant influence and apply the equity method.

Section Reference: Strategic Investments - Investments in Associates

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 315,000 + (\$ 200,000 \times 40\%) - (\$ 50,000 \times 40\%) = \$ 375,000$

Use the following information for questions 77–78.

Red Corp. owns 3,000 of the 10,000 outstanding common shares of Grey Corp. and exercises significant influence. During 2020, Grey reported net income of \$ 120,000 and paid total cash dividends of \$ 40,000.

77. If the beginning 2020 balance in the Investment in Grey Corp. account was \$ 180,000, the balance at December 31, 2020 should be

- a) \$ 260,000.
- b) \$ 204,000.
- c) \$ 180,000.
- d) \$ 132,000.

Answer: b

Difficulty: Medium

Learning Objective: Explain the concept of significant influence and apply the equity method.

Section Reference: Strategic Investments - Investments in Associates

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 180,000 + (\$ 120,000 \times .3) - (\$ 40,000 \times .3) = \$ 204,000$

78. Red Corp. should report investment revenue for 2020 of

- a) \$ 12,000.
- b) \$ 24,000.
- c) \$ 36,000.
- d) \$ 48,000.

Answer: c

Difficulty: Medium

Learning Objective: Explain the concept of significant influence and apply the equity method.

Section Reference: Strategic Investments - Investments in Associates

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$120,000 \times .3 = \$36,000$

Use the following information for questions 79–81.

On January 1, 2020, Abalone Ltd. acquired 30% of Flounder Corp.'s common shares for \$240,000. During 2020, Flounder reported net income of \$100,000 and paid total dividends of \$60,000. Abalone's 30% interest in Flounder gives Abalone the ability to exercise significant influence over their operating and financial policies. During 2021, Flounder reported net income of \$150,000 and paid total dividends of \$30,000 on April 1 and \$40,000 on October 1. On July 1, 2021, Abalone sold half of its shares in Flounder for \$158,000 cash.

79. Before income taxes, what income should Abalone include in its 2020 income statement as a result of this investment?

- a) \$100,000
- b) \$60,000
- c) \$30,000
- d) \$18,000

Answer: c

Difficulty: Medium

Learning Objective: Explain the concept of significant influence and apply the equity method.

Section Reference: Strategic Investments - Investments in Associates

CPA: Financial Reporting

Bloomcode: Analysis

AACSB: Analytic

Feedback: $\$100,000 \times 30\% = \$30,000$

80. The carrying amount of this investment in Abalone's December 31, 2020, statement of financial position should be

- a) \$252,000.
- b) \$240,000.
- c) \$270,000.
- d) \$275,000.

Answer: a

Difficulty: Medium

Learning Objective: Explain the concept of significant influence and apply the equity method.

Section Reference: Strategic Investments - Investments in Associates

CPA: Financial Reporting

Bloomcode: Analysis

AACSB: Analytic

Feedback: $\$240,000 + \$30,000 - (\$60,000 \times 30\%) = \$252,000$

81. The gain on disposal of this investment in Abalone's 2021, income statement should be

- a) \$ 8,000.
- b) \$ 20,750.
- c) \$ 25,250.
- d) \$ 32,000.

Answer: c

Difficulty: Hard

Learning Objective: Explain the concept of significant influence and apply the equity method.

Section Reference: Strategic Investments - Investments in Associates

CPA: Financial Reporting

Bloomcode: Analysis

AACSB: Analytic

Feedback: $\$252,000 - (\$30,000 \times 30\%) + (\$150,000 \times 50\% \times 30\%) = \$265,500$

$\$158,000 - (\$265,500 \div 2) = \$25,250$

82. On January 1, 2020, Scallop Corp. purchased 25% of Prawn Corp.'s common shares; no goodwill resulted from the purchase. Scallop correctly uses the equity method to account for this investment at equity. The Investment in Associate account related to the Scallop investment was reported on the December 31, 2020, statement of financial position at \$ 360,000. Prawn had reported net income of \$ 225,000 for calendar 2020, and paid dividends totalling \$ 90,000 during 2020. How much did Scallop pay for its 25% interest in Prawn?

- a) \$ 393,750
- b) \$ 382,500
- c) \$ 360,000
- d) \$ 326,250

Answer: d

Difficulty: Medium

Learning Objective: Explain the concept of significant influence and apply the equity method.

Section Reference: Strategic Investments - Investments in Associates

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 360,000 - (\$ 225,000 \times 25\%) + (\$ 90,000 \times 25\%) = \$ 326,250$

83. When one corporation has control over another corporation, the investor corporation

- a) is referred to as an associate.
- b) is referred to as the subsidiary.
- c) can determine the investee's strategic operating and financing policies.
- d) must have obtained at least 50% of the investee's issued common shares.

Answer: c

Difficulty: Easy

Learning Objective: Explain the concept of control and when consolidation is appropriate.

Section Reference: Strategic Investments - Investments in Subsidiaries

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

84. An investor that has subsidiaries

- a) is required to prepare consolidated financial statements under IFRS.
- b) is required to prepare consolidated financial statements under ASPE.
- c) does not have to prepare consolidated financial statements under IFRS.
- d) ignores the noncontrolling interest on the consolidated financial statements.

Answer: a

Difficulty: Easy

Learning Objective: Explain the concept of control and when consolidation is appropriate.

Section Reference: Strategic Investments - Investments in Subsidiaries

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

85. If a parent company owns 90% of a subsidiary's outstanding shares, the parent should generally account for the subsidiary's income under the

- a) cost/amortized cost model.
- b) fair value through net income model.
- c) fair value through other comprehensive model.
- d) consolidation method.

Answer: d

Difficulty: Easy

Learning Objective: Explain the concept of control and when consolidation is appropriate.

Section Reference: Strategic Investments - Investments in Subsidiaries

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

86. When the investor has control over the investee, the reporting model to be used is the

- a) cost model.
- b) consolidation model.
- c) market value model.
- d) equity method.

Answer: b

Difficulty: Easy

Learning Objective: Explain the concept of control and when consolidation is appropriate.

Section Reference: Strategic Investments - Investments in Subsidiaries

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

87. When one corporation acquires control of another entity, the investor corporation is referred to as the parent and the investee corporation as the

- a) subsidiary.
- b) joint venture.
- c) associate.
- d) child.

Answer: a

Difficulty: Easy

Learning Objective: Explain the concept of control and when consolidation is appropriate.

Section Reference: Strategic Investments - Investments in Subsidiaries

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

88. Under IFRS, which of the following is NOT a condition for an investment to be classified as current?

- a) It is held primarily for trading purposes.
- b) It is a cash equivalent.

- c) It must be expected to be sold or realized within 12 months from the statement of financial position date.
- d) It must be accounted for under the cost model.

Answer: d

Difficulty: Easy

Learning Objective: Explain how investments are presented and disclosed in the financial statements, noting how this facilitates analysis.

Section Reference: Presentation, Disclosure, and Analysis

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

89. The objectives of disclosures required for investments in debt and equity investments do NOT include

- a) how significant the investments are to the investor's financial position and performance.
- b) whether the investments are classified as current or long-term.
- c) the nature and extent of the risks that the investor faces as a result of the investments.
- d) how the risks that the investor faces as a result of the investments are managed.

Answer: b

Difficulty: Easy

Learning Objective: Explain how investments are presented and disclosed in the financial statements, noting how this facilitates analysis.

Section Reference: Presentation, Disclosure, and Analysis

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

90. 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.

Answer: b

Difficulty: Easy

Learning Objective: Explain how investments are presented and disclosed in the financial statements, noting how this facilitates analysis.

Section Reference: Presentation, Disclosure, and Analysis

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

91. The standards relating to consolidation differ under ASPE and IFRS. Which of the following statements best describes the difference?

- a) IFRS requires consolidation whereas ASPE offers a choice of methods.
- b) ASPE requires consolidation whereas IFRS offers a choice of methods.
- c) Consolidation is specifically excluded as one of the choices under ASPE.
- d) Consolidation is specifically excluded as one of the choices under IFRS.

Answer: a

Difficulty: Easy

Learning Objective: Explain how investments are presented and disclosed in the financial statements, noting how this facilitates analysis.

Section Reference: Presentation, Disclosure, and Analysis

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

92. Which of the following is NOT required to report for associates accounted for using the equity method?

- a) the fair value of any of these investments that has a price quoted in an active market
- b) separate disclosure of income related to equity-accounted associates
- c) the investor's strategy and motivation for holding equity ownership in the associate
- d) information about associates' year ends that are different from the investor's year end

Answer: c

Difficulty: Easy

Learning Objective: Explain how investments are presented and disclosed in the financial statements, noting how this facilitates analysis.

Section Reference: Presentation, Disclosure, and Analysis

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

93. Financial disclosures required regarding acquisitions require that

- a) readers are able to relate the investment category on the SFP to the investment income reported on the income statement.
- b) readers are able to understand the effects of the accounting methods that are used for different categories of investments.
- c) major acquisition dates are disclosed, as the SFP contains all assets, and the P&L only contains income earned by the subsidiary after it was acquired.
- d) all of these describe financial disclosures required regarding acquisitions.

Answer: d

Difficulty: Easy

Learning Objective: Explain how investments are presented and disclosed in the financial statements, noting how this facilitates analysis.

Section Reference: Presentation, Disclosure, and Analysis

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

94. Which of the following is a reason for the differences in the disclosure requirements for investments in associates under IFRS and ASPE?

- a) ASPE requires that the associate must be a private entity.
- b) ASPE does not include an "associates" category.
- c) ASPE allows the use of methods other than the equity method.
- d) ASPE does not allow the equity method.

Answer: c

Difficulty: Easy

Learning Objective: Identify differences in accounting between IFRS and ASPE, and what changes are expected in the near future.

Section Reference: IFRS/ASPE Comparison

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

95. The standards relating to the treatment of transaction costs differ under ASPE and IFRS. Which of the following statements best describe the difference?

- a) ASPE requires that transaction costs are capitalized, except for those investments that are accounted for under the fair value through net income model.
- b) ASPE requires that transaction costs are expensed whenever cost-based measures are used.

- c) IFRS requires that transaction costs are capitalized except for those investments that are accounted for under the fair value through net income model.
- d) IFRS requires that all transaction costs are capitalized.

Answer: c

Difficulty: Easy

Learning Objective: Identify differences in accounting between IFRS and ASPE, and what changes are expected in the near future.

Section Reference: IFRS/ASPE Comparison

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

96. The standards relating to the treatment of interest and dividend income differ under ASPE and IFRS. Which of the following statements is INCORRECT?

- 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) ASPE allows the use of either the straight-line or effective-interest method.
- d) When using the equity method, IFRS allows a dividend from an investee to be recorded as income, while ASPE does not.

Answer: d

Difficulty: Easy

Learning Objective: Identify differences in accounting between IFRS and ASPE, and what changes are expected in the near future.

Section Reference: IFRS/ASPE Comparison

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

EXERCISES

Ex. 9-97 Shares acquired on margin

What does it mean when an investment in shares is acquired on margin and how is the asset recorded?

Solution 9-97

Investments in shares acquired on margin means that the investor pays only part of the purchase price to acquire the shares. The rest is financed by the broker. Since the shares legally belong to the investor, the asset is recorded at the full share price and a liability to the broker for the amount that was financed is also recognized.

Difficulty: Easy

Learning Objective: Understand the nature of and basic accounting for investments, including which types of companies have significant investments.

Section Reference: Understanding Investments

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 9-98 Fair value of bonds

What is the fair value of a \$ 100,000 face value bond priced at

- a) 102
- b) 100
- c) 98

Solution 9-98

d) $\$ 100,000 \times 102\% = \$ 102,000$

e) $\$ 100,000 \times 100\% = \$ 100,000$

f) $\$ 100,000 \times 98\% = \$ 98,000$

Difficulty: Medium

Learning Objective: Understand the nature of and basic accounting for investments, including which types of companies have significant investments.

Section Reference: Understanding Investments

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 9-99 Cost/amortized cost model – ASPE versus IFRS 9

When is the cost/amortized cost model used under ASPE versus IFRS 9?

Solution 9-99

ASPE uses the cost/amortized cost model for most investments, excluding equity investments where an active market exists for trading the shares and derivatives. IFRS 9 uses this model for debt instruments where the entity's business model is to hold the investments to maturity.

Difficulty: Easy

Learning Objective: Explain and apply the cost/amortized cost model of accounting for investments.

Section Reference: Measurement - Cost/Amortized Cost Model

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

Ex. 9-100 Investment in shares of other entities – cost model

Manson Corp. acquired 10,000 shares of Digicex Corp. on July 1, 2020 at \$ 15 per share. There is no quoted market price for Digicex shares as it is a private company. Manson reports under ASPE and has elected to account for the investment using the cost method. On September 1, Digicex declared and paid a \$ 0.75 per share dividend and on December 31, Manson sells the shares at \$ 12 per share.

Instructions

Prepare the journal entries to record the above transactions.

Solution 9-100

July 1	Other Investments	150,000	
	Cash		150,000
	(10,000 shares × \$ 15.00) = \$ 150,000		
Sept 1	Cash	7,500	
	Dividend Revenue		7,500
	(10,000 shares × \$ 0.75)		

Dec 31	Cash	120,000	
	Loss on Disposal of Investments –		
	Cost/Amortized Cost	30,000	
	Other Investments		150,000
	$(10,000 \text{ shares} \times \$ 12) - (10,000 \times \$ 15) = \$ 30,000 \text{ loss}$		

Difficulty: Medium

Learning Objective: Explain and apply the cost/amortized cost model of accounting for investments.

Section Reference: Measurement – Cost/Amortized Cost Model

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 9-101 Motivation for investments

List three reasons why an organization would make investments.

Solution 9-101

1. for the returns provided (interest, dividends, capital appreciation)
2. to develop a special relationship with a supplier or customer
3. to establish a long-term operating relationship with the investee (usually by influencing or controlling the investee)

Difficulty: Easy

Learning Objective: Understand the nature of and basic accounting for investments, including which types of companies have significant investments.

Section Reference: Understanding Investments

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

Ex. 9-102 Types of companies that have investments

Consider the financial statements of a publishing house, a reinsurance provider, and a charitable foundation. What types and proportions of investments would you expect to find on the financial statements of these companies?

Solution 9-102

A publishing house is unlikely to have a significant portion of investments. Their main activity is selling publications. If they do business in a foreign currency, they may hold some investments to hedge foreign exchange risk.

A reinsurance provider will hold a significant proportion of investments as movement in the value of these investment pools is meant to assist in possible payment of insurance policies. Investments would be the main asset of these companies.

A charitable foundation is in place solely to finance the objectives of the charity with which it is affiliated. If it holds investments they are likely in the form of endowments that have been gifted to it by donors over its lifetime. Charitable foundations are not in the business of actively trading investments.

Difficulty: Easy

Learning Objective: Understand the nature of and basic accounting for investments, including which types of companies have significant investments.

Section Reference: Understanding Investments

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 9-103 Types of companies that have investments

Two types of companies that carry significant amounts of investments are banks and pension plans. Explain how these companies use their investment holdings to add value for their customers.

Solution 9-103

Banks add value by investing other people's money and earning a return that is higher than their cost of capital. Their expertise lies in understanding how and when to buy and sell shares and debt instruments in order to maximize profits. They often buy and sell shares and debt instruments over the short term for profit (referred to as trading).

Pension plans collect money from employees and pay out funds as pensions when employees retire. In order to maximize the payout on retirement, pension plans generally invest the money in the interim and try to maximize the value of investments.

Difficulty: Easy

Learning Objective: Understand the nature of and basic accounting for investments, including which types of companies have significant investments.

Section Reference: Understanding Investments

CPA: Communication

CPA: Strategy & Governance

Bloomcode: Comprehension

AACSB: Communication

Ex. 9-104 Application of cost/amortized cost method

Luke Corporation purchased \$ 60,400 of 6-year, 7% bonds of Reed Inc. for \$ 57,566 to yield an 8% return, and classified the purchase as an amortized cost method investment. The bonds pay interest semi-annually.

- Assuming Luke Corporation applies IFRS, prepare its journal entries for the purchase of the investment and receipt of semi-annual interest and discount amortization for the first two interest payments that will be received.
- Assuming Luke Corporation applies ASPE and has chosen the straight-line method of discount amortization, prepare the same three entries requested in part a).

Solution 9-104

a) Bond Investment at Amortized Cost 57,566
 Cash 57,566
 To record the purchase of the investment

Cash 2,114
 Bond Investment at Amortized Cost 189
 Interest Income 2,303

To record the receipt of the semi-annual interest payment

Cash: ($\$ 60,400 \times 7\% \times 6/12$) = \$ 2,114

Interest Income ($\$ 57,566 \times 8\% \times 6/12$) = \$ 2,303

Cash 2,114
 Bond Investment at Amortized Cost 196
 Interest Income 2,310

To record the receipt of the semi-annual interest payment

Interest Income ($[\$ 57,566 + \$ 189] \times 8\% \times 6/12$) = \$ 2,310

b) Bond Investment at Amortized Cost 57,566
 Cash 57,566
 To record the purchase of the investment

Cash 2,114
 Bond Investment at Amortized Cost 236
 Interest Income 2,350

To record the receipt of the semi-annual interest payment

Cash: ($\$ 60,400 \times 7\% \times 6/12$) = \$ 2,114

Interest periods to maturity: $6 \times 2 = 12$

Amortization each interest period: $\$ 2,834 \div 12 = \$ 236$

Cash 2,114

Bond Investment at Amortized Cost	236	
Interest Income		2,350
To record the receipt of the semi-annual interest payment		

Difficulty: Medium

Learning Objective: Explain and apply the cost/amortized cost model of accounting for investments.

Section Reference: Measurement - Cost/Amortized Cost Model

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 9-105 Investment in debt securities at a premium

On April 1, 2020, Margarita Corp. purchased 6%, \$ 120,000 (par value) bonds for \$ 124,725 plus accrued interest. Interest is paid on July 1 and January 1 and the bonds mature on July 1, 2025. Margarita uses the amortized cost model to account for this investment, and intends to hold the bonds to maturity. Margarita Corp. follows ASPE.

Instructions

- Prepare the journal entry to record the purchase.
- The bonds are sold on November 1, 2021 at 103 plus accrued interest. Amortization was recorded when interest was received by the straight-line method. Prepare all entries required to properly record the sale. Round values to the nearest dollar, if necessary.

Solution 9-105

a) Bond Investment at Amortized Cost	124,725	
Interest Income ($\$ 120,000 \times .06 \times 3 \div 12$)	1,800	
Cash		126,525
Premium on bond: $\$ 124,725 - \$ 120,000 = \$ 4,725$		
b) Interest Income ($\$ 4,725 \times 4 \div 63$)	300	
Bond Investment at Amortized Cost		300
Cash ($\$ 120,000 \times .06 \times 4 \div 12$)	2,400	
Interest Income		2,400
Cash	123,600	
Gain on Disposal of Investments – Cost/Amortized Cost		300
Bond Investment at Amortized Cost		123,300
$\$ 124,725 - (\$ 4,725 \times 19 \div 63)$		

Difficulty: Medium

Learning Objective: Explain and apply the cost/amortized cost model of accounting for investments.

Section Reference: Measurement - Cost/Amortized Cost Model

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 9-106 Investment in debt securities at a premium

On January 1, 2020, Genevieve Ltd. purchased 8%, \$ 100,000 (par value) bonds for \$ 108,530. The bonds were purchased to yield 6%. Interest is paid on July 1 and January 1 and the bonds mature on January 1, 2025. Genevieve uses the amortized cost method and the effective-interest method to amortize the premium. Genevieve has a year end of December 31 and follows ASPE.

Instructions

- Prepare the journal entry to record the purchase.
- Prepare the journal entries for the receipt of interest and amortization of the premium for the remainder of 2020. Round all values to the nearest dollar.
- To the nearest dollar, what is the carrying value of the investment at the end of 2021?

Solution 9-106

a) Bond Investment at Amortized Cost	108,530	
Cash		108,530

b) July 1, 2020		
Cash	4,000	
Interest Income		3,256
Bond Investment at Amortized Cost		744
\$ 108,530 $\times$.06 $\times$.5 = \$ 3,256		

December 31, 2020		
Interest Receivable	4,000	
Interest Income		3,234
Bond Investment at Amortized Cost		766
(\$ 108,530 - \$ 744) $\times$.06 $\times$.5 = \$ 3,234		

- c) (\$ 108,530 - \$ 744 - \$ 766) $\times$.06 $\times$.5 = \$ 3,211; \$ 4,000 - \$ 3,211 = \$ 789
 (\$ 108,530 - \$ 744 - \$ 766 - \$ 789) $\times$.06 $\times$.5 = \$ 3,187; \$ 4,000 - \$ 3,187 = \$ 813
 Carrying value at the end of 2021:
 (\$ 108,530 - \$ 744 - \$ 766 - \$ 789 - \$ 813) = \$ 105,418

Difficulty: Medium

Learning Objective: Explain and apply the cost/amortized cost model of accounting for investments.

Section Reference: Measurement - Cost/Amortized Cost Model

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 9-107 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 individual case.

Solution 9-107

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.

Case 2: The accrued interest and discount or premium would have to be updated to the date of disposal. The resulting gain or loss (difference between carrying value and sales proceeds) would be recognized in net income and the investment would be removed from the investor's books.

Case 3: Depending on whether ASPE or IFRS is followed, once the investment has been determined to be impaired, three different models are available to recognize the loss: the incurred loss impairment model, the expected loss impairment model, and the fair value loss impairment model.

Difficulty: Hard

Learning Objective: Explain and apply the cost/amortized cost model of accounting for investments.

Section Reference: Measurement - Cost/Amortized Cost Model

Learning Objective: Explain and apply the incurred loss, expected loss, and fair value loss impairment models.

Section Reference: Measurement - Impairment Models

CPA: Communication
CPA: Financial Reporting
Bloomcode: Evaluate
AACSB: Communication

Ex. 9-108 Cost and equity methods

Compare the cost and equity methods of accounting for investments in shares subsequent to acquisition (when permitted by ASPE).

Solution 9-108

Under the cost method, the investment is originally recorded at fair value plus any direct transaction costs, i.e., cost. The investment remains at this value unless the investment becomes impaired. Dividends are reported as income.

Similarly, under the equity method, the investment is originally recorded at cost.

Subsequently, however, 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 net income of the investor. Dividends received from the investee are recorded as reductions in the investment account.

Difficulty: Easy

Learning Objective: Explain and apply the cost/amortized cost model of accounting for investments.

Section Reference: Measurement - Cost/Amortized Cost Model

Learning Objective: Explain the concept of significant influence and apply the equity method.

Section Reference: Strategic Investments - Investments in Associates

CPA: Communication
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Communication

Ex. 9-109 Fair value through net income method

On October 1, Whiteside Ltd. purchased a 7% bond with a face value of \$ 1,000 for trading purposes, accounting for the investment at fair value through net income. The bond was priced at 1.023 to yield Whiteside 5%, and pays interest annually each October 1. Whiteside has a December 31 year end, and at this date, the bond's fair value was \$ 1,050. Assume Whiteside applies IFRS and follows a policy of not reporting interest income separately from investment income.

Instructions

- a) Prepare Whiteside's entry for the purchase of the investment.
- b) Prepare Whiteside's entry for the December 31 interest accrual.

- c) (i) Prepare Whiteside's entry for the year-end fair value adjustment. (ii) Assume Whiteside applies ASPE, uses the effective-interest method, and follows a policy of reporting interest income separately.

Solution 9-109

a)

FV—NI Investments	1,023	
Cash		1,023
To record purchase of the investment		
Cash = (\$ 1,000 x 1.023) = \$ 1,023		

b)

Interest Receivable	17.50	
Investment Income or Loss		17.50
To record the December 31 interest accrual		
Investment Income or Loss = (7% x \$ 1,000 x 3/12) = \$ 17.50		

c) (i)

FV—NI Investments	27.00	
Investment Income or Loss = (\$ 1,050 – \$ 1,023) .		27.00
To record the year-end fair value adjustment		

(ii) Under ASPE

Interest Receivable	17.50	
FV—NI Investments.....		4.71
Interest Income		12.79
To record the December 31 interest accrual		
Interest Receivable = 7% x \$ 1,000 x 3/12 = \$ 17.50		
Interest Income = 5% x \$ 1,023 x 3/12 = \$ 12.79		

FV—NI Investments	31.71	
Unrealized Gain or Loss		31.71
To record the year-end fair value adjustment		
Unrealized Gain or Loss = \$ 1,050 – (\$ 1,023 – \$ 4.71) = \$ 31.71		

Difficulty: Medium

Learning Objective: Explain and apply the fair value through net income model of accounting for investments.

Section Reference: Measurement - Fair Value through Net Income (FV—NI) Model

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 9-110 Cost and equity methods

Fill in the dollar changes caused in the Investment account and Dividend Revenue or Investment Income account by each of the following transactions, assuming Norah Corp. uses

- the Fair Value through Net Income(FV-NI) method and
- the equity method for accounting for its investments in Jessica Ltd.

Transaction	<u>a) FV-NI Method</u>		<u>b) Equity Method</u>	
	Investment Account	Dividend Revenue	Investment Account	Investment Income or Loss
1. At the beginning of Year 1, Norah bought 30% of Jessica's common shares at their book value. At this time, the book value of all Jessica's common shares was \$ 450,000.				
2. During Year 1, Jessica reported \$ 25,000 net income and paid a total of \$ 12,500 in dividends.				
3. During Year 2, Jessica reported \$ 10,000 net income and paid a total of \$ 12,500 in dividends.				
4. During Year 3, Jessica reported a net loss of \$ 6,000 and paid a total of \$ 2,500 in dividends.				
5. Indicate the Year 3 ending balance in the Investment account, and cumulative totals for Years 1, 2, and 3 for dividend income and investment income.				

Solution 9-110

Transaction	<u>a) FV-NI Method</u>		<u>b) Equity Method</u>	
	Investment Account	Dividend Revenue	Investment Account	Investment Income or Loss
1.	135,000		135,000	

2.			7,500	7,500
		3,750	(3,750)	
3.			3,000	3,000
		3,750	(3,750)	
4.			(1,800)	(1,800)
		750	(750)	
5.	135,000	8,250	135,450	8,700

Difficulty: Medium

Learning Objective: Explain and apply the fair value through net income model of accounting for investments.

Section Reference: Measurement - Fair Value through Net Income (FV-NI) Model

Learning Objective: Explain the concept of significant influence and apply the equity method.

Section Reference: Strategic Investments - Investments in Associates

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 9-111 Fair value through other comprehensive income investments – entries

Lekan Corp provided you with the following information about its investment in Adoweye Inc. shares purchased May 2020, and accounted for using the FV-OCI method

Cost	\$ 29,500
Fair value, December 31, 2020	\$ 30,900
Fair value, December 31, 2021	\$ 23,800
Fair value, December 31, 2022	\$ 26,900

Instructions

- Prepare the adjusting journal entries needed on December 31, 2020, 2021, and 2022.
- Determine the balance in the accumulated other comprehensive income on the statement of financial position on each of December 31, 2020, 2021, and 2022.
- Assume Lekan sold its investment in Adoweye Inc. on February 13, 2023, for \$ 28,100. Prepare the journal entry(ies) needed on this date if (1) the FV-OCI method required recycling, and (2) the FV-OCI method did not require recycling.

Solution 9-111

a)

December 31, 2020

Fair Value—OCI Investments	1,400	
Unrealized Gain or Loss - OCI		1,400
December 31, 2021		
Unrealized Gain or Loss - OCI	7,100	
Fair Value—OCI Investments		7,100
December 31, 2022		
Fair Value—OCI Investments	3,100	
Unrealized Gain or Loss - OCI		3,100

	Dec. 31/20	Dec. 31/21	Dec. 31/22
Fair value of FV-OCI investments	\$ 30,900	\$ 23,800	\$ 26,900
Original cost of FV-OCI investments	29,500	29,500	29,500
Balance in accumulated other comprehensive income	\$ 1,400	\$ (5,700)	\$ (2,600)
Proof of balance:			
Entry, Dec. 31/20	\$ 1,400	\$ 1,400	\$ 1,400
Entry, Dec. 31/21	0	(7,100)	(7,100)
Entry, Dec. 31/22	0	0	3,100
Balance at year end	\$ 1,400	\$ (5,700)	\$ (2,600)

b) Balance at year-end:

December 31, 2020 \$ 1,400
 December 31, 2021 \$ (5,700)
 December 31, 2022 \$ (2,600)

c) Entries to record sale in 2023

February 13, 2023

Fair Value—OCI Investments.....	1,200	
Unrealized Gain or Loss - OCI		1,200
Unrealized Gain or Loss (\$ 28,100 – \$ 26,900) = \$ 1,200		
To bring the investments to their fair value		

February 13, 2023

Cash	28,100	
Fair Value—OCI Investments		28,100
To record the proceeds of disposal		

February 13, 2023

Loss on Disposal of Investments – FV - OCI.....	1,400	
Unrealized Gain or Loss - OCI		1,400

(1) With recycling

February 13, 2023

Retained Earnings	1,400	
Accumulated Other Comprehensive Income		1,400

(2) Without recycling

Unrealized Gain or Loss (\$ 29,500 – \$ 28,100) = \$ 1,400

Difficulty: Medium

Learning Objective: Explain and apply the fair value through other comprehensive income model of accounting for investments.

Section Reference: Measurement - Fair Value through Other Comprehensive Income (FV-OCI) Model

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 9-112 Incurred loss, expected loss, and impairment

Tyne Corporation owns corporate bonds at December 31, 2020, accounted for using the amortized cost model. These bonds have a par value of \$ 864,000 and an amortized cost of \$ 851,000. After an impairment review was triggered, Tyne determined that the discounted impaired cash flows are \$ 796,500 using the current market rate of interest, but are \$ 793,000 using the market rate when the bonds were first acquired. The company follows a policy of directly reducing the carrying amount of any impaired assets.

Instructions

- Assuming Tyne Corporation is a private enterprise that applies ASPE, prepare any necessary journal entry(ies) related to the impairment at December 31, 2020.
- Assuming Tyne Corporation is a private enterprise that applies ASPE, prepare any necessary journal entry(ies) related to a December 31, 2021, fair value of \$ 821,000 and an adjusted carrying amount at that date of \$ 801,000.
- Assuming Tyne applies IFRS and has adopted IFRS 9, prepare any necessary journal entry related to the impairment at December 31, 2020.
- Assuming Tyne applies IFRS and has adopted IFRS 9, prepare any necessary journal entry(ies) related to a December 31, 2021 fair value of \$ 821,000 and an adjusted carrying amount at that date of \$ 801,000.

Solution 9-112

- December 31, 2020

Loss on Impairment	54,500	
Bond Investment at Amortized Cost		54,500

Bond Investment at Amortized Cost ($\$ 851,000 - \$ 796,500$) = $\$ 54,500$
 Under ASPE, the carrying amount is reduced to the higher of the discounted cash flow using a current market rate or the bond's net realizable value. This latter amount is not provided in this situation.

b) December 31, 2021

Bond Investment at Amortized Cost	20,000	
Recovery of Loss from Impairment		20,000

Recovery of Loss from Impairment ($\$ 821,000 - \$ 801,000$) = $\$ 20,000$

c) December 31, 2020

Loss on Impairment	58,000	
Bond Investment at Amortized Cost		58,000

Bond Investment at Amortized Cost ($\$ 851,000 - \$ 793,000$) = $\$ 58,000$
 Under IFRS 9, the carrying amount of a debt instrument is reduced to the discounted remaining estimated cash flows using the historic discount rate.

d) December 31, 2021

Allowance for Investment Impairment	20,000	
Recovery of Loss from Impairment		20,000

Recovery of Loss from Impairment ($\$ 821,000 - \$ 801,000$) = $\$ 20,000$

Difficulty: Medium

Learning Objective: Explain and apply the incurred loss, expected loss, and fair value loss impairment models.

Section Reference: Measurement - Impairment Models

CPA: Financial Reporting

Bloomcode: Application

Bloomcode: Knowledge

AACSB: Analytic

Ex. 9-113 Significant influence

Julep Corporation purchases a 25% interest in Orange Corporation on January 2, 2020, for \$ 800. At that time, the carrying amount of Orange's net assets was \$ 2,952. Any excess of the cost of the investment over Julep's share of Orange's carrying amount can be attributed to unrecorded intangibles with a useful life of 20 years. Orange declared and paid a dividend of \$ 16 and reported net income of \$ 52 for its year ended December 31, 2020.

Instructions

Prepare Julep's 2020 entries to record all transactions and events related to the investment in its associate. Assume Julep is a publicly accountable enterprise that applies IFRS.

Solution 9-113

January 2, 2020

Investment in Associate	800	
Cash		800

December 31, 2020

Cash	4	
Investment in Associate		4
Dividend received from associate		

December 31, 2020

Investment in Associate	13	
Investment Income or Loss		13
Julep's share of associate's net income		

December 31, 2020

Investment Loss	3	
Investment in Associate		3
Amortization of Orange's unrecognized intangible assets		

Calculations:

Cost of 25% investment in Orange Corp. shares	\$ 800
25% of Orange Corp.'s carrying amount (25% X \$ 2,952)	738
Payment in excess of book value of Orange Corp.	62
Fair value allocation to unrecorded intangibles	(62)
Goodwill (unexplained excess)	\$ 0

Annual amortization of excess payment for unrecorded intangibles
 $\$ 62 \div 20\text{-year remaining life} = \$ 3 \text{ per year}$

Cash = $(\$ 16 \times 25\%) = \$ 4$

Investment Income or Loss = $(\$ 52 \times 25\%) = \$ 13$

Difficulty: Medium

Learning Objective: Explain the concept of significant influence and apply the equity method.

Section Reference: Strategic Investments - Investments in Associates

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 9-114

Charles Inc. purchased 30% of Nassar Corporation's 29,000 outstanding common shares at a cost of \$ 15 per share on January 3, 2020. The purchase price of \$ 15 per share was based solely on the book value of Nassar's net assets. On September 21, Nassar declared and paid a cash dividend of \$ 37,800. On December 31, Charles's year end, Nassar reported net income of \$ 82,000 for the year. Nassar shares had a fair value of \$ 14.75 per share at December 31. Charles Inc., a private Canadian corporation, applies ASPE.

Instructions

Under the assumption that the 30% holding of Nassar does not give Charles significant influence over Nassar, identify the possible accounting methods Charles could use under ASPE to account for its investment. Prepare all required 2020 entries under each acceptable method.

Solution 9-114FV-NI Method:

January 3, 2020

FV—NI Investments	130,500	
Cash		130,500
Cash (29,000 x 30%) = 8,700 shares x \$ 15 = \$ 130,500		

September 21, 2020

Cash	11,340	
Dividend Revenue		11,340

December 31, 2020

Unrealized Gain or Loss	2,175	
FV—NI Investments		2,175
Cash (\$ 37,800 x 30%) =	\$ 11,340	
FV (8,700 shares x \$ 14.75) =	128,325	
Carrying amount =	<u>130,500</u>	
Adjustment required =	\$ (2,175)	

Cost Method:

January 3, 2020

Other Investments	130,500	
Cash		130,500

September 21, 2020

Cash	11,340	

Dividend Revenue 11,340

December 31, 2020

No Entries

Difficulty: Medium

Learning Objective: Explain the concept of significant influence and apply the equity method.

Section Reference: Strategic Investments - Investments in Associates

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 9-115 Significant influence

Describe how to determine if an investment results in significant influence.

Solution 9-115

If the ownership is less than 20%, it is presumed that the investor does not have 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 it is presumed the investor has 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.

Difficulty: Easy

Learning Objective: Explain the concept of significant influence and apply the equity method.

Section Reference: Strategic Investments - Investments in Associates

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

Ex. 9-116 Investment in equity securities

On January 1, 2020, Sally Corp. acquired 30% of Wally Ltd.'s common shares for \$ 500,000. At that time, Wally had 1 million no par common shares issued and outstanding. During 2020, Wally paid total cash dividends of \$ 220,000, and later declared and issued a 5% common stock dividend when the market value was \$ 2 per share. Wally's net income for 2020 was \$ 480,000. Sally is using the equity method to account for this investment. What should be the balance in Sally's investment account at the end of 2020?

Solution 9-116

Cost	\$ 500,000
Share of net income (.3 × \$ 480,000)	144,000
Share of dividends (.3 × \$ 220,000)	<u>(66,000)</u>
	\$ 578,000

Difficulty: Medium

Learning Objective: Explain the concept of significant influence and apply the equity method.

Section Reference: Strategic Investments - Investments in Associates

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 9-117 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 ASPE is followed.
- ___ 2. Under IFRS, the investment would generally require more extensive disclosures.
- ___ 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 through 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 9-117

- 1. T
- 2. T
- 3. F
- 4. T
- 5. F
- 6. F

7. T

Difficulty: Easy

Learning Objective: Explain the concept of significant influence and apply the equity method.

Section Reference: Strategic Investments - Investments in Associates

Learning Objective: Explain the concept of control and when consolidation is appropriate.

Section Reference: Strategic Investments - Investments in Subsidiaries

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

Ex. 9-118

Hanuman Corp is a medium-sized corporation that has long dominated their market. With a strong cash-flow position, they have decided to invest excess cash strategically. In particular, Hanuman made periodic investments with their main supplier, Shiva. Although Hanuman currently owns 18% of the common shares of Shiva, it does not yet have significant influence over the operations of this investee company. Hanuman accounts for its investments in Shiva using IFRS 9 and the fair value through other comprehensive income model without recycling.

The controller has gathered the following information about relevant transactions and requests your assistance in preparing required adjusting entries:

1. In 2020, Hanuman acquires shares of Ahimsa Corp and Metta Ltd, for short-term trading purposes. Hanuman purchased 100,000 shares of Ahimsa for \$ 1.2 million and the shares currently have a fair value of \$ 1.4 million. Hanuman's investment in Metta has not been profitable: the company acquired 45,000 shares of Metta at \$ 20 per share and they currently have a fair value of \$ 634,500.
2. Before 2020, Hanuman had invested \$ 22.4 million in Shiva and, at December 31, 2019, the investment had a fair value of \$ 21.3 million. While Hanuman did not sell or purchase any Shiva shares this year, Hanuman declared and paid a dividend totalling \$ 2.2 million on all its common shares, and reported 2020 net income of \$ 13.6 million. Hanuman's 18% ownership of Shiva has a December 31, 2020, fair value of \$ 21,405,000.

Instructions

- a) Prepare the appropriate adjusting entries for Hanuman as at December 31, 2020.
- b) Prepare the dividend and adjusting entries for the Shiva investment, assuming that Hanuman's 18% interest results in significant influence over Shiva's activities.

Solution 9-118

a) Adjusting entries for Hanuman as at December 31, 2020:

Investment Income or Loss	65,500	
FV – NI Investments.....		65,500

To adjust the investments to their fair value

Investment in trading (FV–NI) securities:

Securities	Cost	Fair Value	Unrealized Gain (Loss)
Ahimsa	\$ 1,200,000	\$ 1,400,000	\$ 200,000
Metta	900,000	634,500	(265,500)
Total of portfolio	\$ 2,100,000	\$ 2,034,500	\$ (65,500)

FV – OCI Investments	105,000	
Investment Income or Loss		105,000
To bring the investment to its fair value		

Investment in FV–OCI securities – Shiva:

Fair value of investment in Shiva	\$ 21,405,000
Carrying amount of investment	21,300,000
Unrealized holding gain	\$ 105,000

b) Dividend and adjusting entries for the Shiva investment, assuming that the 18% interest constitutes significant influence

Investment in Associate	2,448,000	
Investment Income or Loss		2,448,000
To record Investment Income or Loss		
(\$ 13,600,000 x 18%) = \$ 2,448,000		

Cash	396,000	
Investment in Associate		396,000
To record the dividend received from investments		
(\$ 2.2M x 18%) = \$ 396,000		

Hanuman has significant influence and therefore should apply the equity method. No fair value adjustments are recorded under the equity method.

Difficulty: Medium

Learning Objective: Explain the concept of control and when consolidation is appropriate.

Section Reference: Strategic Investments - Investments in Subsidiaries

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 9-119

In early January 2020, Janus Inc., a private enterprise that applies ASPE, purchased 40% of the common shares of Keqing Corp. for \$ 484,000. Janus was now able to exercise considerable influence in decisions made by Keqing's management. Keqing Corp.'s statement of financial position reported the following information at the date of acquisition:

Assets not subject to being amortized	\$ 242,000
Assets subject to amortization (10 years average life remaining)	732,000
Liabilities	136,000

Additional information:

- Both the carrying amount and fair value are the same for assets that are not subject to amortization and for the liabilities.
- The fair value of the assets subject to amortization is \$ 885,000.
- The company amortizes its capital assets on a straight-line basis.
- Keqing reported net income of \$ 192,000 and declared and paid dividends of \$ 132,000 in 2020.

Instructions

- Prepare the journal entry to record Janus's investment in Keqing Corp. Assume that any unexplained payment is goodwill.
- Assuming Janus applies the equity method to account for its investment in Keqing, prepare the journal entries to record Janus' equity in the net income and the receipt of dividends from Keqing Corp. in 2020.
- Assume the same factors as above and in part (b), except that Keqing's net income included a loss on discontinued operations of \$ 45,000 (net of tax). Prepare the journal entries necessary to record Janus's equity in the net income of Keqing for 2020.

Solution 9-119

- a)
- | | | |
|------------------------------|---------|---------|
| Investment in Associate..... | 484,000 | |
| Cash | | 484,000 |
- b)
- | | | |
|--|--------|--------|
| Cash | 52,800 | |
| Investment in Associate..... | | 52,800 |
| To record dividends (\$ 132,000 x.40) | | |
| Investment in Associate..... | 76,800 | |
| Investment Income or Loss | 76,800 | |
| To record net income (\$ 192,000 x.40) | | |
| Investment Income or Loss | 6,120 | |

Investment in Associate.....	6,120
To record amortization (\$ 61,200 ÷ 10)	

c)

Loss on Discontinued Operations	18,000	
Investment in Associate.....	76,800	
Investment Income or Loss		94,800
To record net income and loss on discontinued operations:		
(\$ 45,000 x .40)		
Investment Income or Loss \$ 237,000 x 0.40		
Investment Income or Loss	6,120	
Investment in Associate.....		6,120
To record amortization (\$ 61,200 ÷ 10)		

In 2020, Janus Inc. will include investment income in continuing operations of \$ 94,800 – \$ 6,120 = \$ 88,680; and an investment loss of \$ 18,000 in discontinued operations; for a total of \$ 88,680 – \$ 18,000 = \$ 70,680 in net income. Note that this is the same total amount as reported in part b), but it is presented in two different places within net income.

Difficulty: Medium

Learning Objective: Explain how investments are presented and disclosed in the financial statements, noting how this facilitates analysis.

Section Reference: Presentation, Disclosure, and Analysis

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

PROBLEMS

Pr. 9-120 Transaction costs

Discuss whether transaction costs (fees, commissions, or transfer taxes), directly related to the acquisition of financial assets initially measured at their fair value should be expensed immediately or added to the cost of the asset acquired.

Solution

The answer is—it depends. It is logical to capitalize the transaction costs associated with any investment that is accounted for using a cost-based model because transaction costs are a necessary cost of acquiring the asset. Alternatively, for assets accounted for using a fair value model, it makes more sense to expense the transaction costs because the fair value of an asset is its market price. Regardless of how transaction costs are accounted for at acquisition, they are **not included** in the fair value amount at later statement of financial position dates.

Difficulty: Easy

Learning Objective: Understand the nature of and basic accounting for investments, including which types of companies have significant investments.

Section Reference: Understanding Investments

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Pr. 9-121 Accounting for bonds – amortized cost model (IFRS)

On January 1, 2020, on their issue date, Diogenes Inc. purchased 9%, \$ 200,000, 10-year bonds. Interest is paid annually on December 31. Diogenes uses the amortized cost model and the effective-interest method for amortizing premium or discount. The current market rate was 10% and as a result Diogenes paid \$ 187,711 for the bonds. On December 31, 2020, the bonds have a market value of \$ 185,000.

Instructions

- a) Record the receipt of interest for 2020.
- b) Record the amortization of the discount for 2020.

Solution 9-121

a) Interest income = \$ 187,711 × .10	\$ 18,771
Actual interest	<u>18,000</u>
Discount amortization	<u>\$ 771</u>
 Cash	 18,000
Bond Investment at Amortized Cost	771

Interest Income	18,771

- b) No entry is required. Using the amortized cost model, an entry would only be required if there had been an impairment in value. Since this is not mentioned, we can assume there is no impairment. The investment is reported at amortized cost.

Difficulty: Medium

Learning Objective: Explain and apply the cost/amortized cost model of accounting for investments.

Section Reference: Measurement - Cost/Amortized Cost Model

CPA: Communication

CPA: Financial Reporting

Bloomcode: Application

AACSB: Communication

Pr. 9-122 Accounting for debt instruments purchased at a discount – FV–NI model

On January 1, 2020, Pluto Corp. acquired 6%, \$ 100,000 (face value) bonds of Uranus Ltd., to yield 8%. The bonds were dated January 1, 2020, and mature on December 31, 2025, with interest payable each January 1. Pluto intends to hold the bonds to maturity, and will use the FV–NI model and the effective-interest method of amortization of bond premium or discount.

Instructions

Prepare the following entries in Pluto's books:

- Acquisition of bonds on January 1, 2020,
- Year-end adjusting entry at December 31, 2020,
- Receipt of the first interest payment on January 1, 2021.

Round all values to the nearest dollar.

Solution 9-122

a) Acquisition of bonds on January 1, 2020

PV of principal: \$ 100,000 (PVF*5, 8%) = \$ 100,000 x 0.68058	\$ 68,058
PV of interest: (PVF*OA 5, 8%) = \$ 6,000 x 3.99271	<u>23,956</u>
Present value of bond	\$ 92,014

OR 5 N 8 I 6000 PMT 100000 FV CPT PV => 92,014

FV–NI Investments	92,014	
Cash		92,014

b) Year-end adjusting entry at December 31, 2020

Interest Receivable	6,000
FV–NI Investments	1,361

Interest Income	7,361

$$\$ 100,000 \times 6\% = \$ 6,000$$

$$\$ 92,014 \times 8\% = \$ 7,361$$

$$\$ 6,000 - \$ 7,361 = \$ 1,361$$
c) Receipt of first interest payment on January 1, 2021

Cash	6,000	
Interest Receivable		6,000

Difficulty: Medium

Learning Objective: Explain and apply the fair value through net income model of accounting for investments.

Section Reference: Measurement - Fair Value through Net Income (FV-NI) Model

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 9-123 Temporary investments – FV-NI model

During your examination of the financial statements of Venus Corporation for the year ended December 31, 2020, you found a new account called "Investments." Your examination revealed that during 2020, Venus began a program of investments, and all investment-related transactions were entered in this account. Your analysis of this account for 2020 follows:

VENUS CORPORATION
Analysis of Investments
Year Ended December 31, 2020

<u>Date—2020</u>	<u>Debit</u>	<u>Credit</u>

(i)

Jupiter Ltd. Common Shares

Feb. 14	Purchased 3,000 shares @ \$ 55 per share.	\$ 165,000	
Jul. 26	Received 300 Jupiter common shares as a stock dividend. (Memorandum entry)		
Sep. 28	Sold the 300 Jupiter common shares received July 26 @ \$ 70 per share.....		\$ 21,000

(ii)

Mars 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:

- The market values for each security during 2020 follow:

<u>Security</u>	<u>Feb 14</u>	<u>Apr 30</u>	<u>Jul 26</u>	<u>Sep 28</u>	<u>Dec 31</u>
Jupiter Ltd.	\$ 55		\$ 62	\$ 70	\$ 72
Mars Ltd.		\$ 40			32
Venus Corp.	25	28	30	33	35

- All of the investments of Venus are nominal in respect to percentage of ownership (five percent or less).
- Each investment is considered by Venus's management to be temporary.
- The company has adopted ASPE and intended to use the FV-NI method to account for these investments.
- Venus follows a policy of separately reporting dividend income.

Instructions

- Prepare any necessary correcting journal entries related to investments (i) and (ii).
- Prepare the entry, if necessary, to record the proper valuation of these investments at December 31, 2020.

Solution 9-123

(i) Jupiter Ltd.	original purchase	3,000 shares
	stock dividend	<u>300 shares</u>
	total holding	<u>3,300 shares</u>

Total cost of \$ 165,000 ÷ Total shares of 3,300 = \$ 50 average cost per share

Sold 300 shares

Correct entry:

Cash (300 × \$ 70).....	21,000	
FV-NI Investments—Jupiter (300 x \$ 50).....		15,000
Investment Income or Loss		6,000

Entry made:

Cash	21,000	
Investments.....		21,000

Correction:

Investments.....	21,000	
FV-NI Investments		15,000
Investment Income or Loss		6,000

- Mars Ltd. - should record cash dividend as dividend income.

Correct entry:

Cash	6,000	
Dividend Revenue		6,000

Entry made:

Cash	6,000	
Investments.....		6,000

Correction:

Investments.....	6,000	
Dividend Revenue		6,000

b) Valuation at year end:

	<u>Quantity</u>	<u>Cost</u>	<u>Market Value</u>	<u>Increase (Decrease)</u>
Jupiter	3,000 shares	\$ 150,000	\$ 216,000	\$ 66,000
Mars	5,000 shares	<u>200,000</u>	<u>160,000</u>	<u>(40,000)</u>
		<u>\$ 350,000</u>	<u>\$ 376,000</u>	<u>\$ 26,000</u>

Year-end Adjustment:

FV–NI investments—Jupiter	66,000	
Investment Income or Loss		66,000
 Investment Income or Loss	40,000	
FV–NI Investments—Mars		40,000

Difficulty: Medium

Learning Objective: Explain and apply the fair value through net income model of accounting for investments.

Section Reference: Measurement - Fair Value through Net Income (FV–NI) Model

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 9-124 Year-end adjustments for temporary investments

Mercury Corp. has the following portfolio of common shares (without significant influence) at December 31, 2020:

<u>Investment</u>	<u>Cost</u>	<u>Fair value</u>
Albania Inc.	\$ 480,000	\$ 570,000
Bulgaria Ltd.	90,000	620,000
Czech Corp.	<u>120,000</u>	<u>220,000</u>
Total	<u>\$ 690,000</u>	<u>\$ 1,410,000</u>

Instructions

Provide the entry to record the year-end adjustment for these investments, assuming Mercury uses one control account and has adopted the FV–NI model.

Solution 9-124

FV–NI Investments	720,000	
Investment Income or Loss		720,000

Difficulty: Medium

Learning Objective: Explain and apply the fair value through net income model of accounting for investments.

Section Reference: Measurement - Fair Value through Net Income (FV–NI) Model

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 9-125 Accounting for debt investments purchased at a premium – FV–NI model

On January 1, 2020, Pluto Corp. acquired 8%, \$ 100,000 (face value) bonds of Uranus Ltd., to yield 6%. The bonds were dated January 1, 2020, and mature on December 31, 2025, with interest payable each January 1. Pluto intends to hold the bonds to maturity, and will use the FV–NI model and the effective-interest method of amortization of bond premium or discount.

Instructions

Prepare the following entries in Pluto's books:

- Acquisition of bonds on January 1, 2020,
- Year-end adjusting entry at December 31, 2020,
- Receipt of the first interest payment on January 1, 2021.

Round all values to the nearest dollar.

Solution 9-125**a) Acquisition of bonds on January 1, 2020**

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	\$ 33,699
Present value of bond	\$ 108,425

OR 5 N 6 I 8000 PMT 100000 FV CPT PV => 108,425

FV–NI Investments	108,425	
Cash		108,425

b) Year-end adjusting entry at December 31, 2020

Interest receivable	8,000	
FV-NI Investments		1,494
Interest Income		6,506

\$ 100,000 x 8% = \$ 8,000

\$ 108,425 x 6% = \$ 6,506

\$ 8,000 – \$ 6,506 = \$ 1,494

c) Receipt of first interest payment on January 1, 2021

Cash	8,000	
Interest Receivable		8,000

Difficulty: Medium

Learning Objective: Explain and apply the fair value through net income model of accounting for investments.

Section Reference: Measurement - Fair Value through Net Income (FV-NI) Model

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 9-126 Accounting for investments – FV-NI

On December 31, 2020, Hubble Corp. has the following securities in its portfolio of temporary investments:

	<u>Cost</u>	<u>Market</u>
5,000 common shares of Orion Corp.	\$ 80,000	\$ 69,500
10,000 common shares of Rigel Ltd.	<u>91,000</u>	<u>92,500</u>
	<u>\$ 171,000</u>	<u>\$ 162,000</u>

All of the securities had been purchased in 2020. In 2021, Hubble completed the following securities transaction:

Apr 1 Bought 300 common shares of Aries Corp. @ \$ 50 each, plus fees of \$ 550.

On December 31, 2021, Hubble's portfolio of trading equity securities appeared as follows:

	<u>Cost</u>	<u>Market</u>
5,000 common shares of Orion Corp.	\$ 80,000	\$ 78,000
10,000 common shares of Rigel Ltd.	91,000	99,250
300 common shares of Aries Corp.	<u>15,000</u>	<u>12,750</u>
	<u>\$ 186,000</u>	<u>\$ 190,000</u>

Instructions

Assuming Hubble uses the FV-NI model, prepare the general journal entries for:

a) the 2020 year-end adjusting entry,

- b) the purchase of the Aries Corp. shares,
- c) the 2021 year-end adjusting entry.

Solution 9-126

a) December 31, 2020		
Investment Income or Loss	9,000	
FV-NI Investments		9,000
(\$ 171,000 – \$ 162,000)		
b) April 1, 2021		
FV-NI Investments	15,000	
Finance Expense	550	
Cash [(300 x \$ 50) + \$ 550]		15,550
c) December 31, 2021		
FV-NI Investments	13,000	
Investment Income or Loss		13,000
190,000 – (162,000 + 15,000) = 13,000		

Difficulty: Medium

Learning Objective: Explain and apply the fair value through net income model of accounting for investments.

Section Reference: Measurement - Fair Value through Net Income (FV-NI) Model

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 9-127 Long-term investment – FV-NI method

Ceres Corporation is considering making a significant long-term investment in Pisces Ltd., a young and very promising company. Ceres decides to make a smaller investment first, and if Pisces turns out to be successful, Ceres intends to make an additional investment to reach significant influence. Pisces has 200,000 shares authorized, and 110,000 shares outstanding.

On January 1, 2020, Pisces issues Ceres 10,000 shares for \$ 400,000 in cash (so now there are 120,000 shares outstanding).

Additional information:

- On November 1, 2020, Pisces declares a total cash dividend of \$ 180,000.
- Pisces reports \$ 225,000 net income for 2020. Its stock price on December 31, 2020 is \$ 38.
- On November 1, 2021, Pisces announces a total dividend of \$ 270,000 to be paid on January 2, 2022.

4. Pisces reports \$ 360,000 net income for 2021. Its stock price on December 31, 2021 is \$ 44.
5. On March 15, 2022, Ceres is approached by an investment fund which offers to buy all their Pisces shares for \$ 55 per share, a 25% premium over the current stock price of \$ 44. Ceres accepts the offer and sells the shares on that day.

Instructions

Assuming Ceres uses the fair value through net income model (FV–NI) to account for this investment:

- a) Prepare the journal entries in Ceres's books for the 2020 calendar year.
- b) Prepare the journal entries in Ceres's books for the 2021 calendar year.
- c) Prepare the journal entries in Ceres's books for the 2022 calendar year.

Solution 9-127

a) 2020 Entries

FV–NI Investment—Pisces	400,000	
Cash.....	400,000	
To record the initial investment on January 1, 2020		
 Cash	15,000	
Dividend Revenue		15,000
To record Ceres's share of the dividend on November 1, 2020		
\$ 180,000 x 10,000 ÷ 120,000 = \$ 15,000		
 Investment Income or Loss.....	20,000	
FV–NI Investment—Pisces.....		20,000
To record holding loss on December 31, 2020		
(\$ 38 – \$ 40) x 10,000 = \$ 20,000		

b) 2021 Entries

Dividend Receivable.....	22,500	
Dividend Revenue		22,500
To record Ceres's share of the dividend declared on November 1, 2021		
\$ 270,000 x 10,000 ÷ 120,000 = \$ 22,500		
 FV–NI Investment—Pisces	60,000	
Investment Income or Loss.....		60,000
To record holding gain on December 31, 2021		
(\$ 44 – \$ 38) x 10,000 = \$ 60,000		

c) 2022 Entries

Cash.....	22,500	
Dividend Receivable.....		22,500

To record receipt of dividend on January 2, 2022

Cash	550,000	
FV-NI Investment—Pisces		440,000
Gain on Disposal of Investments- FV-NI		110,000
To record gain on disposal of Pisces shares on March 15, 2022		
$\$ 55 \times 10,000 = \$ 550,000$		
$(\$ 55 - \$ 44) \times 10,000 = \$ 110,000$		

Difficulty: Medium

Learning Objective: Explain and apply the fair value through net income model of accounting for investments.

Section Reference: Measurement - Fair Value through Net Income (FV-NI) Model

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 9-128 Equity method (ASPE)

On January 1, 2019, Titanic Corp. bought 30,000 shares of the available 100,000 common shares of Iceberg Inc., a publicly traded firm. This acquisition provided Titanic with significant influence. Titanic paid \$ 700,000 cash for the investment. At the time of the acquisition, Iceberg reported 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 2019 Iceberg reported net income of \$ 400,000 and paid total cash dividends of \$ 100,000. On May 16, 2020, Titanic sold 15,000 of its shares in Iceberg for \$ 425,000. Titanic has no immediate plans to sell its remaining investment in Iceberg.

Iceberg is actively traded, and stock price information follows:

January 1, 2019 \$ 23

December 31, 2019 \$ 25

January 1, 2020 \$ 26

Instructions

- Assuming Titanic is using ASPE, did the initial investment include a payment for goodwill? Provide support for your answer.
- At the end of 2019, what would appear on the income statement and balance sheet of Titanic in connection with its investment in Iceberg? Show supporting calculations.
- Provide the entry to account for Titanic's sale of the shares in May 2020. How should Titanic account for its remaining investment in Iceberg?

Solution 9-128

- a) Note that, even using ASPE, since Iceberg is quoted in an active market, Titanic must use the equity method.

Purchase price.....	\$ 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% x \$ 1,530,000)	<u>(459,000)</u>
Goodwill.....	<u>\$ 241,000</u>
*\$ 2,500,000 + (\$ 730,000 – \$ 500,000)	

b)	
Share of net income (\$ 400,000 x 30%).....	\$ 120,000
Less: amortization of fair value increment	
(\$ 730,000 – \$ 500,000) ÷ 5.....	\$ 46,000
Investor portion 30%.....	<u>(13,800)</u>
Investment income on income statement.....	<u>\$ 106,200</u>

Cost	\$ 700,000
Plus: investment income	106,200
Less: dividends received (\$ 100,000 x 30%)	<u>(30,000)</u>
Investment account on balance sheet	<u>\$ 776,200</u>

c)	
Cash.....	425,000
Investment in Associate.....	388,100
Gain on Disposal of Investments in Associate.....	.36,900
To record the sale of the shares	
\$ 776,200 x 50% = \$ 388,100	

After this sale, Titanic will no longer have significant influence over Iceberg. As a result, the use of the equity method will no longer be appropriate. Under ASPE, Titanic can choose the cost or fair value through net income (FV–NI) model for its remaining investment in Iceberg.

Difficulty: Medium

Learning Objective: Explain and apply the fair value through net income model of accounting for investments.

Section Reference: Measurement - Fair Value through Net Income (FV–NI) Model

Learning Objective: Explain the concept of significant influence and apply the equity method.

Section Reference: Strategic Investments - Investments in Associates

CPA: Communication

CPA: Financial Reporting

Bloomcode: Application
AACSB: Communication

Pr. 9-129 Equity method – IFRS

Capricorn Corporation decided to purchase 35% of the outstanding shares of Aquarius Ltd. Capricorn's CFO conducted an extensive evaluation of the financial statements of Aquarius and reported his findings to the board of directors in the following memo:

Dear Board of Directors,

Following your request, I conducted a detailed analysis of Aquarius Ltd. I found out that the liabilities reported in its books at December 31, 2019 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. Aquarius 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 Aquarius'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 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, CPA

The board of directors of Capricorn Corporation adopted the report by Mr. Connor and on January 1, 2020, purchased 35% of the shares of Aquarius, based on its fair value according to Mr. Connor's analysis. After the acquisition of the shares, Capricorn was able to exercise significant influence over Aquarius.

In 2020, Aquarius reported net income of \$ 10M and distributed 40% of it as cash dividends. In 2021, the earnings of Aquarius doubled compared with 2020. Aquarius distributed 60% of its income as cash dividends.

On December 31, 2021, Capricorn sold its investment in Aquarius Ltd. for \$ 20M.

Instructions

Assuming Capricorn accounts for this investment using the method required under IFRS,

- a) Record the initial purchase by Capricorn Corp.
- b) Record the entries related to the investment in Aquarius Ltd. for 2020.
- c) Record the entries related to the investment in Aquarius Ltd. for 2021.

Solution 9-129

- a) Calculation of amount paid

Net book value of Aquarius (45 – 20)	25M	
Fair value of patent	12M	
Excess value of land (9 – 6).....	3M	
Excess value of building (8 – (10 – 6))	<u>4M</u>	
Fair value of Aquarius.....	44M	
Shares held	35%	
Amount paid	<u>15.4M</u>	

b) Journal entries for 2020

Investment in Associate.....	15.4M	
Cash.....		15.4M
To record initial investment		

Calculation of income to be recorded by Capricorn:

Aquarius's net income	10M	
Capricorn's ownership	<u>35%</u>	
Capricorn's share of net income.....	3.5M	
Amortization of patent (12M ÷ 6) x 35%	(0.7M)	
Excess depreciation of the building (4M x 35%) ÷ 20	<u>(0.07M)</u>	
Capricorn's adjusted share in Aquarius's net income	<u>2.73M</u>	

Investment in Associate.....	2.73M	
Investment Income or Loss		2.73M

Cash	1.4M	
Investment in Associate.....		1.4M
To record dividend distribution (10M x 40% x 35%)		

c) Journal entries for 2021

For recording its share in Aquarius's net income, the only adjustment to the 2020 calculations is that income now is 20M and Capricorn's share is \$ 7M, an increase of \$ 3.5M compared with 2020. Thus, investment income increases to 6.23M (2.73 + 3.5).

Investment in Associate.....	6.23M	
Investment Income or Loss.....		6.23M

Cash.....	4.2M	
Investment in Associate.....		4.2M
To record dividend distribution (10M x 2 x 60% x 35%)		

By the end of 2021, the value of the investment in Capricorn's books is as follows:

Initial investment	15.4	

Investment income 2020.....	2.73	
Dividend 2020	(1.4)	
Investment income 2021.....	6.23	
Dividend 2021	<u>(4.2)</u>	
Investment in Aquarius Dec 31/21.....	18.76M	
Selling price	<u>20.00M</u>	
Gain on disposal of investment	<u>1.24M</u>	
Cash.....	20M	
Investment in Associate.....		18.76M
Gain on Disposal of Investments in Associate.....		
1.24M		

Difficulty: Medium

Learning Objective: Explain the concept of significant influence and apply the equity method.

Section Reference: Strategic Investments - Investments in Associates

CPA: Communication

CPA: Financial Reporting

Bloomcode: Application

AACSB: Communication

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CHAPTER 10

PROPERTY, PLANT, AND EQUIPMENT: ACCOUNTING MODEL BASICS

CHAPTER STUDY OBJECTIVES

1. Identify the business importance and characteristics of property, plant, and equipment assets and explain the recognition criteria. Almost every enterprise invests in long-lived assets. These long-term items include both those that are physical assets—property, plant, and equipment—and those that are intangible. Long-lived assets are particularly important for manufacturing companies because they provide the company with the capacity or infrastructure to produce goods and/or provide services.

Property, plant, and equipment assets are tangible assets held for use in the production of goods and services, for rental to others, or for administrative purposes, and have a useful life of more than one accounting period. This type of asset provides an entity with its operating capacity and infrastructure, but also adds to fixed costs. For this reason, it is important that a company invest enough in PP&E to meet its potential, but not so much that it has to bear the related costs of overcapacity.

PP&E costs that provide probable future economic benefits to the entity and that can be measured reliably are recognized as assets. Asset components should be recognized separately to the extent their costs are significant and/or the related assets have different useful lives or patterns of depreciation.

2. Identify the costs to include in the measurement of property, plant, and equipment at acquisition. Asset costs used when measuring PP&E include all necessary costs directly attributed to acquiring the asset, bringing it to its location, and making it ready for use. These include direct material, direct labour, and variable overhead costs for self-constructed PP&E assets, borrowing costs for those taking substantial time to get ready for use, and dismantling and restoration costs required as a result of the asset's acquisition. Once the asset is in place and ready for use, costs are no longer capitalized.

3. Determine asset cost when the transaction has delayed payment terms or is a lump-sum purchase, a nonmonetary exchange, or a contributed asset. Cost means the asset's cash equivalent cost. When payment is deferred beyond normal credit terms, the excess paid over cash cost is interest. When a number of assets are acquired in a basket purchase, the cost is allocated based on the relative fair value of each. When PP&E assets are acquired and paid for by issuing the entity's shares, cost is usually determined as the fair value of the asset acquired. When acquired in an exchange of assets, cost is the fair value of the assets given up,

unless the fair value of the assets received can be more reliably measured. However, if the transaction lacks commercial substance or fair values cannot be reliably determined, the assets acquired are measured at the book value of the assets given up. This amount cannot exceed the fair value of the assets acquired. Assets contributed to a company are measured at fair value and credited to Contributed Surplus if donated by a shareholder. This is rare. If contributed by government, the contribution is accounted for under the income approach – the amount credited flows through the income statement, usually as the asset is used by the entity..

4. Identify the costs included in specific types of property, plant, and equipment.

Land: Includes all expenditures made to acquire land and to make it ready for use. Land costs typically include the purchase price; closing costs, such as title to the land, legal fees, and registration fees; costs incurred to condition the land for its intended use, such as grading, filling, draining, and clearing; the assumption of any liens, mortgages, or encumbrances on the property; and any additional land improvements that have an indefinite life. **Buildings, including investment property:** Includes all expenditures related directly to their acquisition or construction. These costs include materials, labour, and direct overhead costs that are incurred during construction and professional fees and building permits.

Equipment: Includes the purchase price, freight, and handling charges that are incurred; insurance on the equipment while it is in transit; the cost of special foundations if they are required; assembling and installation costs; and the costs incurred in calibrating the equipment so that it can be used as intended. **Mineral resource properties:** Four types of costs may be included in establishing the cost of mineral resource assets: (1) acquisition (2) exploration and evaluation (3) development, and (4) site restoration and asset retirement costs. Two main methods of accounting for oil and gas properties are the full cost method and the successful efforts method.

5. Understand and apply the cost model, and the revaluation model using the asset adjustment method and the fair value model. The cost model is appropriate for all classes of PP&E, including investment property. Under this model, the assets are carried at cost less accumulated depreciation and any accumulated impairment losses.

Under IFRS, the revaluation model may be applied to any class of PP&E except investment property, provided fair value can be measured reliably. Under this model, the assets are carried at their fair value at the revaluation date less any subsequent accumulated depreciation and any subsequent accumulated impairment losses. While held, net increases in fair value are not reported in income, but are accumulated in a Revaluation Surplus (OCI) account in equity. Net losses are reported in income once the revaluation surplus has been eliminated. At the time of revaluation, under the asset adjustment method, the accumulated depreciation account is eliminated (written off against the asset itself). The asset is then adjusted to its new revalued amount.

The fair value model can be applied only to investment property under IFRS, and the choice between cost and fair value must be made for all investment property reported. Under this model, all changes in fair value are recognized in net income. No depreciation is recognized.

6. Explain and apply the accounting treatment for costs incurred after acquisition. Day-to-day servicing, repair, and maintenance costs, and costs of rearrangement and relocation, are expensed as incurred. PP&E expenditures that provide future economic benefits and whose costs can be reliably measured are capitalized. The cost of additions, replacements, and major overhauls and inspections are capitalized and the carrying amount of the replaced asset or the previous overhaul or inspection is removed.

7. Identify differences in accounting between IFRS and ASPE, and what changes are expected in the near future. In general, the accounting for PP&E assets is very similar under both IFRS and ASPE because the principles underlying both are very similar. However, under IFRS, practice remains closer to the principles identified. This is seen, for example, in accounting for components and major overhauls and inspections, incidental revenues and expenses before asset use, and borrowing costs. IFRS permits application of a revaluation model and a fair value model, neither of which is acceptable under ASPE. The IASB is researching activities related to the extractive industry with the objective of developing accounting standards to cover the exploration for, and the development and extraction of, minerals and oil and gas resources and assets.

8. Calculate the amount of borrowing costs to capitalize for qualifying assets. The avoidable borrowing costs related to the financing of eligible expenditures on qualifying assets are capitalized to the extent they are less than the total borrowing costs incurred in the period.

9. Understand and apply the revaluation model using the proportionate method. The revaluation model may be applied using the proportionate method, provided fair value can be measured reliably. Similar to the asset adjustment method, the amounts debited or credited to the Revaluation Surplus (OCI) account are reported in the statement of comprehensive income as other comprehensive income (OCI) items. However, when revaluing an asset, the account is adjusted proportionately so that both the carrying amount of the asset and the accumulated depreciation are adjusted (upwards if there has been an increase in fair value, or downwards for a decrease in fair value). After adjustment, the net balance is the fair value of the asset at the revaluation date

MULTIPLE CHOICE

Answer	No.	Description
c	1.	Definition of PPE
b	2.	Examples of PPE
d	3.	Recognition of PPE acquisitions
c	4.	Items included in cost of PPE
c	5.	Capitalization of borrowing costs
b	6.	Treatment of restoration costs
b	7.	Accounting for PST
a	8.	Self-constructed assets
c	9.	Calculate cost of truck purchased
c	10.	Purchase of PPE on long-term contract
a	11.	PPE acquired by issuance of public company's shares
d	12.	PPE acquired by issuance of private company's shares
b	13.	Accounting for donated assets
b	14.	Valuation of donated assets
a	15.	Exchange of assets
b	16.	Accounting for asset exchanges
b	17.	Accounting for government grant
d	18.	Allocation of cost of a lump-sum purchase
d	19.	Acquisition of equipment by exchange of shares held as an investment
c	20.	Exchange of similar assets

- c 21. Exchange of similar assets
- c 22. Purchase of asset with long-term note
- b 23. Purchase of asset with long-term note
- d 24. Gain or loss with no commercial substance
- b 25. Calculate cost of machine purchased
- c 26. Calculate cost of machine purchased
- a 27. Cash discounts
- d 28. Valuation of a nonmonetary exchange
- c 29. Exchange of similar assets
- c 30. Valuation of replacement equipment
- c 31. Calculate cost of land acquired
- b 32. Calculate cost of land
- a 33. Calculate cost of building
- d 34. Calculate cost of land and building
- c 35. Determine cost of land
- a 36. Accounting for land costs
- b 37. Inclusion of land in PPE
- d 38. Costs of land improvements
- d 39. Accounting for land and building purchase
- d 40. Measurement of biological assets
- b 41. Classification of sale of building
- c 42. Features of the cost model
- a 43. Features of the revaluation model (asset adjustment method)
- d 44. Accounting with revaluation model
- a 45. Revaluation surplus
- b 46. Features of the fair value model
- c 47. Application of the cost model
- c 48. Components of PP&E assets
- a 49. Application of the revaluation model
- d 50. Application of the revaluation model
- b 51. Application of the revaluation model
- a 52. Application of the fair value model
- d 53. Revenue expenditures
- c 54. Capital expenditures
- a 55. Repairs
- b 56. Components of PP&E assets
- d 57. Costs subsequent to acquisition
- a 58. Comparing IFRS to ASPE
- a 59. Comparing IFRS to ASPE
- a 60. Comparing IFRS to ASPE
- a 61. Comparing IFRS to ASPE
- d *62. Capitalization of borrowing costs

- b *63. Weighted-average accumulated expenditures
- d *64. Capitalization of borrowing costs
- b *65. Calculate amount of interest to be capitalized
- a *66. Calculate weighted-average accumulated expenditures
- c *67. Calculate amount of interest to be capitalized
- b *68. Calculate weighted-average accumulated expenditures
- b *69. Calculate weighted-average accumulated expenditures
- c *70. Calculate weighted-average accumulated expenditures
- c *71. Features of the revaluation model (proportionate method)
- a *72. Revaluation model (proportionate method)
- c *73. Revaluation model (proportionate method)

EXERCISES

Item	Description
E10-74	Componentization
*E10-75	Plant asset accounting
E10-76	Asset exchange with commercial substance
E10-77	Non-interestbearing note
E10-78	Nonmonetary transaction without commercial substance
E10-79	Asset exchange
E10-80	Acquisition cost
E10-81	Costs included in assets
E10-82	Application of the revaluation model
E10-83	Measurement models
E10-84	Application of the fair value model
E10-85	Cost model versus revaluation model versus fair value model
E10-86	Trade-off with historical cost model
E10-87	Revaluation model
* E10-88	Difference between proportionate and asset adjustment methods
*E10-89	Capitalization of interest
*E10-90	Capitalization of interest
E10-91	Revaluation model (proportionate method)

PROBLEMS

Item	Description
P10-92	Asset exchanges
P10-93	Asset exchange – no commercial substance
P10-94	Asset exchange – no commercial substance
P10-95	Nonmonetary exchange
P10-96	Accounting for government grant

P10-97	Purchase of asset by non-interestbearing note
P10-98	Costs included in assets
P10-99	Revaluation model
P10-100	Fair value model
P10-101	Asset overhaul
*P10-102	Capitalization of borrowing costs
*P10-103	Capitalization of borrowing costs
* P10-104	Revaluation model (proportionate method)

MULTIPLE CHOICE

1. Which of the following is NOT included in the IAS16 definition of property, plant, and equipment (PPE)?
- a) PPE will be used over more than one accounting period.
 - b) PPE is held for use in the production of goods and services.
 - c) PPE can be tangible or intangible.
 - d) PPE is tangible.

Answer: c

Difficulty: Easy

Learning Objective: Identify the business importance and characteristics of property, plant, and equipment and explain the recognition criteria.

Section Reference: Definition and Recognition of Property, Plant, and Equipment

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

2. Examples of property, plant, and equipment include

- a) land, equipment, vehicles.
- b) equipment, apple trees, mineral resource property.
- c) machinery, livestock, patents.
- d) computers, cherry orchards, copyrights.

Answer: b

Difficulty: Easy

Learning Objective: Identify the business importance and characteristics of property, plant, and equipment and explain the recognition criteria.

Section Reference: Definition and Recognition of Property, Plant, and Equipment

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

3. Which of the following statements applies to the recognition of property, plant, and equipment acquisitions?

- a) It is certain that the item's associated future benefits will flow to the entity.
- b) It is probable that the item's associated future benefits will flow to the entity.
- c) The cost can be measured reliably.
- d) It is probable that the item's associated future benefits will flow to the entity, and the cost can be measured reliably.

Answer: d

Difficulty: Easy

Learning Objective: Identify the business importance and characteristics of property, plant, and equipment and explain the recognition criteria.

Section Reference: Definition and Recognition of Property, Plant, and Equipment

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

4. Which of the following would NOT be included in the cost of an item of property, plant, and equipment?

- a) the purchase price net of any trade discounts and rebates
- b) delivery costs
- c) costs of training employees to use the asset
- d) costs of obligations associated with the asset's eventual disposal

Answer: c

Difficulty: Easy

Learning Objective: Identify the costs to include in the measurement of property, plant, and equipment at acquisition.

Section Reference: Cost Elements

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

5. Which of the following does NOT apply to the capitalization of borrowing costs for the purchase of assets?

- a) They can have a significant impact on a company's earnings.
- b) This is allowed under both ASPE and IFRS.
- c) This is not allowed under IFRS.
- d) They must be disclosed in the notes to the financial statements.

Answer: c

Difficulty: Easy

Learning Objective: Identify the costs to include in the measurement of property, plant, and equipment at acquisition.

Section Reference: Cost Elements

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

6. Under ASPE, the costs for environmental clean-up at the end of an asset's useful life

- a) are always expensed as incurred.
- b) are recognized only if they represent a legal obligation.
- c) are capitalized once they have become apparent.
- d) include only costs related to the acquisition of the asset.

Answer: b

Difficulty: Easy

Learning Objective: Identify the costs to include in the measurement of property, plant, and equipment at acquisition.

Section Reference: Cost Elements

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

7. The debit for non-refundable provincial sales tax correctly calculated and paid on the purchase of machinery should be included in

- a) Provincial Sales Tax Expense.
- b) Machinery.
- c) Accumulated Depreciation—Machinery.
- d) Prepaid Provincial Sales Tax.

Answer: b

Difficulty: Easy

Learning Objective: Identify the costs to include in the measurement of property, plant, and equipment at acquisition.

Section Reference: Cost Elements

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

8. How should variable overhead costs incurred to self-construct an asset be recorded?

- a) They should be included in the cost of the asset.
- b) They should be assigned to the cost of inventory production.
- c) They should be written off as a loss for the period.
- d) They should be recorded as a one-time special assessment in a separate asset account.

Answer: a

Difficulty: Easy

Learning Objective: Identify the costs to include in the measurement of property, plant, and equipment at acquisition.

Section Reference: Cost Elements

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

9. Upshaw Ltd. bought a lift truck with a list price of \$ 30,000. The dealer granted a 10% reduction in the list price, and an additional 2% cash discount on the net price when payment

was made in 30 days. Provincial sales tax was \$ 1,785 and Upshaw paid an extra \$ 350 to have a special horn installed. The recorded cost of the truck should be

- a) \$ 29,135.
- b) \$ 31,535.
- c) \$ 28,595.
- d) \$ 28,552.

Answer: c

Difficulty: Medium

Learning Objective: Identify the costs to include in the measurement of property, plant, and equipment at acquisition.

Section Reference: Cost Elements

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $(\$ 30,000 \times .90 \times .98) + \$ 1,785 + \$ 350 = \$ 28,595$

10. Property, plant, and equipment purchased on long-term credit contracts should be accounted for at the

- a) actual cash to be paid in the future.
- b) future amount of the future payments.
- c) present value of the future payments.
- d) future value of the current payments.

Answer: c

Difficulty: Easy

Learning Objective: Determine asset cost when the transaction has delayed payment terms or is a lump-sum purchase, a nonmonetary exchange, or a contributed asset.

Section Reference: Measurement of Cost for Nonmonetary Exchange

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

11. 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) market value of the plant asset.
- b) original cost of the plant asset.
- c) book value of the plant asset.
- d) book value of the shares.

Answer: a

Difficulty: Easy

Learning Objective: Determine asset cost when the transaction has delayed payment terms or is a lump-sum purchase, a nonmonetary exchange, or a contributed asset.

Section Reference: Measurement of Cost for Nonmonetary Exchange

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

12. When a closely held corporation issues preferred shares for land, the land should be recorded at the

- a) total 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.

Answer: d

Difficulty: Easy

Learning Objective: Determine asset cost when the transaction has delayed payment terms or is a lump-sum purchase, a nonmonetary exchange, or a contributed asset.

Section Reference: Measurement of Cost for Nonmonetary Exchange

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

13. When an enterprise is the recipient of a donated asset, the account credited would probably be a(n)

- a) equity account.
- b) revenue account.
- c) deferred revenue account.
- d) asset account.

Answer: b

Difficulty: Easy

Learning Objective: Determine asset cost when the transaction has delayed payment terms or is a lump-sum purchase, a nonmonetary exchange, or a contributed asset.

Section Reference: Measurement of Cost for Nonmonetary Exchange

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

14. A plant site donated by a city 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 statement of financial position).
 - d) the value assigned to it by the company's directors.

Answer: b

Difficulty: Easy

Learning Objective: Determine asset cost when the transaction has delayed payment terms or is a lump-sum purchase, a nonmonetary exchange, or a contributed asset.

Section Reference: Measurement of Cost for Nonmonetary Exchange

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

15. Spock Inc. 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 Spock's books at
- a) \$ 31,000.
 - b) \$ 27,000.
 - c) \$ 19,000.
 - d) \$ 12,000.

Answer: a

Difficulty: Medium

Learning Objective: Determine asset cost when the transaction has delayed payment terms or is a lump-sum purchase, a nonmonetary exchange, or a contributed asset.

Section Reference: Measurement of Cost for Nonmonetary Exchange

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

16. When accounting for asset exchanges,
- a) if a transaction lacks commercial substance, it is not recorded.
 - b) an asset cannot be recognized at more than its fair value.

- c) if the fair values of either the asset given up or the asset received cannot be ascertained, then the Board of Directors may assign an arbitrary value.
 d) when an exchange lacks commercial substance, either a gain or loss may be recognized.

Answer: b

Difficulty: Easy

Learning Objective: Determine asset cost when the transaction has delayed payment terms or is a lump-sum purchase, a nonmonetary exchange, or a contributed asset.

Section Reference: Measurement of Cost for Nonmonetary Exchange

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

17. Mozambique Ltd. received a \$ 250,000 grant from the federal government to help buy equipment as an incentive for them to establish manufacturing operations in Ottawa. Assuming that Mozambique uses the cost reduction method for such transactions, they should record this transaction as a

- a) memo entry only.
 b) credit to Equipment for \$ 250,000.
 c) credit to Deferred Revenue for \$ 250,000.
 d) credit to Contribution Revenue for \$ 250,000.

Answer: b

Difficulty: Easy

Learning Objective: Determine asset cost when the transaction has delayed payment terms or is a lump-sum purchase, a nonmonetary exchange, or a contributed asset.

Section Reference: Measurement of Cost for Nonmonetary Exchange

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

18. Chad Corporation purchased a tract of land for \$ 765,000, which included a warehouse and office building. The following data were collected concerning the property:

	<u>Current Assessed Valuation</u>	<u>Vendor's Original Cost</u>
Land	\$ 300,000	\$ 250,000
Warehouse	200,000	150,000
Office building	<u>400,000</u>	<u>300,000</u>
	<u>\$ 900,000</u>	<u>\$ 700,000</u>

What are the appropriate amounts that Chad 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

Answer: d

Difficulty: Medium

Learning Objective: Determine asset cost when the transaction has delayed payment terms or is a lump-sum purchase, a nonmonetary exchange, or a contributed asset.

Section Reference: Measurement of Costs for Nonmonetary Exchange

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: Land: $3/9 \times \$ 765,000 = \$ 255,000$
 Warehouse: $2/9 \times \$ 765,000 = \$ 170,000$
 Office Building: $4/9 \times \$ 765,000 = \$ 340,000$

19. Frosty Ltd. exchanged 400 common shares of Grants Corp., which Frosty was holding as an investment, for new equipment from Milliken Sales. The Grants Corp. common shares, which had been purchased by Frosty for \$ 80 per share, had a quoted market value of \$ 100 per share at the date of exchange. The equipment had a recorded amount on Milliken's books of \$ 37,000, but the fair value was not available. The journal entry that Frosty should make to record this exchange is

a) Equipment.....	32,000	
Investment in Lesotho Corp Common Shares.....		32,000
b) Equipment.....	37,000	
Investment in Lesotho Corp. Common Shares.....		32,000
Gain on Disposal of Investment		5,000
c) Equipment	37,000	
Loss on Disposal of Investment.....	3,000	
Investment in Lesotho Corp. Common Shares.....		40,000
d) Equipment.....	40,000	
Investment in Lesotho Corp. Common Shares.....		32,000
Gain on Disposal of Investment		8,000

Answer: d

Difficulty: Medium

Learning Objective: Determine asset cost when the transaction has delayed payment terms or is a lump-sum purchase, a nonmonetary exchange, or a contributed asset.

Section Reference: Measurement of Costs for Nonmonetary Exchange

CPA: Financial Reporting

Bloomcode: Analysis

AACSB: Analytic

Feedback: $\text{Gain} = 400 \times (\$ 100 - \$ 80) = \$ 8,000$

20. On January 2, 2020, Neeson Delivery Company traded in an old delivery truck for a newer model. Data relative to the old and new trucks follow:

Old Truck

Original cost	\$ 9,000
Accumulated depreciation at January 2, 2020	6,000
Fair value	3,000

New Truck

List price	\$ 15,000
Cash price without trade-in	14,000
Cash paid with trade-in.....	11,000

The cost of the new truck for financial accounting purposes is

- a) \$ 9,000.
- b) \$ 11,000.
- c) \$ 14,000.
- d) \$ 15,000.

Answer: c

Difficulty: Medium

Learning Objective: Determine asset cost when the transaction has delayed payment terms or is a lump-sum purchase, a nonmonetary exchange, or a contributed asset.

Section Reference: Measurement of Costs for Nonmonetary Exchange

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: \$ 14,000 (fair value of new truck, since this is known)

21. Soflo Inc. acquired a new delivery truck in exchange for an old delivery truck that it had acquired several years earlier for \$ 50,000. On the date of the exchange, the old truck had a fair value of \$ 20,000, and its net book value (carrying value) was \$ 19,000. In addition, Soflo paid \$ 65,000 cash for the new truck, which had a list price of \$ 90,000. At what amount should Soflo record the new truck for financial accounting purposes?

- a) \$ 65,000
- b) \$ 84,200
- c) \$ 85,000
- d) \$ 90,000

Answer: c

Difficulty: Medium

Learning Objective: Determine asset cost when the transaction has delayed payment terms or is a lump-sum purchase, a nonmonetary exchange, or a contributed asset.

Section Reference: Measurement of Costs for Nonmonetary Exchange

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$20,000 + \$65,000 = \$85,000$

22. On January 2, 2020, Gabon Corp. purchases a new machine. The company makes a \$ 2,000 cash down payment, and agrees to pay four annual instalments of \$ 4,000 each, starting December 31, 2020, signing a non-interest-bearing note to this effect. The cash equivalent price of the machine is not known, but the appropriate interest rate for this type of transaction is 9% p.a. Rounding to the nearest dollar (if necessary), Gabon should record the cost of the machine at

- a) \$ 18,000.
- b) \$ 16,000.
- c) \$ 14,959.
- d) \$ 12,959.

Answer: c

Difficulty: Medium

Learning Objective: Determine asset cost when the transaction has delayed payment terms or is a lump-sum purchase, a nonmonetary exchange, or a contributed asset.

Section Reference: Measurement of Costs for Nonmonetary Exchange

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: PV of note: $4 \text{ N } 9 \text{ I } 4000 \text{ PMT PV} = \$12,959$ plus DP of \$ 2,000 = \$ 14,959

23. On January 2, 2020, Zimbabwe Corp. purchases a new machine. The company makes a \$ 3,000 cash down payment, and agrees to pay eight semi-annual instalments of \$ 2,000 each, starting July 1, 2020, signing a non-interest-bearing note to this effect. The cash equivalent price of the machine is not known, but the appropriate interest rate for this type of transaction is 8% p.a. Rounding to the nearest dollar (if necessary), Zimbabwe should record the cost of the machine at

- a) \$ 15,413.
- b) \$ 16,465.
- c) \$ 16,000.
- d) \$ 19,000.

Answer: b

Difficulty: Medium

Learning Objective: Determine asset cost when the transaction has delayed payment terms or is a lump-sum purchase, a nonmonetary exchange, or a contributed asset.

Section Reference: Measurement of Costs for Nonmonetary Exchange

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: PV of note: $8 N \quad 4 I \quad 2000 \quad PMT \quad PV = \$13,465$ plus DP of \$ 3,000 = \$ 16, 465

24. Bally Ho Inc. traded one of its used trailers (cost \$ 15,000, accumulated depreciation \$ 13,500) for another used trailer with a fair value of \$ 2,400. Bally Ho also paid \$ 300 to complete the transaction. Since the exchange will leave Bally Ho in the same economic position, this transaction lacks commercial substance. What is the gain or loss on the exchange?

- a) \$ 900 gain
- b) \$ 675 gain
- c) \$ 225 loss
- d) \$ 0 (no gain or loss)

Answer: d

Difficulty: Medium

Learning Objective: Determine asset cost when the transaction has delayed payment terms or is a lump-sum purchase, a nonmonetary exchange, or a contributed asset.

Section Reference: Measurement of Costs for Nonmonetary Exchange

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: No gain or loss. Asset is recorded at BV of old plus cash paid.

25. On August 1, 2020, Chapelle Corp. purchases a new machine. The company makes a \$ 7,200 cash down payment, and agrees to pay four monthly instalments of \$ 10,800 each, starting September 1, 2020, signing a non-interest-bearing note to this effect. The cash equivalent price of the machine is \$ 43,200. As well, Chapelle pays installation costs of \$ 1,200. The recorded cost of the machine should be

- a) \$ 8,400.
- b) \$ 44,400.
- c) \$ 50,400.
- d) \$ 51,600.

Answer: b

Difficulty: Medium

Learning Objective: Determine asset cost when the transaction has delayed payment terms or is a lump-sum purchase, a nonmonetary exchange, or a contributed asset.

Section Reference: Measurement of Costs for Nonmonetary Exchange

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$43,200 + \$1,200 = \$44,400$

26. On August 1, 2020, Burkina Corp. purchases a new machine. The company makes a \$ 2,000 cash down payment, and agrees to pay four annual instalments of \$ 3,000 each, starting August 1, 2021, signing a non-interest bearing-note to this effect. The cash equivalent price of the machine is \$ 12,500. Due to an employee strike, Burkina could not install the machine immediately, and thus incurred \$ 300 of storage costs. As well, Burkina pays installation costs of \$ 400. The recorded cost of the machine should be

- a) \$ 14,000.
- b) \$ 13,200.
- c) \$ 12,900.
- d) \$ 12,500.

Answer: c

Difficulty: Medium

Learning Objective: Determine asset cost when the transaction has delayed payment terms or is a lump-sum purchase, a nonmonetary exchange, or a contributed asset.

Section Reference: Measurement of Costs for Nonmonetary Exchange

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$12,500 + \$400 = \$12,900$

27. Ben's Delivery buys a van with a list price of \$ 60,000. The dealer grants a 15% reduction in list price and an additional 2% cash discount on the net price if payment is made in 30 days, which Ben's did. Non-refundable sales taxes are \$ 800 and Ben's paid an extra \$ 600 to have a GPS device installed. What amount should Ben's record as the cost of the van?

- a) \$ 51,380.
- b) \$ 49,980.
- c) \$ 51,290.
- d) \$ 50,780.

Answer: a

Difficulty: Medium

Learning Objective: Determine asset cost when the transaction has delayed payment terms or is a lump-sum purchase, a nonmonetary exchange, or a contributed asset.

Section Reference: Measurement of Costs for Nonmonetary Exchange

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $(60,000 \times .85 \times .98) + \$ 800 + \$ 600 = \$ 51,380$

28. Ghana Football Club had a player contract with Mowgli that is recorded in its books at \$ 300,000 on July 1, 2020. Ivory Coast Football Club had a player contract with Eeyore that is recorded in its books at \$ 375,000 on July 1, 2020. On this date, Ghana traded Mowgli to Ivory Coast for Eeyore and paid a cash difference of \$ 37,500. The fair value of the Eeyore contract was \$ 450,000 on the exchange date. After the exchange, the Eeyore contract should be recorded in Ghana's books at

- a) \$ 337,500.
- b) \$ 375,000.
- c) \$ 412,500.
- d) \$ 450,000.

Answer: d

Difficulty: Medium

Learning Objective: Determine asset cost when the transaction has delayed payment terms or is a lump-sum purchase, a nonmonetary exchange, or a contributed asset.

Section Reference: Measurement of Costs for Nonmonetary Exchange

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: \$ 450,000 FV of asset received.

29. Dinga Corp. exchanged similar pieces of equipment with Elongo Corp. No cash was exchanged. Since this exchange will not significantly change the economic position of either company, this transaction lacks commercial substance. At this time, the net book value of Dinga's asset is \$ 36,000, while the net book value of Elongo's asset on their books is \$ 33,300. However, it has been reliably determined that the fair value of Dinga's asset is \$ 36,900, while the fair value of Elongo's asset is \$ 34,200. Given these facts, at what amount should Dinga record the asset it receives from Elongo?

- a) \$ 36,900
- b) \$ 36,000
- c) \$ 34,200

d) \$ 33,300

Answer: c

Difficulty: Medium

Learning Objective: Determine asset cost when the transaction has delayed payment terms or is a lump-sum purchase, a nonmonetary exchange, or a contributed asset.

Section Reference: Measurement of Costs for Nonmonetary Exchange

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: \$ 34,200 (FV of asset received). Record a loss of \$ 1,800.

30. On January 2, 2020, Holliwell Inc. replaced its boiler with a more efficient one. The following information was available on that date:

Purchase price of new boiler	\$ 36,000
Carrying amount of old boiler	4,000
Fair value of old boiler	2,400
Installation cost of new boiler	3,200

The old boiler was sold for \$ 2,400. At what amount should Holliwell capitalize the cost of the new boiler?

a) \$ 42,300

b) \$ 43,200

c) \$ 39,200

d) \$ 40,000

Answer: c

Difficulty: Medium

Learning Objective: Determine asset cost when the transaction has delayed payment terms or is a lump-sum purchase, a nonmonetary exchange, or a contributed asset.

Section Reference: Measurement of Costs for Nonmonetary Exchange

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: \$ 36,000 + \$ 3,200 = \$ 39,200

31. Liberia Corporation exchanged 2,000 shares of its common shares for a parcel of land to be held as a future plant site. The book value of the shares is currently \$ 90 per share, and their current market value is \$ 110 per share. Liberia received \$ 30,000 from the sale of scrap when an existing building on the property was removed from the site. Based on these facts, the land should be capitalized at

- a) \$ 150,000.
- b) \$ 180,000.
- c) \$ 190,000.
- d) \$ 220,000.

Answer: c

Difficulty: Medium

Learning Objective: Determine asset cost when the transaction has delayed payment terms or is a lump-sum purchase, a nonmonetary exchange, or a contributed asset.

Section Reference: Measurement of Costs for Nonmonetary Exchange

Learning Objective: Identify the costs included in specific types of property, plant, and equipment.

Section Reference: Measurement of Costs Associated with Specific Assets

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: ($\$ 2,000 \times \$ 110$) – $\$ 30,000 = \$ 190,000$

Use the following information for questions 32–33.

Morocco Corp. purchased land as a factory site for \$ 250,000. They paid \$ 10,000 to tear down two buildings on the land, and the salvage from these old buildings was sold for \$ 1,350. Legal fees of \$ 870 were paid for title investigation and making the purchase. Architect's fees were \$ 10,300. Title insurance cost \$ 600, and liability insurance during construction cost \$ 650. Excavation costs were \$ 2,610. A contractor was paid \$ 600,000 to construct the new building. An assessment made by the city for pavement was \$ 1,600. Interest costs during construction were \$ 42,500.

32. The cost of the land should be recorded at

- a) \$ 260,120.
- b) \$ 261,720.
- c) \$ 262,470.
- d) \$ 264,070.

Answer: b

Difficulty: Medium

Learning Objective: Identify the costs included in specific types of property, plant, and equipment.

Section Reference: Measurement of Costs Associated with Specific Assets

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$250,000 + \$10,000 - \$1,350 + \$870 + \$600 + \$1,600 = \$261,720$

33. The cost of the building should be recorded at

- a) \$ 656,060.
- b) \$ 655,800.
- c) \$ 653,710.
- d) \$ 653,450.

Answer: a

Difficulty: Medium

Learning Objective: Identify the costs included in specific types of property, plant, and equipment.

Section Reference: Measurement of Costs Associated with Specific Assets

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$10,300 + \$650 + \$2,610 + \$600,000 + \$42,500 = \$656,060$

34. On February 1, 2020, Sudan Corp. purchased a parcel of land for \$ 300,000 as a factory site. An old building on the property was demolished, and construction began on a new building which was completed on November 1, 2020. 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.)	

Sudan should record the cost of the land and new building, respectively, at

- 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.

Answer: d

Difficulty: Medium

Learning Objective: Identify the costs included in specific types of property, plant, and equipment.

Section Reference: Measurement of Costs Associated with Specific Assets

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: Land: $\$ 300,000 + \$ 25,000 + \$ 5,000 - \$ 10,000 = \$ 320,000$

Building: $\$ 35,000 + \$ 990,000 = \$ 1,025,000$

35. On December 1, 2020, Guinea Corp. 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 2020 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

On Guinea's December 31, 2020 balance sheet, what amount should be reported for the land?

a) \$ 513,000

b) \$ 521,000

c) \$ 534,000

d) \$ 538,000

Answer: c

Difficulty: Medium

Learning Objective: Identify the costs included in specific types of property, plant, and equipment.

Section Reference: Measurement of Costs Associated with Specific Assets

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 500,000 + \$ 25,000 + \$ 5,000 + \$ 8,000 - \$ 4,000 = \$ 534,000$

36. Chiquita Corp. 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.

Answer: a

Difficulty: Easy

Learning Objective: Identify the costs included in specific types of property, plant, and equipment.

Section Reference: Measurement of Costs Associated with Specific Assets

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

37. 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) special amounts are assessed for local improvements such as sewers.

Answer: b

Difficulty: Easy

Learning Objective: Identify the costs included in specific types of property, plant, and equipment.

Section Reference: Measurement of Costs Associated with Specific Assets

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

38. The costs of land improvements with limited lives, such as a parking lot, are

- a) added to the land account.
- b) recorded in a separate account.
- c) depreciated over their useful lives.
- d) recorded in a separate account and depreciated over their useful lives.

Answer: d

Difficulty: Easy

Learning Objective: Identify the costs included in specific types of property, plant, and equipment.

Section Reference: Measurement of Costs Associated with Specific Assets

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

39. 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) management's plans for the property when the building was acquired.
- d) the planned future use of the parking lot.

Answer: d

Difficulty: Easy

Learning Objective: Identify the costs included in specific types of property, plant, and equipment.

Section Reference: Measurement of Costs Associated with Specific Assets

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

40. Under IFRS, biological assets should normally be measured at

- a) cost.
- b) cost less accumulated depreciation.
- c) fair value.
- d) fair value less costs to sell.

Answer: d

Difficulty: Easy

Learning Objective: Identify the costs included in specific types of property, plant, and equipment.

Section Reference: Measurement of Costs Associated with Specific Assets

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

41. 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.

Answer: b

Difficulty: Easy

Learning Objective: Identify the costs included in specific types of property, plant, and equipment.

Section Reference: Measurement of Costs Associated with Specific Assets

CPA: Financial Reporting

Bloomcode: Comprehension
AACSB: Analytic

42. 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 ASPE.

Answer: c

Difficulty: Easy
Learning Objective: Understand and apply the cost model, the revaluation model using the asset adjustment method, and the fair value model.
Section Reference: Measurement After Acquisition
CPA: Financial Reporting
Bloomcode: Comprehension
AACSB: Analytic

43. The revaluation model of accounting for PP&E assets
- a) uses a revaluation surplus account to hold net increases in the asset's fair value.
 - b) may be applied to all classes of PP&E including investment property.
 - c) may be applied to investment property under ASPE.
 - d) is not allowed under IFRS.

Answer: a

Difficulty: Easy
Learning Objective: Understand and apply the cost model, the revaluation model using the asset adjustment method, and the fair value model.
Section Reference: Measurement After Acquisition
CPA: Financial Reporting
Bloomcode: Comprehension
AACSB: Analytic

44. When using the revaluation model of accounting for PP&E assets (asset-adjustment or elimination method),
- a) the related Accumulated Depreciation account is closed to OCI.
 - b) depreciation continues to be charged in the original pattern.
 - c) the difference between fair value and book value is always debited to Revaluation Surplus (OCI).
 - d) a new depreciation rate must be calculated.

Answer: d

Difficulty: Easy

Learning Objective: Understand and apply the cost model, the revaluation model using the asset adjustment method, and the fair value model.

Section Reference: Measurement After Acquisition

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

45. When can the balance in the Revaluation Surplus (OCI) account be transferred to retained earnings?

- a) at the end of every year, or when the asset is sold
- b) whenever a revaluation is performed
- c) only when the revalued asset is sold
- d) never

Answer: a

Difficulty: Easy

Learning Objective: Understand and apply the cost model, the revaluation model using the asset adjustment method, and the fair value model.

Section Reference: Measurement After Acquisition

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

46. The fair value model of accounting for PP&E assets

- a) recognizes changes in the asset's fair value in other comprehensive income.
- b) should be applied to investment property only.
- c) once chosen for one investment property does not have to be applied to all investment property.
- d) is acceptable under both IFRS and ASPE.

Answer: b

Difficulty: Easy

Learning Objective: Understand and apply the cost model, the revaluation model using the asset adjustment method, and the fair value model.

Section Reference: Measurement After Acquisition

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

47. Round Up Corporation uses the cost model to account for its property, plant, and equipment, which were acquired on January 1, 2020, for \$ 200,000. Round Up uses straight-line depreciation and estimates the assets will have an eight-year life with no residual value. Assuming Round Up did not experience any impairment losses, the December 31, 2021, net book value of the assets is
- a) \$ 200,000.
 - b) \$ 175,000.
 - c) \$ 150,000.
 - d) \$ 125,000.

Answer: c

Difficulty: Medium

Learning Objective: Understand and apply the cost model, the revaluation model using the asset adjustment method, and the fair value model.

Section Reference: Measurement After Acquisition

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 200,000 - (\$ 200,000 \times 2 \div 8) = \$ 150,000$

48. Nigeria Ltd. acquires a new machine. It is comprised of two different components (A and B) that are expected to be overhauled at different times.

The acquisition costs of the components are as follows:

Component A: \$ 198,000

Component B: \$ 240,000

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. Nigeria uses straight-line depreciation for all its equipment. What is the net book value of component A after 5 years?

- a) \$ 0
- b) \$ 19,000
- c) \$ 20,000
- d) \$ 55,600

Answer: c

Difficulty: Medium

Learning Objective: Understand and apply the cost model, the revaluation model using the asset adjustment method, and the fair value model.

Section Reference: Measurement After Acquisition

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: \$ 20,000 (residual value)

Use the following information for questions 49–50.

Tunisia Inc. owns assets to which it applies the revaluation model (asset-adjustment method). The following additional information is available:

1. Accumulated Depreciation at December 31, 2021, (prior to any fair value adjustments) was \$ 12,000.
2. Between December 31, 2020, and December 31, 2021, the property's fair value had increased by \$ 30,000.
3. The December 31, 2021, balance in the revaluation surplus account (prior to any fair value adjustments) was \$ 2,000.

49. The adjusted December 31, 2021, balance in the related contra-asset account will be

- a) \$ 0.
- b) \$ 10,000.
- c) \$ 12,000.
- d) \$ 14,000.

Answer: a

Difficulty: Medium

Learning Objective: Understand and apply the cost model, the revaluation model using the asset adjustment method, and the fair value model.

Section Reference: Measurement After Acquisition

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 12,000 - \$ 12,000 = 0$ (Acc. Dep. is eliminated.)

50. The adjusted December 31, 2021, in the revaluation surplus account will be

- a) \$ 0.
- b) \$ 28,000.
- c) \$ 30,000.
- d) \$ 32,000.

Answer: d

Difficulty: Medium

Learning Objective: Understand and apply the cost model, the revaluation model using the asset adjustment method, and the fair value model.

Section Reference: Measurement After Acquisition

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$2,000 + \$30,000 = \$32,000$

51. Assume the same facts as indicated above, except that, between December 31, 2020, and December 31, 2021, the property's fair value had decreased by \$ 10,000. As a result, Tunisia's 2021 income statement will include a

- a) \$ 10,000 loss.
- b) \$ 8,000 loss.
- c) \$ 8,000 gain (other comprehensive income).
- d) \$ 2,000 loss.

Answer: b

Difficulty: Medium

Learning Objective: Understand and apply the cost model, the revaluation model using the asset adjustment method, and the fair value model.

Section Reference: Measurement After Acquisition

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$10,000 - \$2,000 = \$8,000$ loss

52. Nickel Corporation uses the fair value model of accounting for its investment property. The fair values of its property were: December 31, 2020, \$ 180,000 and December 31, 2021, \$ 195,000. At December 31, 2021, Nickel should

- a) recognize a gain of \$ 15,000 in income.
- b) report a gain of \$ 15,000 in other comprehensive income.
- c) defer the gain until the property is sold.
- d) do nothing (ignore it).

Answer: a

Difficulty: Medium

Learning Objective: Understand and apply the cost model, the revaluation model using the asset adjustment method, and the fair value model.

Section Reference: Measurement After Acquisition

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: \$ 195,000 – \$ 180,000 = \$ 15,000

53. Which of the following expenditures after acquisition would NOT be capitalized?

- a) adding a new wing to a hospital
- b) replacing the air conditioning system in an office building
- c) major overhaul of a fleet of trucks
- d) replacing all the tires on an 18-wheel semi-trailer

Answer: d

Difficulty: Easy

Learning Objective: Explain and apply the accounting treatment for costs incurred after acquisition.

Section Reference: Costs Incurred after Acquisition

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

54. A major overhaul made to a machine increased its fair 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.
- d) allocated between accumulated depreciation and the machine account.

Answer: c

Difficulty: Easy

Learning Objective: Explain and apply the accounting treatment for costs incurred after acquisition.

Section Reference: Costs Incurred after Acquisition

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

55. An expenditure that maintains an existing asset so that it can function in the manner intended should be

- a) fully expensed in the period in which it is made.
- b) partially expensed in the period in which it is made.
- c) fully capitalized in the period in which it is made.
- d) partially capitalized in the period in which it is made.

Answer: a

Difficulty: Easy

Learning Objective: Explain and apply the accounting treatment for costs incurred after acquisition.

Section Reference: Costs Incurred after Acquisition

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

56. Kenya Ltd. acquires a new machine. It is comprised of two different components (A and B) that are expected to be overhauled at different times.

The acquisition costs of the components are as follows:

Component A: \$ 198,000

Component B: \$ 240,000

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. Kenya uses straight-line depreciation for all its equipment. 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, but the residual value will then be zero. What is the net book value of component A one year after the overhaul?

a) \$ 120,000

b) \$ 80,000

c) \$ 66,667

d) \$ 40,000

Answer: b

Difficulty: Medium

Learning Objective: Explain and apply the accounting treatment for costs incurred after acquisition.

Section Reference: Costs Incurred after Acquisition

CPA: Financial Reporting

Bloomcode: Analysis

AACSB: Analytic

Feedback: $\$ 20,000 + \$ 100,000 = \$ 120,000$; $\$ 120,000 - (\$ 120,000 \div 3) = \$ 80,000$

57. On September 10, 2020, Angola Printing 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

Answer: d

Difficulty: Medium

Learning Objective: Explain and apply the accounting treatment for costs incurred after acquisition.

Section Reference: Costs Incurred after Acquisition

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 84,000 + \$ 10,000 + \$ 36,000 + \$ 14,000 = \$ 144,000$

58. Which of the following statements is correct?

- a) IFRS treats major overhauls that allow the continued use of an asset, as replacements; ASPE usually treats them as expenses.
- b) ASPE treats major overhauls that allow the continued use of an asset, as replacements; IFRS usually treats them as expenses.
- c) Both IFRS and ASPE treat major overhauls that allow the continued use of an asset, as replacements.
- d) Both IFRS and ASPE treat major overhauls that allow the continued use of an asset, as expenses.

Answer: a

Difficulty: Easy

Learning Objective: Identify differences in accounting between ASPE and IFRS, and what changes are expected in the near future.

Section Reference: IFRS/ASPE Comparison

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

59. Which of the following statements is correct?

- a) IFRS allows the cost, revaluation, or fair value models; ASPE allows only the cost model.
- b) ASPE allows the cost, revaluation, or fair value models; IFRS allows only the cost model.

- c) Both IFRS and ASPE allow the cost, revaluation, or fair value models.
- d) IFRS allows the cost, revaluation, or fair value models; ASPE allows only the cost and revaluation models.

Answer: a

Difficulty: Easy

Learning Objective: Identify differences in accounting between ASPE and IFRS, and what changes are expected in the near future.

Section Reference: IFRS/ASPE Comparison

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

60. Which of the following statements is correct?

- a) IFRS requires that any net revenues or expenses derived from an asset before it is ready for use be included in income; ASPE requires that such revenues and expenses be included in the asset's cost.
- b) ASPE requires that any net revenues or expenses derived from an asset before it is ready for use be included in income; IFRS requires that such revenues and expenses be included in the asset's cost.
- c) Both IFRS and ASPE require that any net revenues or expenses derived from an asset before it is ready for use be included in income.
- d) Both IFRS and ASPE require that any net revenues or expenses derived from an asset before it is ready for use be included in the asset's cost.

Answer: a

Difficulty: Easy

Learning Objective: Identify differences in accounting between ASPE and IFRS, and what changes are expected in the near future.

Section Reference: IFRS/ASPE Comparison

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

61. Which of the following statements is correct?

- a) ASPE considers investment, mining, and oil and gas properties to be part of property, plant, and equipment; IFRS has different standards for each of these.
- b) IFRS considers investment, mining, and oil and gas properties to be part of property, plant, and equipment; ASPE has different standards for each of these.

- c) Both ASPE and IFRS consider investment, mining, and oil and gas properties to be part of property, plant, and equipment.
- d) Both ASPE and IFRS have different standards for investment, mining, and oil and gas properties; they do not consider them to be part of property, plant, and equipment.

Answer: a

Difficulty: Easy

Learning Objective: Identify differences in accounting between ASPE and IFRS, and what changes are expected in the near future.

Section Reference: IFRS/ASPE Comparison

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

*62. 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 a “qualifying asset”
- d) the depreciation period

Answer: d

Difficulty: Easy

Learning Objective: Calculate the amount of borrowing costs to capitalize for qualifying assets.

Section Reference: Capitalization of Borrowing Costs (Appendix 10A)

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

*63. 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) $8 \div 8$.
- b) $8 \div 12$.
- c) $9 \div 12$.
- d) $11 \div 12$.

Answer: b

Difficulty: Medium

Learning Objective: Calculate the amount of borrowing costs to capitalize for qualifying assets.

Section Reference: Capitalization of Borrowing Costs (Appendix 10A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

*64. Borrowing costs 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 straight-line over a 40-year period.
- c) not be written off until the related asset is fully depreciated or disposed of.
- d) be amortized over the related asset's useful life.

Answer: d

Difficulty: Easy

Learning Objective: Calculate the amount of borrowing costs to capitalize for qualifying assets.

Section Reference: Capitalization of Borrowing Costs (Appendix 10A)

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

*65. A company is constructing an asset for its own use. Construction began in 2020. The asset is being financed entirely with a specific new borrowing. Construction expenditures were made in 2020 and 2021 at the end of each quarter. The total amount of interest cost capitalized in 2021 should be determined by applying the interest rate on the specific new borrowing to the

- a) total accumulated expenditures for the asset in 2020 and 2021.
- b) weighted-average accumulated expenditures for the asset in 2020 and 2021.
- c) weighted-average expenditures for the asset in 2021.
- d) total expenditures for the asset in 2021.

Answer: b

Difficulty: Easy

Learning Objective: Calculate the amount of borrowing costs to capitalize for qualifying assets.

Section Reference: Capitalization of Borrowing Costs (Appendix 10A)

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

*66. On May 1, 2020, Ethiopia Ltd. began construction of a new building for its own use. 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, 2020. For the purpose of determining the amount of interest cost to be capitalized, the weighted-average accumulated expenditures on the building during 2020 were

- a) \$ 62,500.
- b) \$ 75,000.
- c) \$ 187,500.
- d) \$ 375,000.

Answer: a

Difficulty: Medium

Learning Objective: Calculate the amount of borrowing costs to capitalize for qualifying assets.

Section Reference: Capitalization of Borrowing Costs (Appendix 10A)

CPA: Financial Reporting

Bloomcode: Application

Feedback: $\$ 75,000 \times \frac{(4 + 3 + 2 + 1)}{12} = \$ 75,000 \times 10 \div 12 = \$ 62,500$

12

*67. During calendar 2020, Somalia Corp. incurred weighted-average accumulated expenditures of \$ 800,000 during construction of assets that qualified for capitalization of interest. The only debt outstanding during 2020 was a \$ 900,000, 8%, five-year note payable dated January 1, 2018. The amount of interest that should be capitalized during calendar 2020 is

- a) \$ 0.
- b) \$ 32,000.
- c) \$ 64,000.
- d) \$ 72,000.

Answer: c

Difficulty: Medium

Learning Objective: Calculate the amount of borrowing costs to capitalize for qualifying assets.

Section Reference: Capitalization of Borrowing Costs (Appendix 10A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 800,000 \times .08 = \$ 64,000$

*68. On March 1, Senegal Inc. began construction of a small building for its own use. 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) \$ 75,000.
- c) \$ 150,000.
- d) \$ 450,000.

Answer: b

Difficulty: Medium

Learning Objective: Calculate the amount of borrowing costs to capitalize for qualifying assets.

Section Reference: Capitalization of Borrowing Costs (Appendix 10A)

CPA: Financial Reporting

Bloomcode: Application

Feedback: $\$ 150,000 \times \frac{(3 + 2 + 1)}{12} = \$ 150,000 \times 6 \div 12 = \$ 75,000$

Use the following information for questions *70–*71.

On March 1, 2020, Mauritania Ltd. purchased land for \$ 270,000 cash, which they intend to use for their new head office. Construction on the office building began on March 1. The following expenditures were incurred for construction:

<u>Date</u>	<u>Expenditures</u>
March 1, 2020	\$ 450,000
April 1, 2020	252,000
May 1, 2020	450,000
June 1, 2020	720,000

The office building was completed and ready for occupancy on July 1. To help pay for construction, Mauritania borrowed \$ 360,000 on March 1, 2020, on a 9%, three-year note payable. Other than this note, the only other debt outstanding during 2020 was a \$ 150,000, 10%, six-year note payable dated January 1, 2019.

*69. The weighted-average accumulated expenditures on the construction project during 2020 were

- a) \$ 1,467,000.
- b) \$ 348,000.
- c) \$ 258,000.

d) \$ 156,000.

Answer: b

Difficulty: Medium

Learning Objective: Calculate the amount of borrowing costs to capitalize for qualifying assets.

Section Reference: Capitalization of Borrowing Costs (Appendix 10A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $(\$ 450,000 \times 4 \div 12) + (\$ 252,000 \times 3 \div 12) + (\$ 450,000 \times 2 \div 12) + (\$ 720,000 \times 1 \div 12) = \$ 348,000$

*70. The actual interest cost incurred during 2020 was

a) \$ 27,000.

b) \$ 39,500.

c) \$ 42,000.

d) \$ 47,400.

Answer: c

Difficulty: Medium

Learning Objective: Calculate the amount of borrowing costs to capitalize for qualifying assets.

Section Reference: Capitalization of Borrowing Costs (Appendix 10A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $(\$ 360,000 \times 9\% \times 10 \div 12) + (\$ 150,000 \times 10\%) = \$ 42,000$

*71. When using the revaluation model of accounting for PP&E assets (proportionate method),

a) a Revaluation Surplus account is not used.

b) depreciation continues to be charged in the original pattern.

c) the asset account and its related contra-asset are both adjusted.

d) over the life of the asset, it is possible that there can be a net increase in net income from revaluations.

Answer: c

Difficulty: Easy

Learning Objective: Understand and apply the revaluation model using the proportionate method.

Section Reference: Revaluation: The Proportionate Method (Appendix 10B)

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

Use the following information for questions *72–*73.

Egypt Corp. owns equipment that originally cost \$ 100,000. At December 31, 2020, the equipment's book value (after 2020 depreciation was booked) is \$ 60,000. It is determined that the fair value of the equipment at this date is \$ 90,000. Although Egypt's policy is to apply the revaluation model using the proportionate method, this is the first time the company has done it.

*72. By how much must the accumulated depreciation account be increased (decreased) at December 31, 2020?

- a) \$ 20,000
- b) \$ 40,000
- c) \$ 60,000
- d) \$ (60,000)

Answer: a

Difficulty: Medium

Learning Objective: Understand and apply the revaluation model using the proportionate method.

Section Reference: Revaluation: The Proportionate Method (Appendix 10B)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: Increase in FV over BV = $(\$ 90,000 - \$ 60,000) \div \$ 60,000 = 50\%$

Acc Dep = $\$ 100,000 - \$ 60,000 = \$ 40,000$; therefore Acc. Dep. Should be increased by $\$ 40,000 \times 50\% = \$ 20,000$

*73. The adjusting entry to record the revaluation will include a

- a) debit to Accumulated Depreciation of \$ 20,000.
- b) credit to Equipment of \$ 10,000.
- c) credit to Revaluation Surplus (OCI) of \$ 30,000.
- d) debit to Revaluation Surplus (OCI) of \$ 10,000.

Answer: c

Difficulty: Medium

Learning Objective: Understand and apply the revaluation model using the proportionate method.

Section Reference: Revaluation: The Proportionate Method (Appendix 10B)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: AJE is Dr. Equipment \$ 50,000, Cr. Acc. Dep \$ 20,000, Cr. Revaluation \$ 30,000

EXERCISES

Ex. 10-74 Componentization

Explain the concept of componentization as it applies to the recognition of PP&E assets.

Solution 10-74

Componentization refers to recognizing major parts of an asset as separate assets for accounting purposes, such as the separate parts of a building (roof, heating system, flooring, elevators, foundation). Each part is then depreciated separately to reflect differing useful lives and different patterns of delivering economic benefits to the organization. The extent of componentization is left to professional judgement, with the primary consideration being the significance of the “parts” to the “whole.”

Difficulty: Easy

Learning Objective: Identify the business importance and characteristics of property, plant, and equipment and explain the recognition criteria.

Section Reference: Definition and Recognition of Property, Plant, and Equipment

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

*Ex. 10-75 Plant asset accounting

During 2020 and 2021, Mauritius 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 = Overstated; U = Understated; NE = No Effect

If no error was made, write NE in each of the four columns.

<u>Transaction</u>	<u>Net Book Value of Plant Assets at Dec 31/2020</u>	<u>2020 Net Income</u>	<u>Net Book Value of Plant Assets at Dec 31/2021</u>	<u>2021 Net Income</u>
1. The cost of installing a new computer system in 2020 was not recorded in 2020. It was charged to expense in 2021.	_____	_____	_____	_____
2. In 2021, clerical workers were trained to use the new computer system at a cost of \$ 15,000, which was incorrectly 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 2020, which extended its useful life by five years, was charged to accumulated depreciation in 2020.	_____	_____	_____	_____
4. Interest cost qualifying for capitalization in 2020 was charged to interest expense in 2020.	_____	_____	_____	_____
5. In 2020, land was bought for an employee parking lot. The \$ 2,000 title search fee was charged to expense in 2020.	_____	_____	_____	_____
6. The cost of moving several manufacturing facilities from metropolitan locations to suburban areas in 2020 was capitalized. The cost was written off over a 10-year period beginning in 2020.	_____	_____	_____	_____

Solution 10-75

	Net Book Value of Plant Assets at <u>Dec 31/2020</u>	2020 Net <u>Income</u>	Net Book Value of Plant Assets at <u>Dec 31/2021</u>	2021 Net <u>Income</u>
1.	U	O	U	U
2.	NE	NE	O	O
3.	NE	NE	NE	NE
4.	U	U	U	O
5.	U	U	U	O
6.	NE	NE	NE	NE

Difficulty: Medium

Learning Objective: Identify the costs to include in the measurement of property, plant, and equipment at acquisition.

Section Reference: Cost Elements

Learning Objective: Identify the costs included in specific types of property, plant, and equipment.

Section Reference: Measurement of Costs Associated with Specific Assets

Learning Objective: Explain and apply the accounting treatment for costs incurred after acquisition.

Section Reference: Costs Incurred after Acquisition

Learning Objective: Calculate the amount of borrowing costs to capitalize for qualifying assets.

Section Reference: Capitalization of Borrowing Costs (Appendix 10A)

CPA: Financial Reporting

Bloomcode: Analysis

AACSB: Analytic

Ex. 10-76 Asset exchange with commercial substance

In 2021, Malawi Inc. exchanged equipment for two delivery trucks. The equipment had been purchased for \$ 95,000 ten years ago and has since been fully depreciated. While the equipment was recently appraised at \$ 22,000, a reliable valuation for the trucks was not available. This transaction has commercial substance.

Instructions

Prepare the journal entry to record the exchange.

Solution 10-76

Trucks	22,000	
Accumulated depreciation—equipment.....	95,000	
Equipment.....		95,000
Gain on disposal of equipment		22,000

Difficulty: Medium

Learning Objective: Determine asset cost when the transaction has delayed payment terms or is a lump-sum purchase, a nonmonetary exchange, or a contributed asset.

Section Reference: Measurement of Cost for Nonmonetary Exchange

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 10-77 Non-interest-bearing note

Togo Auto purchased several trucks by issuing a \$ 40,000, 4-year, non-interest-bearing note to Rabat Motors. The market interest rate for this type of transaction is 8%.

Instructions

Prepare the journal entry to record the purchase of these trucks.

Solution 10-77

Truck (\$ 40,000 x .0.73503) *	29,401	
Notes Payable		29,401

* OR 4 N 8 I FV 40000 CPT PV = 29,401

Difficulty: Medium

Learning Objective: Determine asset cost when the transaction has delayed payment terms or is a lump-sum purchase, a nonmonetary exchange, or a contributed asset.

Section Reference: Measurement of Cost for Nonmonetary Exchange

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 10-78 Non-monetary transaction without commercial substance

Malawi Auto traded one of its used trailers (cost \$ 40,000, accumulated depreciation \$ 36,000) for another used trailer with a fair value of \$ 6,400. Malawi also paid \$ 600 to complete the transaction.

Instructions

Assuming the transaction lacks commercial substance, prepare the journal entry to record the exchange.

Solution 10-78

Trailer (new)	4,600	
Accumulated Depreciation	36,000	
Trailer (old)		40,000
Cash		600

Note: Since the transaction lacks commercial substance, no gain is recognized, and the new asset is recognized at the book value of the old asset plus the cash paid.

Difficulty: Medium

Learning Objective: Determine asset cost when the transaction has delayed payment terms or is a lump-sum purchase, a nonmonetary exchange, or a contributed asset.

Section Reference: Measurement of Cost for Nonmonetary Exchange

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 10-79 Asset exchange

Arabia 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 Arabia was required to make a cash payment of \$ 400,000.

Instructions

Prepare the required entr(ies) to record the exchange.

Solution 10-79

Fleet (new).....	500,000	
Accumulated depreciation	250,000	
Loss on disposal of fleet.....	25,000	
Fleet (old).....		375,000
Cash		400,000

Difficulty: Medium

Learning Objective: Determine asset cost when the transaction has delayed payment terms or is a lump-sum purchase, a nonmonetary exchange, or a contributed asset.

Section Reference: Measurement of Cost for Nonmonetary Exchange

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 10-80 Acquisition Cost

Rwanda Corporation purchased land at a cost of \$ 100,000. Closing costs were \$ 3,800, plus Rwanda paid \$ 48,000 for site preparation so they could construct a building on the site.

Instructions

Calculate the amount that should be recorded as the cost of the land.

Solution 10-80

$$\text{\$ } 100,000 + \text{\$ } 3,800 + \text{\$ } 48,000 = \text{\$ } 151,800$$

Difficulty: Medium

Learning Objective: Identify the costs included in specific types of property, plant, and equipment.

Section Reference: Measurement of Costs Associated with Specific Assets

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 10-81 Costs included in assets

Eritrea Ltd. is expanding its operations. Due to the expansion, they incurred the following costs during the fiscal period when they constructed a 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

Instructions

Which of these costs should be included in the cost of the new factory?

Solution 10-81

Direct labour	\$ 70,000
Loan interest to finance expansion	3,000
Architectural drawings.....	15,000
Direct material for factory.....	81,000
Allocation of overhead based on labour	
hours worked on factory	<u>58,000</u>
Total.....	\$ 227,000

Difficulty: Medium

Learning Objective: Identify the costs included in specific types of property, plant, and equipment.

Section Reference: Measurement of Costs Associated with Specific Assets

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 10-82 Application of the revaluation model

Aden Motels Inc. owns a motel that it had purchased on January 1, 2020, for \$ 1.5 million cash 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. Aden uses straight-line depreciation over the asset's 15-year useful life with no residual value.

The asset's fair value was equal to its book value on Dec. 31, 2020, and was \$ 1,450,000 on Dec. 31, 2021.

Instructions

Assuming Aden uses the asset adjustment (elimination) method for revaluation, prepare all required journal entries for 2020 and 2021.

Solution 10-82Journal Entries – 2020:

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 2020 depreciation ($\$ 1,500,000 - 0 \div 15 = \$ 100,000$)		

Journal Entries – 2021:

December 31:

Depreciation expense	100,000	
Accumulated depreciation—Structures.....		100,000
To record 2021 depreciation (prior to revaluation) ($\$ 1,500,000 - 0 \div 15 = \$ 100,000$)		

December 31:

Accumulated depreciation—Structures.....	200,000	
Structures		200,000
To eliminate accumulated depreciation (as part of the revaluation process) ($\$ 100,000 \times 2 = \$ 200,000$)		

December 31:

Structures	150,000	
Revaluation Surplus (OCI).....		150,000
To adjust the Structures account to fair value $\$ 1,450,000 - (\$ 1,500,000 - \$ 200,000) = \$ 150,000$		

Difficulty: Medium

Learning Objective: Understand and apply the cost model, the revaluation model using the asset adjustment method, and the fair value model.

Section Reference: Measurement After Acquisition

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 10-83 Measurement models

Identify and briefly describe the three main models to accounting for PP&E assets.

Solution 10-83

The following three models are available and may be used subject to the asset type and whether IFRS or ASPE is used:

1. The cost model: This model can be used for all types of PP&E assets, and is acceptable under both ASPE and IFRS. The assets, after acquisition, are measured at cost less accumulated depreciation 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, and is only used under IFRS. Net increases in fair value are accumulated in a separate account, Revaluation Surplus, and reported in other comprehensive income. There are two accounting methods allowed, the proportionate method and the asset-adjustment or elimination method.
3. The fair value model: This model can only be used for investment property, and again, is only used under IFRS. Assets are not depreciated and all changes in fair value are recognized in net income.

Difficulty: Easy

Learning Objective: Understand and apply the cost model, the revaluation model using the asset adjustment method, and the fair value model.

Section Reference: Measurement After Acquisition

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

Ex. 10-84 Application of the fair value model

On January 20, 2021, Trail Corp. purchased a luxury apartment complex in British Columbia for \$ 10 million cash. In addition to the purchase price, Trail paid transfer fees of \$ 150,000 and legal fees of \$ 20,000.

Wages were paid to maintenance staff during each of the following three years:

2021: \$ 103,000

2022: \$ 107,000

2023: \$ 110,000

Fair value information:

Dec 31, 2021: \$ 9.1 million

Dec 31, 2022: \$ 10.9 million

Dec 31, 2023: \$ 11.7 million

Other information:

The complex qualifies as investment property.

Trail applies the fair value model to all its investment property.

Instructions

Prepare all required journal entries for 2021, 2022, and 2023.

Solution 10-84

Journal Entries – 2021

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 2021		
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, 2021		
(\$ 10,170,000 – \$ 9,100,000 = \$ 1,070,000)		

Journal Entries – 2022

Wages expense	107,000	
Cash		107,000
To account for wages paid during 2022		
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, 2022		
(\$ 10,900,000 – \$ 9,100,000 = \$ 1,800,000)		

Journal Entries – 2023

Wages expense	110,000	
Cash		110,000
To account for wages paid during 2023		
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, 2023
(\$ 11,700,000 – \$ 10,900,000 = \$ 800,000)

Difficulty: Medium

Learning Objective: Understand and apply the cost model, the revaluation model using the asset adjustment method, and the fair value model.

Section Reference: Measurement After Acquisition

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 10-85 Cost model versus revaluation model versus fair value model

For each of the following types of assets, indicate with an “x” which of the three models: cost model (CM), revaluation model (RM), and/or fair value model (FVM) a company can choose, given international and private enterprise standards, to account for its property, plant, and equipment assets after acquisition.

ASSET TYPE	ASPE			IFRS		
	CM	RM	FVM	CM	RM	FVM
Investment property						
Other property, plant, and equipment assets						

Solution 10-85

ASSET TYPE	ASPE			IFRS		
	CM	RM	FVM	CM	RM	FVM
Investment property	√			√		√
Other property, plant, and equipment assets	√			√	√	

Difficulty: Easy

Learning Objective: Understand and apply the cost model, the revaluation model using the asset adjustment method, and the fair value model.

Section Reference: Measurement After Acquisition

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

Ex. 10-86 Trade-off with historical cost model

Explain the qualitative characteristic trade-off related to the historical cost method.

Solution 10-86

Historical costs are verifiable and therefore are considered more reliable. On the other hand, they often do not faithfully represent the value of the asset to the business and therefore are considered a less relevant measure. This is an example of a qualitative characteristic trade-off.

Difficulty: Easy

Learning Objective: Understand and apply the cost model, the revaluation model using the asset adjustment method, and the fair value model.

Section Reference: Measurement After Acquisition

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 10-87 Revaluation model

How often should a company revalue its property, plant, and equipment when using the revaluation model?

Solution 10-87

A revaluation is not required at each reporting date but must be carried out often enough that the carrying amount reported is not materially different from the assets' fair value. Some assets need to be remeasured only every three to five years, but for assets whose values change rapidly, an annual revaluation may be needed.

Difficulty: Easy

Learning Objective: Understand and apply the cost model, the revaluation model using the asset adjustment method, and the fair value model.

Section Reference: Measurement After Acquisition

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

Ex. 10-88 Difference between proportionate and asset adjustment methods

Explain the difference between the proportionate and asset adjustment methods of accounting when revaluing an asset.

Solution 10-88

The proportionate approach adjusts both the asset's carrying amount and its accumulated depreciation, so that the net balance is the fair value of the asset at the revaluation date. The asset adjustment (or elimination) method eliminates the balance in the Accumulated Depreciation account, writing it off against the asset itself. The asset is then adjusted to its new revalued amount.

Difficulty: Easy

Learning Objective: Understand and apply the cost model, the revaluation model using the asset adjustment method, and the fair value model.

Section Reference: Measurement After Acquisition

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

***Ex. 10-89** Capitalization of interest

In February 2021, Quorum Corp. began the construction of a 10-storey building. The construction is expected to be completed by January 2022.

During 2021, the following payments were made:

Apr. 1: \$ 1,000,000

Jun. 1: \$ 1,500,000

Aug. 1: \$ 900,000

Oct. 1: \$ 950,000

No asset specific debt was incurred.

During 2021, Quorum's general debt consisted of the following:

\$ 2 million, 5%, 2-year note,

\$ 1.2 million, 4.5%, 2-year note,

\$ 0.75 million, 3%, 5-year note.

Instructions

- a) Calculate the weighted-average accumulated expenditures for the year ended December 31, 2021.

- b) Calculate the weighted-average capitalization rate on Quorum's general-purpose debt for the year ended December 31, 2021.
- c) Calculate the avoidable borrowing costs.
- d) Calculate the amount of Quorum's borrowing costs that should be capitalized.

Solution 10-89

- a) Weighted-average accumulated expenditures for the year ended December 31, 2021:

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, 2021:

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:
 $(\$ 2,237,500 - \$ 0) \times 4.47\% = \$ 100,016$

- d) Borrowing costs to be capitalized:
 $\$ 0 + \$ 100,016 = \$ 100,016$

Difficulty: Medium

Learning Objective: Calculate the amount of borrowing costs to capitalize for qualifying assets.

Section Reference: Capitalization of Borrowing Costs (Appendix 10A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

***Ex. 10-90** Capitalization of interest

On March 1, Dubai Corp. began construction of a small building. The following expenditures were incurred for construction:

Mar. 1	\$ 75,000	Jun. 1	\$ 300,000
Apr. 1	84,000	Jul. 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

- Calculate the weighted-average accumulated expenditures.
- Calculate avoidable interest.

Solution 10-90

a)

<u>Date</u>	<u>Expenditures</u>	<u>Capitalization Period</u>	<u>Weighted-Average Accum. Expend.</u>
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
			<u>\$ 101,000</u>

b)

<u>Weighted-Average Accum. Expend.</u>	<u>Rate</u>	<u>Avoidable Interest</u>
\$ 60,000	.10	\$ 6,000
<u>41,000</u>	.08	<u>3,280</u>
<u>\$ 101,000</u>		<u>\$ 9,280</u>

Difficulty: Medium

Learning Objective: Calculate the amount of borrowing costs to capitalize for qualifying assets.

Section Reference: Capitalization of Borrowing Costs (Appendix 10A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 10-91 Revaluation model (proportionate method)

Aden Motels Inc. owns a motel that it had purchased on January 1, 2020, for \$ 1.5 million cash 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. Aden uses straight-line depreciation over the asset's 15-year useful life with no residual value.

The asset's fair value was equal to its book value on Dec. 31, 2020, and was \$ 1,450,000 on Dec. 31, 2021.

Instructions

Assuming Aden uses the proportionate method to adjust for revaluation, prepare all required journal entries for 2020 and 2021.

Solution 10-91

Journal Entries – 2020:

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 2020 depreciation ($\$ 1,500,000 - 0 \div 15 = \$ 100,000$)		

Journal Entries – 2021:

December 31:

Depreciation expense	100,000	
Accumulated depreciation—Structures.....		100,000
To record 2021 depreciation (prior to revaluation) ($\$ 1,500,000 - 0 \div 15 = \$ 100,000$)		

December 31:

Structures	173,077	
Accumulated depreciation—Structures		23,077
Revaluation Surplus (OCI).....		150,000
To adjust the Structures account to fair value		

	Before		Proportionate	(A) - (B)

	revaluation (A)		amount after revaluation (B)	
Structures	\$ 1,500,000	$\times 1,450/1,300$	\$ 1,673,077	\$ 173,077
Accumulated depreciation	<u>200,000</u>	$\times$ $1,450/1,300$	<u>223,077</u>	<u>23,077</u>
Carrying amount	<u>\$ 1,300,000</u>	$\times$ $1,450/1,300$	<u>\$ 1,450,000</u>	<u>\$ 150,000</u>

Difficulty: Medium

Learning Objective: Understand and apply the revaluation model using the proportionate method

Section Reference: Revaluation: The Proportionate Method

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

PROBLEMS

Pr. 10-92 Asset exchanges

Bahrain Corporation follows a policy of a 10% depreciation charge per year on machinery and a 5% depreciation charge per year on buildings.

The following transactions occurred in 2020:

March 31, 2020 A warehouse that Bahrain had purchased on January 1, 2011, for \$ 1.7 million (with a current fair value of \$ 1 million) was exchanged for another warehouse which also had a current fair value of \$ 1 million. Depreciation has been properly charged from Jan. 1, 2011 through Dec. 31, 2019. 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, 2020 Machinery with a cost of \$ 120,000 and accumulated depreciation through December 31, 2019, of \$ 90,000 was exchanged, along with \$ 75,000 cash, for a parcel of land with a fair market value of \$ 115,000.

Instructions

Prepare all appropriate journal entries for Bahrain Corporation for the above dates.

Solution 10-92

Mar 31, 2020	Depreciation Expense	21,250	
	Accumulated Depreciation—Warehouse.....		21,250
	(\$ 1,700,000 $\times$ 5% $\times$ 3 $\div$ 12)		

Warehouse ("new").....	913,750	
Accumulated Depreciation—Warehouse.....	786,250	
Warehouse ("old")		1,700,000
(\$ 1,700,000 × 5% × 111 ÷ 12 = \$ 786,250)		

Note: Since this transaction would leave Bahrain in basically the same economic position as before, the transaction lacks commercial substance; therefore the "new" warehouse is recorded at the book value of the old one. Recording it at its fair value would create a gain, which is not correct when there is no commercial substance.

June 30, 2020	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		

Note: Since the assets involved are sufficiently dissimilar, this transaction will change Bahrain's economic position, and the transaction has commercial substance. Therefore, a gain on exchange can be recorded. Note the new asset cannot be recorded at higher than fair value.

Difficulty: Medium

Learning Objective: Determine asset cost when the transaction has delayed payment terms or is a lump-sum purchase, a nonmonetary exchange, or a contributed asset.

Section Reference: Measurement of Cost for Nonmonetary Exchange

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 10-93 Asset exchange – no commercial substance

Turkey Corp. has a computer that they purchased on March 30, 2016, for \$ 106,000. This computer had an estimated life of ten years and a residual value of \$ 6,000. On December 31, 2020, the old computer is exchanged for a similar computer with a fair value of \$ 58,000. Turkey also received \$ 2,000 cash. Assume that the last fiscal period ended on December 31, 2019, and that straight-line depreciation is used.

Instructions

Prepare all entries that are necessary on December 31, 2020.

Solution 10-93

Depreciation Expense (\$ 106,000 – \$ 6,000) ÷ 10	10,000	
Accumulated Depreciation—Computer		10,000
Accumulated Depreciation—Computer (\$ 10,000 x 4 ¾)	47,500	
Computer (“new”)	56,500	
Cash	2,000	
Computer (“old”)		106,000

Note: Since this transaction would leave Turkey in basically the same economic position as before, the transaction lacks commercial substance; therefore the “new” computer is recorded at the book value of the old one minus the cash received (\$ 106,000 – \$ 47,500 = \$ 58,500 – \$ 2,000 = \$ 56,500). Recording it at the fair value of the new computer would create a gain, which is not correct when there is no commercial substance.

Difficulty: Medium

Learning Objective: Determine asset cost when the transaction has delayed payment terms or is a lump-sum purchase, a nonmonetary exchange, or a contributed asset.

Section Reference: Measurement of Cost for Nonmonetary Exchange

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 10-94 Asset exchange – no commercial substance

Syria Corp. 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 which belongs to Russia Ltd. Building M has an appraised value of \$ 1,620,000, a cost of \$ 3,100,000, and accumulated Depreciation of \$ 1,750,000. Russia paid Syria the difference between the appraised values of the two buildings. Assume depreciation has been updated to the date of exchange.

Instructions

Prepare the entries on both companies’ books, assuming the buildings are similar assets.

Solution 10-94Syria Corp.:

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)		
Cost of Building M = book value of Building 24 less cash received.		

Russia Ltd.:

Accumulated Depreciation	1,750,000	
Building 24.....	1,430,000	
Building M.....		3,100,000
Cash		80,000
Cost of Building 24 = book value of Building M plus cash paid.		

Note: Since this transaction would leave both companies in basically the same economic position as before, the transaction lacks commercial substance; therefore the “new” buildings are recorded at the book value of the old one, less cash received, or plus cash paid. Recording them at fair value would create a gain, which is not correct when there is no commercial substance.

Difficulty: Medium

Learning Objective: Determine asset cost when the transaction has delayed payment terms or is a lump-sum purchase, a nonmonetary exchange, or a contributed asset.

Section Reference: Measurement of Cost for Nonmonetary Exchange

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 10-95 Non-monetary exchange

Athens Inc. exchanged machinery with an appraised value of \$ 1,170,000, a recorded cost of \$ 1,800,000 and accumulated depreciation of \$ 900,000, for machinery that Sparta Corp. owns. Sparta’s machinery has an appraised value of \$ 1,140,000, a recorded cost of \$ 2,160,000, and accumulated depreciation of \$ 1,188,000. Sparta also gave Athens \$ 30,000 in the exchange. Assume depreciation has been updated to the date of exchange.

Instructions

- Prepare the entries on both companies’ books assuming that the transaction has commercial substance.
- Prepare the entries on both companies’ books assuming that the transaction lacks commercial substance.

Solution 10-95

- Commercial substance

Athens Inc.

Machinery	1,140,000	Cost	\$ 1,800,000
Cash	30,000	A/D	<u>900,000</u>
Accum. Depreciation—.....		BV	900,000
Machinery	900,000	FV	<u>1,170,000</u>
Gain on Exchange of		Gain	<u>\$ 270,000</u>
Plant Assets	270,000		

Machinery 1,800,000

Sparta Corp.

Machinery	1,170,000	Cost	\$ 2,160,000
Accum. Depreciation—			A/D
Machinery	1,188,000	BV	972,000
Gain on Exchange of			FV
Plant Assets	168,000		Gain
Machinery	2,160,000		
Cash	30,000		

b) No commercial substance

Athens Inc.

Machinery	870,000
Cash	30,000
Accumulated Depreciation—Machinery	900,000
Machinery	1,800,000

Sparta Corp.

Machinery	1,002,000
Accumulated Depreciation—Machinery	1,188,000
Machinery	2,160,000
Cash	30,000

Note: When there is no commercial substance, no gain is recorded. Instead, the asset is recorded at its book value plus any cash paid or less any cash received. For Athens, the value would be \$ 900,000 – \$ 30,000 cash received = \$ 870,000. For Sparta, the value would be \$ 972,000 + \$ 30,000 cash paid = \$ 1,002,000.

Note also that the “new” asset cannot be recorded at higher than fair value.

Difficulty: Medium

Learning Objective: Determine asset cost when the transaction has delayed payment terms or is a lump-sum purchase, a nonmonetary exchange, or a contributed asset.

Section Reference: Measurement of Cost for Nonmonetary Exchange

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 10-96 Accounting for government grant

Gorgen Corp. qualified for a 25% government grant that would assist the company in the purchase of machinery for its manufacturing operations. The cost of the machinery is \$ 200,000 and the new asset has an estimated useful life of 16 years.

Instructions

- Assuming that Gorgen uses the cost reduction method, prepare the journal entries to record the purchase of the machinery and the receipt of the government grant.
- Assuming that Gorgen uses the deferral method, prepare the journal entries to record the purchase of the machinery, the receipt of the grant, and the adjusting entry required at the end of the first year (assuming the machinery was purchased on the first day of the fiscal year).

Solution 10-96

- (a) Cost reduction method:

Machinery	200,000	
Cash		200,000
Cash	50,000	
Equipment (\$ 200,000 x .25)		50,000

- (b) Deferral method:

Machinery	200,000	
Cash		200,000
Cash	50,000	
Deferred Revenue— Government Grants		50,000
Deferred Revenue—Government Grants	3,125	
Revenue—Government Grants (\$ 50,000 ÷ 16 years)		3,125

Difficulty: Medium

Learning Objective: Determine asset cost when the transaction has delayed payment terms or is a lumpsum purchase, a nonmonetary exchange, or a contributed asset.

Section Reference: Measurement of Cost for Nonmonetary Exchange

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 10-97 Purchase of asset by non-interest-bearing note

Lebanon Corporation is a Calgary-based manufacturer of automobile parts. In early January 2020, the company acquired land and a building to be used as the company's new head office. Lebanon issued a \$ 2M, five-year non-interest-bearing note to the seller. Payment is to be made in five equal instalments 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 Lebanon'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:

1. One-third of the total value of the acquisition is attributable to the land.
2. The building is expected to have a useful life of 25 years.
3. Throughout the year, Lebanon incurred maintenance costs of \$ 87,000 and paid them in cash.
4. A parking lot was built at a cost of \$ 100,000 cash. The work was completed on July 1 and is expected to have a useful life of 10 years.

Instructions

Prepare all journal entries that are required to record the above events and transactions. Round all values to the nearest dollar.

Solution 10-97

Land	518,620	
Building	1,037,240	
Note Payable		1,555,860
To record the acquisition of land and building		
$\$ 400,000 \times 3.88965 = \$ 1,555,860$ OR $5 \text{ N } 9 \text{ I } 400000 \text{ PMT CPT PV} = 1,555,861$		
Land: $\$ 1,555,860 \times 1 \div 3 = \$ 518,620$		
Building: $\$ 1,555,860 \times 2 \div 3 = \$ 1,037,240$		

Maintenance Expense	87,000	
Cash		87,000
To record maintenance costs		
Land Improvements—Parking Lot	100,000	
Cash		100,000
To record creation of parking lot		

Difficulty: Medium

Learning Objective: Identify the costs included in specific types of property, plant, and equipment.

Section Reference: Measurement of Costs Associated with Specific Assets

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 10-98 Costs included in assets

Below is a list of various expenditures that an organization could make. In the columns marked Land, Building, Equipment, and Expensed, indicate by a “+” or “-” which columns the expenditure would be added to or subtracted from. The first has been done for you as an example.

Item	Land	Building	Equipment	Expensed
0. Construction costs		+		
1. Title search				
2. Property transfer tax				
3. Installation of equipment				
4. Soil decontamination costs				
5. Transportation costs of equipment				
6. Labour to construct building				
7. Special foundation for machinery				
8. Damage to machinery while uncrating				
9. Proceeds from salvage of old building on land purchased for factory site				
10. Property taxes in arrears paid on purchase				
11. Insurance on building after occupancy				
12. Clearing land for factory site				

Solution 10-98

Item	Land	Building	Equipment	Expensed
0. Construction costs		+		
1. Title search	+			
2. Property transfer tax	+			
3. Installation of equipment			+	
4. Soil decontamination costs	+			
5. Transportation costs of equipment			+	
6. Labour to construct building		+		
7. Special foundation for machinery			+	
8. Damage to machinery while uncrating				+
9. Proceeds from salvage of old building	+			

on land purchased for factory site				
10. Property taxes in arrears paid on purchase	+			
11. Insurance on building after occupancy				+
12. Clearing land for factory site	+			

Difficulty: Easy

Learning Objective: Identify the costs included in specific types of property, plant, and equipment.

Section Reference: Measurement of Costs Associated with Specific Assets

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

Pr. 10-99 Revaluation model

Mongolia Inc. owns equipment that it purchased on January 1, 2021, for \$ 4 million.

The following additional information is available:

Dec. 31, 2021 – Book value (after recording 2021 depreciation): \$ 3,600,000

Dec. 31, 2021 – Fair value: \$ 4,100,000

The company uses the revaluation model (asset adjustment method) 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 10-99

Accumulated Depreciation—Equipment	400,000	
Equipment		400,000
To eliminate accumulated depreciation		
(\$ 4,000,000 - \$ 3,600,000 = \$ 400,000)		
Equipment	500,000	
Revaluation Surplus (OCI)		500,000
To adjust the equipment account to fair value		
\$ 4,100,000 - \$ 3,600,000 = \$ 500,000		

Difficulty: Medium

Learning Objective: Understand and apply the cost model, the revaluation model using the asset adjustment method, and the fair value model.

Section Reference: Measurement After Acquisition

CPA: Financial Reporting
 Bloomcode: Application
 AACSB: Analytic

Pr. 10-100 Fair value model

In February 2020, Jordan Corp. purchased a vineyard in southern Ontario for \$ 7.5 million cash. This amount included legal fees of \$ 18,000 and property taxes of \$ 40,000 (of that amount, \$ 30,000 were in arrears). Based on appraisals, the property's year-end fair values were \$ 8.2 million at the end of 2020, and \$ 8 million at the end of 2021.

Other information:

1. The vineyard qualifies as investment property.
2. Jordan applies the fair value model to all its investment property.

Instructions

Prepare all required journal entries for 2020 and 2021.

Solution 10-100

Journal Entries – 2020

Investment Property—Vineyard	7,490,000	
Property Tax Expense	10,000	
Cash		7,500,000
To account for acquisition in February 2020		
\$ 7,500,000 – (\$ 40,000 – \$ 30,000) = \$ 7,490,000		
Investment Property—Vineyard	710,000	
Gain in Value of Investment Property		710,000
To adjust the value of the investment property		
to fair value at Dec 31, 2020		
(\$ 8,200,000 – \$ 7,490,000 = \$ 710,000)		

Journal Entry – 2021

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, 2021		
(\$ 8,200,000 – \$ 8,000,000 = \$ 200,000)		

Difficulty: Medium

Learning Objective: Understand and apply the cost model, the revaluation model using the asset adjustment method, and the fair value model.

Section Reference: Measurement After Acquisition

CPA: Financial Reporting
 Bloomcode: Application
 AACSB: Analytic

Pr. 10-101 Asset overhaul

Swift Corporation is an international provider of freight services that follows IFRS. Its fleet of vehicles includes a truck that is carried in its books as "VC1-016." This truck was purchased two years ago for \$ 150,000 and has been depreciated on a straight-line basis. By December 31, 2020, its book value (carrying value) is \$ 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. The associated costs of the overhauls are tracked in separate accounts.

At December 31, 2020, the balances for VC1-016 are as follows:

Overhauls # 1 – 5:

Accumulated Depreciation:	\$ 0

Overhaul # 6:

Cost	\$ 20,000
Less accumulated depreciation:	(16,400)
Book value	\$ 3,600

On January 1, 2021, 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, 2021, for \$ 28,000 cash.

Because of a slowdown in the economy, the truck only operated for 21,000 km for the remainder of 2021.

Instructions

Prepare the appropriate journal entries for 2021 relating to the truck's overhaul.

Solution 10-101

Truck overhaul (VC1-016 #7)	28,000	
Cash		28,000
To account for costs of January 2021 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 record 2021 depreciation expense for current overhaul		
$\$ 28,000 \div 50,000 \text{ km} \times 21,000 \text{ km} = \$ 11,760$		

Difficulty: Medium

Learning Objective: Explain and apply the accounting treatment for costs incurred after acquisition.

Section Reference: Costs Incurred after Acquisition

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

***Pr. 10-102** Capitalization of borrowing costs

During 2020, Tibet 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 2020 were \$ 2.8 million. The company had the following debts outstanding at December 31, 2020:

1. 8%, five-year note to finance construction of various assets,
dated January 1, 2020, with interest payable annually on January 1 \$ 1,800,000
2. 10%, ten-year bonds issued at par on December 31, 2015, with interest
payable annually on December 31 2,000,000
3. 7%, three-year note payable, dated January 1, 2019, with interest payable
annually on January 1 1,000,000

Instructions

Calculate the amounts of the following for 2020 (show calculations):

- a) avoidable interest,
- b) total interest to be capitalized.

Solution 10-102

- a) Weighted-Average

<u>Accumulated Expenditures</u>	<u>Applicable Interest Rate</u>	<u>Avoidable Interest</u>
\$ 1,800,000	.08	\$ 144,000
<u>1,000,000</u>	.09*	<u>90,000</u>
<u>\$ 2,800,000</u>		<u>\$ 234,000 = Avoidable Interest</u>

*Calculation of weighted-average interest rate:

	<u>Principal</u>	<u>Interest</u>
10% ten-year bonds	\$ 2,000,000	\$ 200,000
7% three-year note	<u>1,000,000</u>	<u>70,000</u>
	<u>\$ 3,000,000</u>	<u>\$ 270,000</u>

Weighted-average interest rate = \$ 270,000 ÷ \$ 3,000,000 = 9%.

b) Actual interest cost during 2020:

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	<u>70,000</u>
	<u>\$ 414,000</u>

The interest cost to be capitalized is \$ 234,000 (the lesser of the \$ 234,000 avoidable interest and the \$ 414,000 actual interest).

Difficulty: Medium

Learning Objective: Calculate the amount of borrowing costs to capitalize for qualifying assets.

Section Reference: Capitalization of Borrowing Costs (Appendix 10A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

***Pr. 10-103** Capitalization of borrowing costs

Early in 2020, Qatar Corporation engaged Emirate Ltd. to design and construct a complete modernization of Qatar's manufacturing facility. Construction began on June 1, 2020, and was completed on December 31, 2020. Qatar made the following payments to Emirate Ltd. during 2020:

<u>Date</u>	<u>Payment</u>
June 1, 2020	\$ 3,300,000
August 31, 2020	4,800,000
December 31, 2020	4,000,000

In order to help finance the construction, Qatar issued the following during 2020:

1. \$ 2,000,000, ten-year, 9% bonds payable, issued at par on May 31, 2020, with interest payable annually on May 31,
2. 1,000,000 common shares, issued at \$ 10 per share on October 1, 2020.

In addition to the 9% bonds payable, the only other debt outstanding during 2020 was a \$ 700,000, 12% note payable dated January 1, 2019, and due January 1, 2022, with interest payable annually on January 1.

Instructions

Calculate the amounts of each of the following (show calculations):

- a) weighted-average accumulated expenditures qualifying for capitalization of interest cost,

- b) avoidable interest incurred during 2020,
 c) total amount of interest cost to be capitalized during 2020.

Solution 10-103

Weighted-Average			
<u>Date</u>	<u>Capitalization Expenditures</u>	<u>Period</u>	<u>Accumulated Expenditures</u>
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
			<u>\$ 3,525,000</u>

- b) Weighted-Average

<u>Accumulated Expenditures</u>	<u>Appropriate Interest Rate</u>	<u>Avoidable Interest</u>
\$ 2,000,000	.09	\$ 180,000
<u>1,525,000</u>	.12	<u>183,000</u>
<u>\$ 3,525,000</u>		<u>\$ 363,000</u>

- c) Actual interest incurred during 2020:
- | | |
|--|-------------------|
| 9% bonds payable, \$ 2,000,000 × .09 × 7 ÷ 12..... | \$ 105,000 |
| 12% note payable, \$ 700,000 × .12 | <u>84,000</u> |
| | <u>\$ 189,000</u> |

The interest cost to be capitalized is \$ 189,000 (the lesser of the \$ 363,000 avoidable interest and the \$ 189,000 actual interest cost).

Difficulty: Medium

Learning Objective: Calculate the amount of borrowing costs to capitalize for qualifying assets.

Section Reference: Capitalization of Borrowing Costs (Appendix 10A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 10-104 Revaluation model (proportionate method)

Mongolia Inc. owns equipment that it purchased on January 1, 2021, for \$ 4 million.

The following additional information is available:

Dec. 31, 2021 – Book value (after recording 2021 depreciation): \$ 3,600,000

Dec. 31, 2021 – Fair value: \$ 4,100,000

The company uses the revaluation model (proportionate method) to account for its property, plant, and equipment.

Instructions 10-104

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

Equipment	555,556	
Accumulated depreciation—Equipment		55,556
Revaluation Surplus (OCI).....		500,000
To adjust the equipment account to fair value		

	Before revaluation (A)		Proportionate amount after revaluation (B)	(A)- (B)
Equipment	\$ 4,000,000	$\times 4,100/3,600$	\$ 4,555,556	\$ 555,556
Accumulated depreciation	<u>400,000</u>	$\times$ $4,100/3,600$	<u>455,556</u>	<u>55,556</u>
Carrying amount	<u>\$ 3,600,000</u>	$\times$ $4,100/3,600$	<u>\$ 4,100,000</u>	<u>\$ 500,000</u>

Difficulty: Medium

Learning Objective: Understand and apply the revaluation model using the proportionate method

Section Reference: Revaluation: The Proportionate Method

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

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CHAPTER 11

DEPRECIATION, IMPAIRMENT, AND DISPOSITION

CHAPTER STUDY OBJECTIVES

1. Understand the importance of depreciation, impairment, and disposition from a business perspective. The economic benefits of property, plant, and equipment are typically consumed as the items are used by the organization. Because the benefits are consumed over multiple periods, companies use depreciation to allocate the benefits of the PP&E to each period as the capacity of the assets is used up. By allocating the cost of property, plant, and equipment over its useful life, businesses are better able to match the costs and benefits of the assets to the revenues that they help generate. Companies also need to assess their PP&E each year under IFRS for indications of impairment, and if these indications are present, they should re-estimate how much will be recoverable. Following GAAP should also help companies better understand their businesses.

2. Explain the concept of depreciation and identify the factors to consider when determining depreciation charges. Depreciation is the process of allocating the cost of property, plant, and equipment assets in a systematic and rational manner to the periods that are expected to benefit from their use. The allocation of the cost of intangible capital assets is termed “amortization” and the allocation of the costs of mineral resource assets is termed “depletion.” Four factors involved in determining depreciation expense are (1) the recognition of the appropriate asset components, (2) the amount to be depreciated (depreciable amount), (3) the estimated useful life, and (4) the pattern and method of depreciation.

3. Identify how depreciation methods are selected; calculate and recognize depreciation using the straight-line, decreasing charge, and activity methods. The depreciation method chosen should amortize an asset in a pattern and at a rate that corresponds to the benefits received from that asset. The choice often involves the use of professional judgement. Tax reporting, simplicity, perceived economic consequences, and impact on ratios are examples of factors that influence such judgements in practice.

The straight-line method assumes that an asset provides its benefits as a function of time. As such, cost less residual value is divided by the useful life to determine the depreciation expense per period. The decreasing charge method provides for a higher depreciation charge in the early years and lower charges in later periods. For this method, a constant rate (such as double the straight-line rate) is multiplied by the net book value (cost less accumulated

depreciation and accumulated impairment losses) at the start of the period to determine each period's expense. The main justification for this approach is that the asset provides more benefits in the earlier periods. The activity method assumes that the benefits provided by the asset are a function of use instead of the passage of time. The asset's life is considered in terms of either the output that it provides or an input measure, such as the number of hours it works. The depreciation charge per unit of activity (depreciable amount divided by estimated total units of output or input) is calculated and multiplied by the units of activity produced or consumed in a period to determine the depreciation.

4. Explain the accounting issues for depletion of mineral resources. After the depletion base has been established through accounting decisions related to the acquisition, exploration and evaluation, development, and restoration obligations associated with mineral resources, these costs are allocated to the natural resources that are removed from the ground. Depletion is normally calculated using the unit of production method. In this approach, the resource's cost less residual value, if any, is divided by the number of units that are estimated to be in the resource deposit, to obtain a cost per unit of product. The cost per unit is then multiplied by the number of units withdrawn in the period to calculate the depletion.

5. Explain and apply the accounting procedures for partial periods and a change in depreciation rate. Because all the variables in determining depreciation are estimates—with the exception, perhaps, of an asset's original cost—it is common for a change in those estimates to result in a change in the depreciation amount. When this occurs, there is no retroactive change and no catch-up adjustment. The change is accounted for in the current in the current and future periods.

6. Explain the issues and apply the accounting standards for capital asset impairment under both IFRS and ASPE. A capital asset is impaired when its carrying amount is not fully recoverable. The cost recovery method (ASPE) defines recoverable as the undiscounted cash flows from the asset's use and later disposal. If impaired, the asset is written down to its fair value, and this loss cannot be reversed later if the asset's value recovers. The rational entity model (IFRS) defines recoverable amount as the higher of the asset's value in use and fair value less costs of disposal. Both these values are discounted cash flow amounts. If the recoverable amount subsequently improves, the impairment losses recognized are reversed.

7. Account for derecognition of property, plant, and equipment and explain and apply the accounting standards for long-lived assets that are held for sale. Assets held for sale are no longer depreciated. They are remeasured to their fair value less costs of disposal at each statement of financial position date. Recoveries in value may be recognized to the extent of

previous losses. Held-for-sale items of PP&E are separately reported as non-current assets unless they meet the definition of current assets. Under ASPE, assets held for sale are only permitted to be reported in current assets if sold before the financial statements are completed and the proceeds on sale are expected within 12 months from the date of the statement of financial position (or operating cycle, if longer).

Depreciation continues for PP&E assets until they are classified as held for sale or derecognized. At the date of disposal, all accounts related to the retired asset are removed from the books. Gains and losses from the disposal of PP&E assets are shown on the income statement in income before discontinued operations, unless the conditions for reporting as a discontinued operation are met. For property, plant, and equipment donated to an organization outside the reporting entity, the donation is reported at its fair value with a gain or loss on disposal recognized.

8. Describe the types of disclosures required for property, plant, and equipment and analysis of investment in capital assets. The type of information required to be disclosed for PP&E is governed by the information needs of users. Because users of private entities' financial information are often able to seek further specific information from a company, there are fewer required disclosures than for public companies reporting under IFRS. The required disclosures under IFRS include those relating to measurement, changes in account balances and the reasons for the changes, information about how fair values are determined, and many others. The efficiency of use of a company's investment in assets may be evaluated by calculating and interpreting the asset turnover rate, the profit margin, and the rate of return on assets.

9. Identify differences in accounting between IFRS and ASPE, and what changes are expected in the near future. In most major ways, international and Canadian accounting standards for the depreciation of property, plant, and equipment are similar. Some differences do exist, however, in the extent of componentization for depreciation, the impairment models applied, and the extent of disclosure. The impairment differences relate to how it is determined whether an asset is impaired, how the impairment is measured, and the ability to recognize recoveries in value.

10. Calculate capital cost allowance in routine and non-routine situations. "Capital cost allowance" (CCA) is the term used for depreciation when calculating taxable income in income tax returns. The CCA method is similar to the declining-balance method except that rates are specified for asset classes and the amount claimed is based on year-end balances. The half-year rule is applied to net additions in the year, which means that only 50% of the normal rate is permitted. For an asset class, retirements are accounted for under specific rules that govern the calculation of taxable income. Capital gains occur if the proceeds on

disposal are more than the asset's original cost. When an asset class is eliminated, a terminal loss or recapture of capital cost allowance can occur.

MULTIPLE CHOICE

Answer	No.	Description
d	1.	Knowledge of depreciation accounting
c	2.	Factors in depreciation accounting
b	3.	Definition of componentization
c	4.	Asset's useful life
b	5.	Depreciation commencement or continuation
c	6.	Graphic depiction of straight-line and declining-balance methods
b	7.	Disadvantage of using straight-line method
d	8.	Depreciation as variable expense
d	9.	Units of production depreciation
a	10.	Units of production depreciation
b	11.	Time based depreciation
d	12.	Knowledge of double declining-balance method

- c 13. Effect of accelerated depreciation on the income statement
- c 14. Componentization of assets
- c 15. Calculate depreciation using double declining-balance.
- b 16. Calculate depreciation using double declining-balance.
- b 17. Double declining-balance method
- d 18. Calculate book value of asset.
- c 19. Calculate depreciation using straight-line.
- a 20. Calculate acquisition cost from straight-line depreciation.
- d 21. Calculate acquisition cost from units of production.
- d 22. Calculate depreciation expense.
- d 23. Calculate depreciation expense using double declining-balance.
- c 24. Calculate accumulated depreciation using units of production.
- b 25. Calculate depreciation using double declining-balance.
- b 26. Calculate accumulated depreciation using straight-line.
- a 27. Calculate depreciation using double declining-balance.
- b 28. Calculate depreciation using double declining-balance.
- c 29. Calculate accumulated depreciation using double declining-balance.
- a 30. Classification of depletion expense
- d 31. Depletion expense method
- b 32. Definition of liquidating dividend
- c 33. Calculate units-of-production depletion expense.
- c 34. Calculate depletion expense.
- c 35. Units of production depletion expense
- c 36. Revision of depreciation
- a 37. Disclosure of changes in depreciation
- d 38. Calculate revised depreciation expense.
- a 39. Calculate revised depreciation expense after major overhaul.
- b 40. Calculate loss on disposal.
- a 41. Calculate loss on disposal.
- c 42. ASPE requirements for impairment
- b 43. IFRS requirements for impairment
- d 44. Indicators of asset impairment
- a 45. Cost recovery impairment model
- d 46. Rational entity impairment model
- b 47. Definition of cash generating unit (CGU)
- a 48. Journal entry for impairment loss under ASPE
- b 49. Calculate recoverable amount.
- d 50. Proper accounting treatment for impairment loss
- d 51. Assets held for sale
- b 52. Discontinuation of depreciation
- a 53. Loss on disposal of asset
- b 54. Accounting treatment for gain under involuntary conversion

- a 55. Depreciation on asset held for sale
- a 56. Fair value adjustment on equipment held for sale
- d 57. Calculate depreciation expense from change in contra-asset account.
- b 58. Calculate depreciation expense from change in contra-asset account.
- c 59. Calculate gain for held for sale assets.
- c 60. Calculate gain on disposal.
- d 61. Depreciation cessation
- b 62. Asset turnover ratio
- c 63. Rate of return on assets
- c 64. PP&E disclosures
- c 65. Calculate asset turnover ratio.
- b 66. Calculate rate of return on assets.
- a 67. Calculate asset turnover ratio.
- b 68. Calculate profit margin ratio.
- c 69. Calculate rate of return on assets.
- c *70. Objectives of CCA method
- d *71. Factors to consider for CCA
- c *72. Calculate CCA for the year.
- b *73. Calculate CCA for the year.
- d *74. Calculate recapture or terminal loss on disposal.

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

EXERCISES

Item	Description
E11-75	Treatment for impairment losses
E11-76	Depreciation as a cost allocation
E11-77	Componentization and depreciation of PP&E assets
E11-78	Definitions
E11-79	Calculate depletion expense.
E11-80	Revising depreciation
E11-81	Calculate depreciation and CCA.
*E11-82	Calculate depreciation and CCA.
E11-83	True or false
E11-84	Rational entity impairment model
E11-85	Impairment
E11-86	Held for sale assets and depreciation
E11-87	Asset depreciation and disposition

PROBLEMS

Item	Description
*P11-88	Calculate depreciation and CCA.
P11-89	Cost recovery impairment model, revision of depreciation
P11-90	Differences between the rational entity versus cost recovery methods
P11-91	Loss on impairment
P11-92	Calculation of ratios

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

MULTIPLE CHOICE

1. Which of the following is INCORRECT regarding depreciation?
- a) It is not a matter of valuation.
 - b) It is part of the matching of revenues and expenses.
 - c) It is a means of cost allocation.
 - d) It is an attempt to reflect the fair market values of the related assets.

Answer: d

Difficulty: Easy

Learning Objective: Understand the importance of depreciation, impairment, and disposition from a business perspective.

Section Reference: The Importance of Depreciation, Impairment, and Disposition from a Business Perspective

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

2. Factors to consider in the depreciation process do NOT include
- a) the asset's depreciable amount.
 - b) the period over which to depreciate the asset.
 - c) the asset's fair market value.
 - d) which asset components should be depreciated separately.

Answer: c

Difficulty: Easy

Learning Objective: Explain the concept of depreciation and identify the factors to consider when determining depreciation charges.

Section Reference: Factors Considered in the Depreciation Process

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

3. Deciding which PP&E components to depreciate separately is called

- a) separate depreciation.
- b) componentization.
- c) group depreciation.
- d) individual asset depreciation.

Answer: b

Difficulty: Easy

Learning Objective: Explain the concept of depreciation and identify the factors to consider when determining depreciation charges.

Section Reference: Factors Considered in the Depreciation Process

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

4. 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) is not affected by physical and economic factors.

Answer: c

Difficulty: Easy

Learning Objective: Explain the concept of depreciation and identify the factors to consider when determining depreciation charges.

Section Reference: Factors Considered in the Depreciation Process

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

5. 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) The asset is taken out of service.

Answer: b

Difficulty: Easy

Learning Objective: Explain the concept of depreciation and identify the factors to consider when determining depreciation charges.

Section Reference: Factors Considered in the Depreciation Process

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

6. 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

Answer: c

Difficulty: Easy

Learning Objective: Identify how depreciation methods are selected; calculate and recognize depreciation using the straight-line, decreasing charge, and activity methods.

Section Reference: Depreciation—Methods of Allocation and Calculation

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

7. 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.

Answer: b

Difficulty: Easy

Learning Objective: Identify how depreciation methods are selected; calculate and recognize depreciation using the straight-line, decreasing charge, and activity methods.

Section Reference: Depreciation—Methods of Allocation and Calculation

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

8. For income statement purposes, depreciation is a decreasing expense if the depreciation method used is

- a) units of production.

- b) straight-line.
- c) increasing charge.
- d) declining-balance.

Answer: d

Difficulty: Easy

Learning Objective: Identify how depreciation methods are selected; calculate and recognize depreciation using the straight-line, decreasing charge, and activity methods.

Section Reference: Depreciation—Methods of Allocation and Calculation

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

9. If a company uses the units of production method for calculating depreciation on its 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.

Answer: d

Difficulty: Easy

Learning Objective: Identify how depreciation methods are selected; calculate and recognize depreciation using the straight-line, decreasing charge, and activity methods.

Section Reference: Depreciation—Methods of Allocation and Calculation

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

10. When the unit of production method of depreciation is used, which of the following best describes depreciation expense?
- a) Depreciation expense will vary directly with output.
 - b) Depreciation expense will vary directly with sales.
 - c) Depreciation rate per unit will vary directly with output.
 - d) Depreciation rate per unit will vary directly with sales.

Answer: a

Difficulty: Easy

Learning Objective: Identify how depreciation methods are selected; calculate and recognize depreciation using the straight-line, decreasing charge, and activity methods.

Section Reference: Depreciation—Methods of Allocation and Calculation

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

11. Which of the following is NOT a time-based depreciation method?

- a) straight-line
- b) units of production
- c) double-declining balance
- d) any diminishing balance method

Answer: b

Difficulty: Easy

Learning Objective: Identify how depreciation methods are selected; calculate and recognize depreciation using the straight-line, decreasing charge, and activity methods.

Section Reference: Depreciation—Methods of Allocation and Calculation

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

12. Which of the following does NOT apply to the declining-balance method?

- a) It results in a decreasing charge to depreciation expense.
- b) Residual value is not deducted in calculating the depreciation base.
- c) The book value should not be reduced below residual value.
- d) In certain circumstances, the book value may be reduced below residual value.

Answer: d

Difficulty: Easy

Learning Objective: Identify how depreciation methods are selected; calculate and recognize depreciation using the straight-line, decreasing charge, and activity methods.

Section Reference: Depreciation—Methods of Allocation and Calculation

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

13. If income tax effects are ignored, accelerated depreciation methods

- a) provide funds for the earlier replacement of 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 current ratio.

Answer: c

Difficulty: Easy

Learning Objective: Identify how depreciation methods are selected; calculate and recognize depreciation using the straight-line, decreasing charge, and activity methods.

Section Reference: Depreciation—Methods of Allocation and Calculation

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

14. 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 lives are 12, 4, and 7 years for components A, B, and C respectively. Components A and B are not expected to have any residual value, but Component C is expected to have a residual value of \$18,000. Assuming straight-line depreciation, total annual depreciation expense, to the nearest dollar, relating to these assets is

- a) \$100,100.
- b) \$125,120.
- c) \$187,905.
- d) \$190,476.

Answer: c

Difficulty: Medium

Learning Objective: Identify how depreciation methods are selected; calculate and recognize depreciation using the straight-line, decreasing charge, and activity methods.

Section Reference: Depreciation—Methods of Allocation and Calculation

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$1,200,000 \div 3 = \$400,000$

$(400,000 \div 12) + (400,000 \div 4) + (400,000 - 18,000) \div 7 = \$187,905$

15. Cassidy Corporation purchased factory equipment that was installed and put into service on January 2, 2019, at a total cost of \$55,000. Residual value was estimated at \$3,000. The equipment is being depreciated over four years using the double-declining-balance method.

For the calendar year 2020, Cassidy should record depreciation expense on this equipment of

- a) \$27,500.
- b) \$52,000.

- c) \$13,750.
- d) \$13,000.

Answer: c

Difficulty: Medium

Learning Objective: Identify how depreciation methods are selected; calculate and recognize depreciation using the straight-line, decreasing charge, and activity methods.

Section Reference: Depreciation—Methods of Allocation and Calculation

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $[\$55,000 - (\$55,000 \times 2 \div 4)] \times 2 \div 4 = \$13,750$

16. Ella Inc. purchased machinery that was installed and ready for use on January 3, 2019, at a total cost of \$460,000. Residual value was estimated at \$60,000. The machinery will be depreciated over five years using the double-declining-balance method. For the calendar year 2020, Ella should record depreciation expense on this machinery of

- a) \$96,000.
- b) \$110,400.
- c) \$120,000.
- d) \$184,000.

Answer: b

Difficulty: Medium

Learning Objective: Identify how depreciation methods are selected; calculate and recognize depreciation using the straight-line, decreasing charge, and activity methods.

Section Reference: Depreciation—Methods of Allocation and Calculation

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $[\$460,000 - (\$460,000 \times 2 \div 5)] \times 2 \div 5 = \$110,400$

17. A machine has a cost of \$24,000, a residual value of \$6,000, and an estimated three-year life. If depreciation in the second year was \$2,000, which depreciation method was used?

- a) straight-line
- b) double declining-balance
- c) units of production
- d) cannot tell from information given

Answer: b

Difficulty: Medium

Learning Objective: Identify how depreciation methods are selected; calculate and recognize depreciation using the straight-line, decreasing charge, and activity methods.

Section Reference: Depreciation—Methods of Allocation and Calculation

CPA: Financial Reporting

Bloomcode: Analysis

AACSB: Analytic

Feedback: $\$24,000 \times 2 \div 3 = \$16,000$; $\$24,000 - \$16,000 = \text{BV of } \$8,000$;

$\$8,000 \times 2 \div 3 = \$5,333$, but only need $\$2,000$ to arrive at residual value of $\$6,000$

18. On January 1, 2019, Incredible Corp. purchased a new machine for \$350,000. The new machine has an estimated useful life of eight years and the residual value was estimated to be \$25,000. Depreciation was calculated using the double-declining-balance method. To the nearest dollar, what amount should be shown in Incredible's balance sheet at December 31, 2020, net of accumulated depreciation, for this machine?

a) \$153,125

b) \$175,000

c) \$201,563

d) \$196,875

Answer: d

Difficulty: Medium

Learning Objective: Identify how depreciation methods are selected; calculate and recognize depreciation using the straight-line, decreasing charge, and activity methods.

Section Reference: Depreciation—Methods of Allocation and Calculation

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$350,000 \times 2 \div 8 = \$87,500$; $(\$350,000 - \$87,500) \times 2 \div 8 = \$65,625$

$\$350,000 - (\$87,500 + \$65,625) = \$196,875$

19. On April 1, 2015, Ninja Ltd. purchased equipment for \$120,000. The equipment was estimated to have a residual value of \$15,000 and is being depreciated over ten years using the straight-line method. What should be the depreciation expense for this equipment for the year ended December 31, 2020?

a) \$7,875

b) \$8,000

c) \$10,500

d) \$12,000

Answer: c

Difficulty: Medium

Learning Objective: Identify how depreciation methods are selected; calculate and recognize depreciation using the straight-line, decreasing charge, and activity methods.

Section Reference: Depreciation—Methods of Allocation and Calculation

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $(\$120,000 - \$15,000) \div 10 = \$10,500$

20. On January 3, 2018, City Corp. purchased machinery. The machinery has an estimated useful life of eight years and an estimated residual value of \$67,500. City uses straight-line depreciation for all their machinery, and recorded \$115,500 depreciation expense for 2020. The acquisition cost of the machinery was

- a) \$991,500.
- b) \$924,000.
- c) \$856,500.
- d) \$655,500.

Answer: a

Difficulty: Medium

Learning Objective: Identify how depreciation methods are selected; calculate and recognize depreciation using the straight-line, decreasing charge, and activity methods.

Section Reference: Depreciation—Methods of Allocation and Calculation

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\text{Original cost} = (\$115,500 \times 8) + \$67,500 \text{ residual} = \$991,500$

21. On January 2, 2019, Urban Ltd. purchased equipment to be used in its manufacturing operations. The equipment has an estimated useful life of ten years, and an estimated residual value of \$33,000. It was also estimated that the equipment would be used a total of 63,000 hours over its useful life. The depreciation expense for this equipment was \$156,000 for calendar 2020, using the units of production method. The machine was used for 7,500 hours in 2020. The acquisition cost of the equipment was

- a) \$1,587,600.
- b) \$1,527,000.
- c) \$1,066,200.
- d) \$1,343,400.

Answer: d

Difficulty: Medium

Learning Objective: Identify how depreciation methods are selected; calculate and recognize depreciation using the straight-line, decreasing charge, and activity methods.

Section Reference: Depreciation—Methods of Allocation and Calculation

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: UOP rate = $\$156,000 \div 7,500 \text{ hours} = \$20.80$; $\$20.80 \times 63,000 \text{ hours} = \$1,310,400$ (depreciable amount) + $\$33,000$ residual = $\$1,343,400$ original cost

22. Consider an asset for which the following information is available:

Carrying value at Dec 31, 2020 before depreciation	\$9,000
Calculated depreciation for 2020	\$2,400
Original cost	\$24,000
Residual value	\$8,500
Remaining useful life	3 years

The depreciation expense for 2020 is

- a) \$3,100.
- b) \$3,000.
- c) \$2,400.
- d) \$500.

Answer: d

Difficulty: Medium

Learning Objective: Identify how depreciation methods are selected; calculate and recognize depreciation using the straight-line, decreasing charge, and activity methods.

Section Reference: Depreciation—Methods of Allocation and Calculation

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$9,000 - \$8,500 = \$500$ (maximum)

23. Swallow Ltd. 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 Swallow's pieces of equipment at December 31, 2019, are as follows:

Acquisition year	2017
Cost	\$280,000
Residual value	40,000
Accumulated depreciation	219,520

Estimated useful life 5 years

Using the same depreciation method that was used in 2017, 2018, and 2019, how much depreciation expense should be recorded in 2020 for this asset?

- a) \$60,480
- b) \$48,000
- c) \$32,000
- d) \$20,480

Answer: d

Difficulty: Medium

Learning Objective: Identify how depreciation methods are selected; calculate and recognize depreciation using the straight-line, decreasing charge, and activity methods.

Section Reference: Depreciation—Methods of Allocation and Calculation

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$280,000 \times .6 \times .6 \times .6 = \$60,480$

$\$60,480 - \$40,000 = \$20,480$ maximum

24. On March 24, 2019, Dagger Ltd. purchased a new machine for \$50,000. This machine has an eight-year estimated useful life, an estimated residual value of \$2,500, and is expected to produce 95,000 units over its useful life. The machine produced 5,500 units in 2019 and 6,500 units in 2020. Using the unit of production method, to the nearest dollar, the related Accumulated Depreciation account on the adjusted trial balance at December 31, 2020 would be

- a) \$6,500.
- b) \$6,316.
- c) \$6,000.
- d) \$3,250.

Answer: c

Difficulty: Medium

Learning Objective: Identify how depreciation methods are selected; calculate and recognize depreciation using the straight-line, decreasing charge, and activity methods.

Section Reference: Depreciation—Methods of Allocation and Calculation

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: UOP rate = $(\$50,000 - \$2,500) \div 95,000 = \$0.50$ per unit;

Acc. Dep. to end 2020 = $\$0.50 \times (5,500 + 6,500) = \$6,000$

25. On July 1, 2019, Boots Corporation purchased factory equipment for \$200,000. Residual value was estimated to be \$5,000. The equipment will be depreciated over ten years using the double-declining-balance method. Counting the year of acquisition as one-half year, Boots should record depreciation expense on this equipment for the calendar year 2020 of

- a) \$36,100.
- b) \$36,000.
- c) \$180,000.
- d) \$16,000.

Answer: b

Difficulty: Medium

Learning Objective: Identify how depreciation methods are selected; calculate and recognize depreciation using the straight-line, decreasing charge, and activity methods.

Section Reference: Depreciation—Methods of Allocation and Calculation

Learning Objective: Explain and apply the accounting procedures for partial periods and a change in depreciation rate.

Section Reference: Other Depreciation Issues

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: [$\$200,000 - (\$200,000 \times 2 \div 10 \times 50\%)$] $\times 2 \div 10 = \$36,000$

26. On April 10, 2019, Rio Corp. purchased machinery for \$180,000. Residual value was estimated at \$4,000. The machinery will be depreciated over ten years using the straight-line method. If depreciation is calculated on the basis of the nearest full month, the related Accumulated Depreciation account at December 31, 2020 will be

- a) \$31,500.
- b) \$30,800.
- c) \$30,000.
- d) \$29,333.

Answer: b

Difficulty: Medium

Learning Objective: Identify how depreciation methods are selected; calculate and recognize depreciation using the straight-line, decreasing charge, and activity methods.

Section Reference: Depreciation—Methods of Allocation and Calculation

Learning Objective: Explain and apply the accounting procedures for partial periods and a change in depreciation rate.

Section Reference: Other Depreciation Issues

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $(\$180,000 - \$4,000) \div 10 \times 1.75 \text{ years} = \$30,800$

27. On September 25, 2019, Panther Corp. purchased machinery for \$336,000. Residual value was estimated to be \$15,000. The machinery will be depreciated over eight years using the double-declining-balance method. If depreciation is calculated on the basis of the nearest full month, Panther should record depreciation expense for calendar 2020 on this machinery of

- a) \$78,750.
- b) \$63,000.
- c) \$60,000.
- d) \$42,000.

Answer: a

Difficulty: Medium

Learning Objective: Identify how depreciation methods are selected; calculate and recognize depreciation using the straight-line, decreasing charge, and activity methods.

Section Reference: Depreciation—Methods of Allocation and Calculation

Learning Objective: Explain and apply the accounting procedures for partial periods and a change in depreciation rate.

Section Reference: Other Depreciation Issues

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$336,000 \times 2 \div 8 \times 3 \div 12 = \$21,000$; $(\$336,000 - \$21,000) \times 2 \div 8 = \$78,750$

28. On July 1, 2020, Eland Corp. purchased a machine for \$375,000. The machine has an estimated useful life of five years and a residual value of \$50,000. The machine is being depreciated using the double-declining-balance method. For the year ended December 31, 2020, Eland should record depreciation expense on this machine of

- a) \$65,000.
- b) \$75,000.
- c) \$130,000.
- d) \$150,000.

Answer: b

Difficulty: Medium

Learning Objective: Identify how depreciation methods are selected; calculate and recognize depreciation using the straight-line, decreasing charge, and activity methods.

Section Reference: Depreciation—Methods of Allocation and Calculation

Learning Objective: Explain and apply the accounting procedures for partial periods and a change in depreciation rate.

Section Reference: Other Depreciation Issues

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$375,000 \times 2 \div 5 \times 1 \div 2 = \$75,000$

29. On April 1, 2018, Chickadee Corp. purchased new machinery for \$400,000. The machinery has an estimated useful life of ten years, a residual value of \$20,000, and depreciation is calculated using the double-declining-balance method. Chickadee's year end is December 31. The accumulated depreciation on this machinery at March 31, 2020, should be

- a) \$102,500.
- b) \$131,200.
- c) \$141,600.
- d) \$182,400.

Answer: c

Difficulty: Medium

Learning Objective: Identify how depreciation methods are selected; calculate and recognize depreciation using the straight-line, decreasing charge, and activity methods.

Section Reference: Depreciation—Methods of Allocation and Calculation

Learning Objective: Explain and apply the accounting procedures for partial periods and a change in depreciation rate.

Section Reference: Other Depreciation Issues

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: 2018 $(\$400,000 \times 2 \div 10 \times 9 \div 12) = \$60,000$

2019 $(\$400,000 - \$60,000) \times 2 \div 10 = \$68,000$

2020 $(\$400,000 - \$60,000 - \$68,000) \times 2 \div 10 \times 3 \div 12 = \$13,600$

Acc Dep = $\$60,000 + \$68,000 + \$13,600 = \$141,600$

30. 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.

Answer: a

Difficulty: Easy

Learning Objective: Explain the accounting issues for depletion of mineral resources.

Section Reference: Depletion of Mineral Resources

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

31. The most common method of recording depletion for accounting purposes is the

- a) single-declining method.
- b) double-declining method.
- c) straight-line method.
- d) units of production method.

Answer: d

Difficulty: Easy

Learning Objective: Explain the accounting issues for depletion of mineral resources.

Section Reference: Depletion of Mineral Resources

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

32. When all or a portion of shareholders' capital investments are returned to them, this is called a

- a) return dividend.
- b) liquidating dividend.
- c) stock dividend.
- d) investment dividend.

Answer: b

Difficulty: Easy

Learning Objective: Explain the accounting issues for depletion of mineral resources.

Section Reference: Depletion of Mineral Resources

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

33. In January, 2020, Camel Corporation purchased a mine for \$2,550,000 with removable ore estimated by geological surveys at 1 million tonnes. The property has an estimated (residual) value of \$150,000 after the ore has been extracted. The company incurred \$750,000 in

development costs preparing the mine for production. During 2020, 250,000 tonnes were removed and 200,000 tonnes were sold. What is the amount of depletion that Camel should expense for 2020?

- a) \$480,000
- b) \$600,000
- c) \$787,500
- d) \$840,000

Answer: c

Difficulty: Medium

Learning Objective: Explain the accounting issues for depletion of mineral resources.

Section Reference: Depletion of Mineral Resources

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $[(\$2,550,000 - \$150,000 + \$750,000) \div 1,000,000] \times 250,000 = \$787,500$

34. In 2020, Elk Corporation purchased a mine for \$200 million (of this, \$30 million was applicable to the land). An independent evaluation estimated the mine's reserves at 7.5 million tonnes. During 2020, Elk extracted 900,000 tonnes. Elk's depletion expense for 2020 is

- a) \$200,000.
- b) \$18,000,000.
- c) \$20,400,000.
- d) \$24,000,000.

Answer: c

Difficulty: Medium

Learning Objective: Explain the accounting issues for depletion of mineral resources.

Section Reference: Depletion of Mineral Resources

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $[(\$200 \text{ million} - \$30 \text{ million}) \div 7.5 \text{ million}] \times 900,000 = \$20.4 \text{ million}$

35. Roan Corp. acquired a tract of land containing an extractable natural resource. The company is required by the government 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 tonnes, 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 Roan maintains no inventories, what is the depletion charge per tonne of extracted resource?

- a) \$1.00
- b) \$1.32
- c) \$1.44
- d) \$1.63

Answer: c

Difficulty: Medium

Learning Objective: Explain the accounting issues for depletion of mineral resources.

Section Reference: Depletion of Mineral Resources

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $(\$8,000,000 + \$2,100,000 - \$1,200,000) \div 6,200,000 = \$1.44$

36. On January 1, 2015, Rabbit Corp. acquired machinery that it depreciated using the straight-line method with an estimated useful life of 15 years and no residual value. On January 1, 2020, Rabbit estimated that the remaining life of this machinery was six years with no residual value. This change should be accounted for

- a) as a prior period adjustment.
- b) as the cumulative effect of a change in accounting principle in 2020.
- c) by setting future annual depreciation equal to one-sixth of the book value on January 1, 2020.
- d) by continuing to depreciate the machinery over the original 15-year life.

Answer: c

Difficulty: Medium

Learning Objective: Explain and apply the accounting procedures for partial periods and a change in depreciation rate.

Section Reference: Other Depreciation Issues

CPA: Financial Reporting

Bloomcode: Analysis

AACSB: Analytic

37. Changes in the depreciation rate are accounted for as a(n)

- a) adjustment to current and future periods.
- b) adjustment to the current period only.
- c) adjustment to future periods only.

d) catch-up adjustment to prior periods.

Answer: a

Difficulty: Easy

Learning Objective: Explain and apply the accounting procedures for partial periods and a change in depreciation rate.

Section Reference: Other Depreciation Issues

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

38. On July 1, 2017, Puppy Corp. purchased a machine for \$500,000. The machine was estimated to have a useful life of ten years with an estimated residual value of \$28,000. During 2020, it became apparent that the machine would become uneconomical after December 31, 2021, and that the machine would have no salvage value. Accumulated depreciation on this machine at December 31, 2019, was \$118,000, using the straight-line method. The depreciation expense for 2020 should be

- a) \$95,500.
- b) \$82,000.
- c) \$76,400.
- d) \$191,000.

Answer: d

Difficulty: Medium

Learning Objective: Explain and apply the accounting procedures for partial periods and a change in depreciation rate.

Section Reference: Other Depreciation Issues

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $(\$500,000 - \$118,000) \div 2 = \$191,000$

39. On January 3, 2013, Hippo Corp. purchased a machine for \$600,000. The machine was being depreciated using the straight-line method over an estimated useful life of ten years, with no residual value. At the beginning of 2020, 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). The depreciation expense for 2020 should be

- a) \$41,250.
- b) \$50,000.

- c) \$60,000.
- d) \$66,000.

Answer: a

Difficulty: Medium

Learning Objective: Explain and apply the accounting procedures for partial periods and a change in depreciation rate.

Section Reference: Other Depreciation Issues

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: Acc. Dep. to end 2019 = $(\$600,000 \div 10) \times 7 = \$420,000$

BV = $\$600,000 - \$420,000 + \$150,000 = \$330,000$; $\$330,000 \div 8 = \$41,250$

40. On May 1, 2011, Platypus Ltd. purchased a new machine 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, 2020, the machine was sold for \$18,000. The loss to be recognized from the sale is

- a) \$0.
- b) \$2,700.
- c) \$6,000.
- d) \$8,700.

Answer: b

Difficulty: Medium

Learning Objective: Explain and apply the accounting procedures for partial periods and a change in depreciation rate.

Section Reference: Other Depreciation Issues

Learning Objective: Account for derecognition of property, plant, and equipment and explain and apply the accounting standards for long-lived assets that are held for sale.

Section Reference: Long-Lived Assets to Be Disposed of by Sale

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $(\$132,000 - \$6,000) \div (10 \times 12) = \$1,050$ per month

$\$18,000 - [\$132,000 - (\$1,050 \times 106 \text{ mo.})] = \$2,700$ loss

41. On June 1, 2018, Morgan Manufacturing acquired a machine for \$100,000 with an estimated useful life of five 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 were disposed of for \$16,000 on May 1, 2020, the loss on disposal would be

- a) \$20,000.
- b) \$26,400.
- c) \$24,000.
- d) \$36,000.

Answer: a

Difficulty: Medium

Learning Objective: Explain and apply the accounting procedures for partial periods and a change in depreciation rate.

Section Reference: Other Depreciation Issues

Learning Objective: Account for derecognition of property, plant, and equipment and explain and apply the accounting standards for long-lived assets that are held for sale.

Section Reference: Long-Lived Assets to Be Disposed of by Sale

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: 2018 – $\$100,000 \times 2 \div 5 = \$40,000$; 2019 $(\$100,000 - \$40,000) \times 2 \div 5 = \$24,000$

BV now $\$100,000 - \$40,000 - \$24,000 = \$36,000$

Loss on disposal is $\$36,000 - \$16,000 = \$20,000$

42. ASPE 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.

Answer: c

Difficulty: Easy

Learning Objective: Explain the issues and apply the accounting standards for capital asset impairment under both IFRS and ASPE.

Section Reference: Impairment

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

43. IFRS 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) when events and circumstances indicate that asset's carrying amount may not be recoverable.
- d) whenever the method of depreciation has changed.

Answer: b

Difficulty: Easy

Learning Objective: Explain the issues and apply the accounting standards for capital asset impairment under both IFRS and ASPE.

Section Reference: Impairment

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

44. Which of the following is NOT likely to be an indicator of possible asset impairment?

- a) evidence of obsolescence or physical damage
- b) a significant decrease in the asset's market value
- c) the book value of the entity's net assets is greater than the entity's market capitalization
- d) costs incurred for asset acquisition or operation are significantly lower than originally expected

Answer: d

Difficulty: Easy

Learning Objective: Explain the issues and apply the accounting standards for capital asset impairment under both IFRS and ASPE.

Section Reference: Impairment

Bloomcode: Comprehension

AACSB: Analytic

45. The cost recovery impairment model

- a) uses undiscounted cash flows in its determination of impairment.
- b) uses discounted cash flows in its determination of impairment.
- c) is the method used under IFRS.
- d) requires the calculation of value in use.

Answer: a

Difficulty: Easy

Learning Objective: Explain the issues and apply the accounting standards for capital asset impairment under both IFRS and ASPE.

Section Reference: Impairment

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

46. The rational entity impairment model

- a) does not allow the reversal of previously recognized impairment losses.
- b) is the method used under ASPE.
- c) uses undiscounted cash flows in its determination of impairment.
- d) compares the asset's carrying value with its recoverable amount.

Answer: d

Difficulty: Easy

Learning Objective: Explain the issues and apply the accounting standards for capital asset impairment under both IFRS and ASPE.

Section Reference: Impairment

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

47. Which of the following best describes the concept of cash-generating units (CGU)?

- a) Their cash flows are dependent on 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 CGU is the largest identifiable group of assets that generates cash inflows predominantly independent from other CGUs.
- d) IFRS does not recognize the concept of cash-generating units (CGU).

Answer: b

Difficulty: Easy

Learning Objective: Explain the issues and apply the accounting standards for capital asset impairment under both IFRS and ASPE.

Section Reference: Impairment

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

48. For a company that uses ASPE, the required year-end journal entry to record an impairment loss 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 related asset.
- d) a debit to Other Comprehensive Income and a credit to the related asset.

Answer: a

Difficulty: Easy

Learning Objective: Explain the issues and apply the accounting standards for capital asset impairment under both IFRS and ASPE.

Section Reference: Impairment

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

49. Monkey Shines Ltd., a Canadian public corporation, owns equipment for which the following year-end information is available:

Carrying amount (book value).....	\$120,000
Value in use.....	102,000
Fair value less disposal costs.....	108,000

The recoverable amount to be used in the determination of impairment is

- a) \$102,000.
- b) \$108,000.
- c) \$120,000.
- d) Cannot be determined from the information given.

Answer: b

Difficulty: Medium

Learning Objective: Explain the issues and apply the accounting standards for capital asset impairment under both IFRS and ASPE.

Section Reference: Impairment

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: higher of value in use and FV less disposal costs

50. Gibbon Corp., a Canadian public corporation, owns equipment for which the following year-end information is available:

Carrying amount (book value).....	\$59,000
Recoverable amount.....	52,000
Fair value less disposal costs.....	55,000

Which of the following *best* describes the proper accounting treatment for Gibbon's equipment?

- a) It is not impaired and a loss should not be recognized.
- b) It is impaired and a loss must be recognized, with no reversal possible.
- c) It is not impaired, but a loss must be recognized.
- d) It is impaired and a loss must be recognized, but the loss but may be reversed in future periods.

Answer: d

Difficulty: Easy

Learning Objective: Explain the issues and apply the accounting standards for capital asset impairment under both IFRS and ASPE.

Section Reference: Impairment

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

Feedback: Since recoverable amount (higher of value in use and FV less disposal costs) is lower than BV, there is impairment.

51. Long-lived assets that are held for sale

- a) continue to be depreciated.
- b) are carried at the higher of book value and fair values less costs of disposal.
- c) are generally not re-measured at each balance sheet date.
- d) are reported separately from other assets.

Answer: d

Difficulty: Easy

Learning Objective: Account for derecognition of property, plant, and equipment and explain and apply the accounting standards for long-lived assets that are held for sale.

Section Reference: Long-Lived Assets to Be Disposed of by Sale

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

52. Depreciation should be discontinued when an asset has been

- a) derecognized or taken out of service.
- b) derecognized or classified as held for sale.
- c) taken out of service.
- d) taken out of service or classified as held for sale.

Answer: b

Difficulty: Easy

Learning Objective: Account for derecognition of property, plant, and equipment and explain and apply the accounting standards for long-lived assets that are held for sale.

Section Reference: Long-Lived Assets to Be Disposed of by Sale

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

53. The sale of a depreciable asset resulting in a loss indicates that the proceeds from the sale were

- a) less than book value.
- b) greater than cost.
- c) greater than book value.
- d) less than current market value.

Answer: a

Difficulty: Easy

Learning Objective: Account for derecognition of property, plant, and equipment and explain and apply the accounting standards for long-lived assets that are held for sale.

Section Reference: Long-Lived Assets to Be Disposed of by Sale

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

54. One of Spade Corp.'s assets was expropriated by government authorities. The following additional information is available:

Book value at the time of expropriation	\$600,000
Cash received	\$1,500,000

Under ASPE, this situation would be reflected in the company's financial statements as a \$900,000

- a) gain that would be included in other comprehensive income.
- b) gain that would be included in net income.
- c) gain from discontinued operations.
- d) gain that would appear on the statement of shareholders' equity.

Answer: b

Difficulty: Medium

Learning Objective: Account for derecognition of property, plant, and equipment and explain and apply the accounting standards for long-lived assets that are held for sale.

Section Reference: Long-Lived Assets to Be Disposed of by Sale

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

55. On January 1, 2010, Antelope Ltd. purchased a building for \$800,000. At this time, the building had an estimated residual value of \$300,000 and an estimated useful life of 20 years. The company has recorded monthly depreciation using the straight-line method. On January 1, 2020, it is decided to put the building up for sale for \$1,200,000. At December 31, 2020, the building is still for sale. The correct depreciation to record for 2020 is

- a) \$0.
- b) \$25,000.
- c) \$40,000.
- d) \$60,000.

Answer: a

Difficulty: Medium

Learning Objective: Account for derecognition of property, plant, and equipment and explain and apply the accounting standards for long-lived assets that are held for sale.

Section Reference: Long-Lived Assets to Be Disposed of by Sale

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: \$0 (no depreciation on property held for sale)

56. Golden Goose Corp. has a piece of equipment, which is being held for sale, and has a carrying value of \$100,000. When the decision to sell had been made, the equipment had been written down from a carrying value of \$180,000. At December 31, 2020, it is estimated that the fair value less disposal costs (net realizable value) is \$130,000. For the calendar year 2020, Golden Goose should recognize a recovery (gain) of

- a) \$0.
- b) \$30,000.
- c) \$50,000.
- d) \$80,000.

Answer: a

Difficulty: Medium

Learning Objective: Account for derecognition of property, plant, and equipment and explain and apply the accounting standards for long-lived assets that are held for sale.

Section Reference: Long-Lived Assets to Be Disposed of by Sale

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: \$0. Assets held for sale are reported at lower of amortized cost (BV) and NRV

57. On January 1, 2020, the Accumulated Depreciation—Machinery account of Bonobo Corp. showed a balance of \$760,000. At the end of 2020, after the adjusting entries were posted, it showed a balance of \$820,000. During 2020, one of the machines that 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, depreciation expense for 2020 was

- a) \$189,000.
- b) \$182,000.
- c) \$180,000.
- d) \$175,000.

Answer: d

Difficulty: Medium

Learning Objective: Account for derecognition of property, plant, and equipment and explain and apply the accounting standards for long-lived assets that are held for sale.

Section Reference: Long-Lived Assets to Be Disposed of by Sale

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $(\$820,000 - \$760,000) + [\$240,000 - (\$118,000 + \$7,000)] = \$175,000$

58. During 2020, Jersey Ltd. sold equipment that had originally cost \$206,000 for \$127,600. This resulted in a gain of \$9,600. The balance in the Accumulated Depreciation—Equipment was \$660,000 on January 1, 2020, and \$630,000 on December 31, 2020. No other equipment was disposed of during 2017. Depreciation expense for 2020 was

- a) \$20,000.
- b) \$58,000.
- c) \$59,600.
- d) \$101,000.

Answer: b

Difficulty: Medium

Learning Objective: Account for derecognition of property, plant, and equipment and explain and apply the accounting standards for long-lived assets that are held for sale.

Section Reference: Long-Lived Assets to Be Disposed of by Sale

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$630,000 - \{\$660,000 - [\$206,000 - (\$127,600 - \$9,600)]\} = \$58,000$

59. The following information is available for an asset that is classified as held for sale:

Accumulated depreciation (at March 31, 2020)	\$24,300

Asset cost.....	50,000

If the asset were sold on April 1, 2020 for \$27,600, there would be

- a) a loss of \$1,900.
- b) a gain of \$1,400.
- c) a gain of \$1,900.
- d) a loss of \$22,400.

Answer: c

Difficulty: Medium

Learning Objective: Account for derecognition of property, plant, and equipment and explain and apply the accounting standards for long-lived assets that are held for sale.

Section Reference: Long-Lived Assets to Be Disposed of by Sale

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$27,600 - (\$50,000 - \$24,300) = \$1,900$ gain

60. On January 1, 2012, Owl Corporation purchased equipment for \$76,000, having a useful life of ten years and an estimated residual value of \$4,000. Owl has recorded monthly depreciation using the straight-line method. On December 31, 2020, the equipment was sold for \$14,000. The gain to be recognized from the sale is

- a) \$14,000.
- b) \$6,800.
- c) \$2,800.
- d) \$0.

Answer: c

Difficulty: Medium

Learning Objective: Account for derecognition of property, plant, and equipment and explain and apply the accounting standards for long-lived assets that are held for sale.

Section Reference: Long-Lived Assets to Be Disposed of by Sale

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $(\$76,000 - \$4,000) \div (10 \times 12) = \$600$ per month

$\$14,000 - [\$76,000 - (\$600 \times 108 \text{ mo.})] = \$2,800$

61. 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.

Answer: d

Difficulty: Easy

Learning Objective: Describe the types of disclosures required for property, plant, and equipment and analysis of investment in capital assets.

Section Reference: Presentation and Disclosure

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

62. The asset turnover ratio is calculated by dividing

- a) net income by ending total assets.
- b) net sales by average total assets.
- c) net sales by ending total assets.
- d) net income by average total assets.

Answer: b

Difficulty: Easy

Learning Objective: Describe the types of disclosures required for property, plant, and equipment and analysis of investment in capital assets.

Section Reference: Analysis

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

63. The rate of return on assets (ROA) is calculated by dividing

- a) average total assets by net income.

- b) net revenue by average total assets.
- c) net income by average total assets.
- d) net income by net revenue.

Answer: c

Difficulty: Easy

Learning Objective: Describe the types of disclosures required for property, plant, and equipment and analysis of investment in capital assets.

Section Reference: Analysis

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

64. For 2020, Walrus Company reported net revenues, average total assets, and net income of \$180,000, \$24,000, and \$100,000 respectively. Walrus Company's asset turnover ratio for 2020 was

- a) 1.8.
- b) 3.8.
- c) 7.5.
- d) 8.0.

Answer: c

Difficulty: Medium

Learning Objective: Describe the types of disclosures required for property, plant, and equipment and analysis of investment in capital assets.

Section Reference: Analysis

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$180,000 \div \$24,000 = 7.5$

65. In 2020, Elephant Corporation's financial statements included the following information:

Net income	\$19,000
Sales.....	98,000
Total assets, beginning of year	85,000
Total assets, end of the year.....	112,000
Inventory	70,000

To one decimal, Elephant's return on assets (ROA) for 2020 was

- a) 21.0%.
- b) 19.3%.

- c) 17.2%.
- d) 0.99%.

Answer: b

Difficulty: Medium

Learning Objective: Describe the types of disclosures required for property, plant, and equipment and analysis of investment in capital assets.

Section Reference: Analysis

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$19,000 \div [(85,000 + 112,000) \div 2] = 19.3\%$

Use the following data for questions 69–71.

Wren Corp. reported the following data on its most recent financial statements:

Net revenues:	\$312,500
Net income	58,200
Total assets, Jan 1	174,280
Total assets, Dec 31	168,420

66. To two decimals, what is Wren Corp.'s asset turnover ratio?

- a) 1.82
- b) 1.79
- c) 0.35
- d) 0.34

Answer: a

Difficulty: Medium

Learning Objective: Describe the types of disclosures required for property, plant, and equipment and analysis of investment in capital assets.

Section Reference: Analysis

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$312,500 \div (\$174,280 + \$168,420) \div 2 = 1.82$

67. To two decimals, what is Wren Corp.'s profit margin ratio?

- a) 33.97%
- b) 18.62%

- c) 18.24%
- d) 5.37%

Answer: b

Difficulty: Medium

Learning Objective: Describe the types of disclosures required for property, plant, and equipment and analysis of investment in capital assets.

Section Reference: Analysis

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $(\$58,200 \div \$312,500) \times 100 = 18.62\%$

68. To two decimals, what is Wren Corp.'s rate of return on assets (ROA)?

- a) 18.24%
- b) 18.62%
- c) 33.97%
- d) 34.56%

Answer: c

Difficulty: Medium

Learning Objective: Describe the types of disclosures required for property, plant, and equipment and analysis of investment in capital assets.

Section Reference: Analysis

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $[\$58,200 \div (\$174,280 + \$168,420) \div 2] \times 100 = 33.97\%$

69. Disclosures relating to PP&E assets are

- a) identical under IFRS and ASPE.
- b) less extensive under IFRS.
- c) less extensive under ASPE.
- d) more extensive under ASPE.

Answer: c

Difficulty: Easy

Learning Objective: Identify differences in accounting between IFRS and ASPE, and what changes are expected in the near future.

Section Reference: A Comparison of IFRS and ASPE

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

*70. A major objective of capital cost allowance for tax depreciation is to

- a) reduce the amount of depreciation expense claimed for income tax purposes.
- b) assure that the amount of depreciation for income tax and book purposes will be the same.
- c) help taxpayers achieve a faster write-off of their capital assets.
- d) require taxpayers to use the actual economic lives of assets in calculating tax depreciation.

Answer: c

Difficulty: Easy

Learning Objective: Calculate capital cost allowance in routine and non-routine situations.

Section Reference: Capital Cost Allowance Method (Appendix 11A)

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

*71. Under the capital cost allowance system, which of the following is NOT relevant?

- a) the capital cost of the asset
- b) the asset class
- c) the half-year rule
- d) the asset's residual value

Answer: d

Difficulty: Easy

Learning Objective: Calculate capital cost allowance in routine and non-routine situations.

Section Reference: Capital Cost Allowance Method (Appendix 11A)

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

*72. On January 1, 2020, Seal Corp. purchased a machine costing \$250,000. The machine is in an asset class for tax purposes with a 30% CCA rate. It has an estimated \$40,000 residual value at the end of its five-year useful life. The CCA deduction for tax purposes for the year 2020 is

- a) \$25,000.
- b) \$31,500
- c) \$37,500.

d) \$75,000.

Answer: c

Difficulty: Medium

Learning Objective: Calculate capital cost allowance in routine and non-routine situations.

Section Reference: Capital Cost Allowance Method (Appendix 11A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$250,000 \times 30\% \times 1 \div 2 = \$37,500$

Use the following information to answer questions *73–*74.

Tarantula Corp. reported the following information about the only machine that it owns:

Date of purchase March 31, 2020

Capital cost..... \$200,000

Estimated useful life 10 years

Estimated residual value \$20,000

CCA Class Class 10 (30%)

Tarantula uses straight-line depreciation to the nearest month for accounting purposes.

*73. Assuming Tarantula always takes the maximum CCA, what is the CCA for calendar 2020?

a) \$22,500

b) \$30,000

c) \$45,000

d) \$60,000

Answer: b

Difficulty: Medium

Learning Objective: Calculate capital cost allowance in routine and non-routine situations.

Section Reference: Capital Cost Allowance Method (Appendix 11A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$200,000 \times 30\% \times \frac{1}{2} = \$30,000$

*74. Assume that at the end of calendar 2019, the UCC for this machine is \$83,300. Tarantula sells the machine on January 2, 2020 for \$90,000, and does not replace it. The recapture of CCA or terminal loss would be

a) \$60,500 terminal loss.

- b) \$56,000 recapture.
- c) \$6,700 terminal loss.
- d) \$6,700 recapture.

Answer: d

Difficulty: Medium

Learning Objective: Calculate capital cost allowance in routine and non-routine situations.

Section Reference: Capital Cost Allowance Method (Appendix 11A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$83,000 \text{ (UCC)} - \$90,000 \text{ (sale price)} = \$6,700 \text{ recapture}$

EXERCISES

Ex. 11-75

What should a company do if an asset's carrying value exceeds its recoverable amount due to poor estimates? How can companies keep such instances to a minimum?

Solution 11-75

If an asset's carrying value exceeds its recoverable amount, the carrying amount should be reduced. Companies need to regularly assess their PP&E for signs of impairment to keep these instances to a minimum. If there are signs, companies should re-estimate how much will be recoverable. This should help them better understand their business, along with complying with GAAP.

Difficulty: Easy

Learning Understand the importance of depreciation, impairment, and disposition from a business perspective.

Section Reference: The importance of depreciation, impairment, and disposition from a business perspective.

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 11-76

Explain why depreciation is not a method of determining an asset's declining value or a matter of valuation.

Solution 11-76

Depreciation—or amortization, as it is also called—is a means of cost allocation. It is the process of allocating the depreciable amount of a PP&E asset to expense in a systematic manner to those periods expected to benefit from its use. While it is true that an asset's value changes between the time it is purchased and the time it is sold or scrapped, most companies use a cost allocation approach rather than a valuation approach because objectively measuring the changes in an assets' value every reporting period is often difficult and usually costly.

Difficulty: Easy

Learning Objective: Understand the importance of depreciation, impairment, and disposition from a business perspective.

Section Reference: The importance of depreciation, impairment, and disposition from a business perspective.

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 11-77 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 that only gives you the following information:

Grinding Equipment

Model: XZ-1-1000

Cost: \$1,250,000

Instructions

To be able to properly account for this asset, list and briefly describe what additional information you require.

Solution 11-77

The information should include details on the machine's

- Components
- Depreciable amount
- Depreciation period (useful life)
- 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 the same as the given cost of \$1,250,000, since it 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 which depreciation method to use: straight-line, declining balance, or units of production.

Difficulty: Easy

Learning Objective: Understand the importance of depreciation, impairment, and disposition from a business perspective.

Section Reference: The Importance of Depreciation, Impairment, and Disposition from a Business Perspective

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

Ex. 11-78 Definitions

Provide clear, concise answers for the following:

1. Define depreciation.
2. Define depreciation accounting.
3. Does depreciation accounting provide cash? If not, what does provide cash? In relation to cash, what does depreciation accounting do?

Solution 11-78

1. Depreciation is the decline in service potentials or in future economic benefits of a PP&E asset due to physical or economic factors.
2. Depreciation accounting is the systematic and rational allocation of the cost of PP&E assets to the periods benefited from the use of the assets.
3. Depreciation accounting does not provide cash. Revenues provide cash. Depreciation accounting retains cash by reducing income taxes and dividends.

Difficulty: Easy

Learning Objective: Understand the importance of depreciation, impairment, and disposition from a business perspective.

Section Reference: The Importance of Depreciation, Impairment, and Disposition from a Business Perspective

Learning Objective: Describe the types of disclosures required for property, plant, and equipment and analysis of investment in capital assets.

Section Reference: Analysis

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

Ex. 11-79

Halcour Corporation acquired the right to mine a piece of land at a cost to lease of \$600,000. The related excavation costs were \$1,000,000, while developmental costs were an additional \$8,000,000, all of which will contribute to Halcour extracting 25,000 tonnes. In the first year of operations Halcour mined and sold 5,000 tonnes, while in its second year the company extracted 6,500 tonnes but only sold 6,000 tonnes.

Instructions

Prepare the journal entry to record depletion expense for the first two years.

Solution 11-79

Depletion cost per tonne:

$(\$600,000 + \$1,000,000 + \$8,000,000) \div 25,000 \text{ tonnes} = \$384 \text{ per tonne}$

Year 1: $5,000 \text{ tonnes} \times \$384 = \$1,920,000$

Inventory	1,920,000	
Accumulated Depletion		1,920,000

Year 2: $6,500 \text{ tonnes} \times \$384 = \$2,496,000$

Inventory.....	2,496,000	
Accumulated Depletion		2,496,000

Difficulty: Medium

Learning Objective: Explain the accounting issues for depletion of mineral resources.

Section Reference: Depletion of Mineral Resources

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 11-80

JB Corporation purchased equipment costing \$135,000 on January 1, 2018. At that time the useful life of the equipment was estimated to be 12 years and the residual value was estimated to be \$7,500. Depreciation up to December 31, 2019 has been recorded using the

straight-line method and the company operates on a calendar year basis. On January 1, 2020, the estimated useful life was revised to a total of 10 years and the residual value was revised to \$8,000.

Instructions

Prepare the journal entry to record the depreciation expense for 2020. (Show calculations.)

Solution 11-80

$\$135,000 - \$7,500$
 $\text{—————} = \$10,625 \times 2 = \$21,250$ accumulated depreciation at December 31, 2019
 12 years

Equipment cost	\$135,000
Less: Accumulated depreciation	<u>21,250</u>
Carrying amount of equipment at December 31, 2019	113,750
Less revised estimated residual value	<u>8,000</u>
Costs to be depreciated	<u>\$105,750</u>

Revised depreciation = $\$105,750 \div (10 - 2)$ years remaining life = \$13,219 per year

The entry to record depreciation in 2020:

Depreciation Expense	13,219	
Accumulated Depreciation—Machinery		13,219

Difficulty: Medium

Learning Objective: Explain and apply the accounting procedures for partial periods and a change in depreciation rate.

Section Reference: Other Depreciation Issues

CPA: Communication

CPA: Financial Reporting

Bloomcode: Application

AACSB: Communication

AACSB: Analytic

*Ex. 11-81 Calculate depreciation and CCA

Five identical vehicles that cost \$500,000 (total) are acquired on April 1, 2019. Their estimated residual value is \$20,000 and expected life is eight years. These assets are Class 10 with a maximum CCA rate of 30%. The company has a December 31 year end.

Instructions

Calculate the depreciation expense/CCA (to the nearest dollar) by each of the following methods:

- a) Straight-line for 2019
- b) Double-declining-balance for 2020
- c) Maximum capital cost allowance for 2020

Solution 11-81

- a) $(\$500,000 - \$20,000) \div 8 \times 9 \div 12 = \$45,000$
- b) 2019: $25\% \times \$500,000 \times 9 \div 12 = \$93,750$
2020: $25\% \times \$406,250 = \$101,563$
- c) 2019: $30\% \times \$500,000 \times 1 \div 2 = \$75,000$
2020: $30\% \times \$425,000 = \$127,500$

Difficulty: Medium

Learning Objective: Identify how depreciation methods are selected; calculate and recognize depreciation using the straight-line, decreasing charge, and activity methods.

Section Reference: Depreciation—Methods of Allocation and Calculation

Learning Objective: Explain and apply the accounting procedures for partial periods and a change in depreciation rate.

Section Reference: Other Depreciation Issues

Learning Objective: Calculate capital cost allowance in routine and non-routine situations.

Section Reference: Capital Cost Allowance Method (Appendix 11A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

***Ex. 11-82** Calculate depreciation and CCA

A machine costing \$400,000 is acquired on October 1, 2019. 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/CCA for 2019 and 2020 by each of the following methods:

- a) Double declining-balance
- b) Capital cost allowance

Solution 11-82

- a) 2019: $25\% \times \$400,000 \times 3 \div 12 = \$25,000$
2020: $25\% \times \$375,000 = \$93,750$

- b) 2019: $20\% \times \$400,000 \times 1 \div 2 = \$40,000$
2020: $20\% \times \$360,000 = \$72,000$

Difficulty: Medium

Learning Objective: Identify how depreciation methods are selected; calculate and recognize depreciation using the straight-line, decreasing charge, and activity methods.

Section Reference: Depreciation—Methods of Allocation and Calculation

Learning Objective: Explain and apply the accounting procedures for partial periods and a change in depreciation rate.

Section Reference: Other Depreciation Issues

Learning Objective: Calculate capital cost allowance in routine and non-routine situations.

Section Reference: Capital Cost Allowance Method (Appendix 11A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 11-83 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 judgement.
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 ASPE 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. When using the straight-line method, an asset's residual value is deducted in the calculation of depreciation expense.
9. An asset that has been depreciated to its residual value can continue to be depreciated until it reaches a net book value of zero.

Solution 11-83

1. F
2. F

3. T
4. F
5. F
6. F
7. T
8. T
9. F

Difficulty: Easy

(1,2,8,9) Learning Objective: Identify how depreciation methods are selected; calculate and recognize depreciation using the straight-line, decreasing charge, and activity methods.

Section Reference: Depreciation—Methods of Allocation and Calculation

(3) Learning Objective: Explain and apply the accounting procedures for partial periods and a change in depreciation rate.

Section Reference: Other Depreciation Issues

(5,6,7) Learning Objective: Explain the issues and apply the accounting standards for capital asset impairment under both IFRS and ASPE.

Section Reference: Impairment

(4) Learning Objective: Account for derecognition of property, plant, and equipment and explain and apply the accounting standards for long-lived assets that are held for sale.

Section Reference: Long-Lived Assets to Be Disposed of by Sale

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

Ex. 11-84 Rational entity impairment model

Cougar Corp.'s balance sheet includes the following asset:

Equipment.....	\$95,000
Less: accumulated depreciation	<u>(25,000)</u>
Book value (carrying amount)	\$70,000

After performing its annual review for impairment, Cougar obtains the following data:

Asset's value in use	\$58,000
Fair value less disposal costs.....	62,000

Instructions

Assuming Cougar uses the rational entity impairment model,

- Calculate the recoverable amount.
- Calculate the impairment loss.
- Prepare the entry to record the impairment loss.

Solution 11-84

- Recoverable amount: \$62,000, the higher of the asset's value in use of \$58,000 and its fair value less disposal costs of \$62,000.

- Impairment loss:

Carrying amount	\$70,000
Recoverable amount.....	<u>62,000</u>
Impairment loss	\$8,000

- Journal entry:

Loss on impairment	8,000	
Accumulated impairment loss—equipment.....		8,000

Difficulty: Medium

Learning Objective: Explain the issues and apply the accounting standards for capital asset impairment under both IFRS and ASPE.

Section Reference: Impairment

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 11-85 Impairment

Assume the same information as in Ex. 11-81 above, except for the following:

Cougar's review for impairment indicates the following:

Asset's value in use	\$64,000
Fair value less disposal costs.....	73,000

Instructions

- Calculate the recoverable amount.
- Calculate the impairment loss.

Solution 11-85

- Recoverable amount: \$73,000, the higher of the asset's value in use of \$64,000 and its fair value less disposal costs of \$73,000.

- Impairment loss:

Carrying amount	\$70,000
Recoverable amount.....	73,000
Impairment loss	none

Because the recoverable amount is higher than the asset's carrying amount, there is no impairment loss.

Difficulty: Medium

Learning Objective: Explain the issues and apply the accounting standards for capital asset impairment under both IFRS and ASPE.

Section Reference: Impairment

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 11-86

Explain why assets that are held for sale are not depreciated while they are held.

Solution 11-86

Assets that are held for sale are not depreciated while they are held as it would be inconsistent to amortize assets that are not in use, that are likely to be sold, and that are carried at the equivalent of the lower of (amortized) cost and net realizable value. In many respects, these assets are closer to inventory than capital assets.

Difficulty: Easy

Learning Objective: Account for derecognition of property, plant, and equipment and explain and apply the accounting standards for long-lived assets that are held for sale.

Section Reference: Held for Sale

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 11-87 Asset depreciation and disposition

Answer each of the following questions.

1. On January 2, 2019, a machine was purchased for \$180,000. It has an estimated useful life of ten years and an estimated residual value of \$14,000. Depreciation for 2020, using the double-declining-balance method, is \$_____.
2. A vehicle purchased for \$50,000 has an estimated useful life of five years and a residual value of \$3,800. It is expected to be driven 210,000 kilometres over its useful life. The asset was driven 45,000 kilometres in the second year. Depreciation for the *second year*, using the units of production method, is \$_____.

3. A machine costing \$72,000, with an estimated useful life of five years and a residual value of \$12,000, is depreciated 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 is \$_____.

Solution 11-87

1. Year 1 depreciation = $\$180,000 \times 2 \div 10 = \$36,000$; NBV now \$144,000
Year 2 depreciation = $\$144,000 \times 2 \div 10 = \$28,800$
2. Depreciation per km = $(\$50,000 - \$3,800) \div 210,000 = \$0.22$
Year 2 depreciation = $\$0.22 \times 45,000 = \$9,900$
3. \$2,000 G
Annual depreciation is $(\$72,000 - \$12,000) \div 5 = \$12,000$
BV at time of sale = $\$72,000 - (2 \times \$12,000) = \$48,000$
Gain on disposal = $\$50,000 - \$48,000 = \$2,000$

Difficulty: Medium

Learning Objective: Identify how depreciation methods are selected; calculate and recognize depreciation using the straight-line, decreasing charge, and activity methods.

Section Reference: Depreciation—Methods of Allocation and Calculation

Learning Objective: Account for derecognition of property, plant, and equipment and explain and apply the accounting standards for long-lived assets that are held for sale.

Section Reference: Long-Lived Assets to Be Disposed of by Sale

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

PROBLEMS

***Pr. 11-88** Calculate depreciation and CCA

On July 2, 2019, Vicuna Inc. purchased equipment for \$720,000. This equipment has an estimated useful life of six years and 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%. Vicuna has a December year end.

Instructions

- a) Complete the schedule below by determining the depreciation expense/CCA and year-end book values/UCC for 2019 and 2020 using the
1. double-declining-balance method.

2. capital cost allowance method (using maximum rate).

<u>Double-Declining-Balance Method</u>	<u>2019</u>	<u>2020</u>
Depreciation expense for year		
Accumulated depreciation		
Year-end book value		

<u>Capital Cost Allowance Method</u>	<u>2019</u>	<u>2020</u>
CCA for year		
End of year UCC		
Total CCA claimed		

- b) Instead, assume Vicuna used straight-line depreciation during 2019 and 2020. During 2021, the company determined that the equipment would be useful to the company for only one more year beyond 2021. Residual value is estimated at \$40,000. Calculate the amount of depreciation expense for the 2021 income statement.

Solution 11-88

a) <u>Double-Declining-Balance Method</u>	<u>2019</u>	<u>2020</u>
Depreciation expense for year	\$120,000	\$200,000
Accumulated depreciation, end of year	120,000	320,000
Year-end book value	600,000	400,000

<u>Capital Cost Allowance Method</u>	<u>2019</u>	<u>2020</u>
CCA for year	\$ 72,000	\$129,600
End of year UCC	648,000	518,400
Total CCA claimed	72,000	201,600

b) Cost	\$720,000
Depreciation	(172,500)
Residual	<u>(40,000)</u>
2021 depreciation	$\$507,500 \times 1/2 = \$253,750$

Difficulty: Medium

Learning Objective: Identify how depreciation methods are selected; calculate and recognize depreciation using the straight-line, decreasing charge, and activity methods.

Section Reference: Depreciation—Methods of Allocation and Calculation

Learning Objective: Explain and apply the accounting procedures for partial periods and a change in depreciation rate.

Section Reference: Other Depreciation Issues

Learning Objective: Calculate capital cost allowance in routine and non-routine situations.

Section Reference: Capital Cost Allowance Method (Appendix 11A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 11-89 Cost recovery impairment model, revision of depreciation

Rhino 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 2017 and is being depreciated using the units of production method. By December 31, 2018, the book (carrying) value was \$430,000 (after depreciation expense had been recorded). However, at that time, Rhino became aware of new technology that would make the equipment obsolete within the next five years. An appraisal puts the equipment's future undiscounted net cash flows at \$390,000 and its fair value at \$300,000. While considering its options for the eventual replacement, Rhino will continue using the equipment, but will change to straight-line depreciation.

Instructions

Assuming Rhino is a private Canadian corporation,

- Prepare the journal entry, if any, to record the impairment loss at December 31, 2018.
- Prepare the journal entries to record 2019 and 2020 depreciation.

Solution 11-89

a)

Recoverability test: Carrying value \$430,000 – undiscounted net cash flows \$390,000 = - 40,000, therefore asset impaired.

Loss on impairment	130,000	
Accumulated impairment losses—equipment		130,000
(Carrying value \$430,000 – fair value \$300,000 = \$130,000 impairment loss)		

b)

2019 depreciation:

Depreciation expense	60,000	
Accumulated depreciation-equipment		60,000
(\$300,000 ÷ 5 years = \$60,000)		

2020 Depreciation:

Depreciation expense	60,000	
Accumulated depreciation-equipment		60,000
(\$300,000 ÷ 5 years = \$60,000)		

Difficulty: Medium

Learning Objective: Explain and apply the accounting procedures for partial periods and a change in depreciation rate.

Section Reference: Other Depreciation Issues

Learning Objective: Explain the issues and apply the accounting standards for capital asset impairment under both IFRS and ASPE.

Section Reference: Impairment

CPA: Financial Reporting

Bloomcode: Analysis

AACSB: Analytic

Pr. 11-90

Explain the core difference between the rational entity model (IFRS) and the cost recovery impairment method (ASPE).

Solution 11-90

The rational entity (IFRS) approach better reflects the economic circumstances underlying the asset's usefulness to the entity, capturing both the declines and recoveries in value. The cost recovery (ASPE) approach waits until circumstances indicate that conditions are very bad before recognizing impairment. It does not take into account the time value of money in the recoverability test. It is not neutral because, after recognizing impairment, it does not allow for later recognition of any recovery. That is, no reversals of impairment loss are permitted. Overall, the rational entity model used under IFRS provides better information for users: it provides better representational faithfulness as it is more neutral; it is more relevant; it provides more timely information; and it better reflects the time value of money and the fair value of impaired assets.

Difficulty: Easy

Learning Objective: Explain the issues and apply the accounting standards for capital asset impairment under both IFRS and ASPE.

Section Reference: Impairment

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

AACSB: Analytic

Pr. 11-90

On January 1, 2018, Phonetic Company purchased machinery costing \$146,000 and incurred \$5,000 in installation costs. The machinery has an estimated useful life of 15 years and a residual value of \$10,000. The company uses the straight-line method of depreciation. At the end of 2019, Phonetic recorded depreciation and assessed the asset, determining a recoverable amount of \$122,000. Phonetic sold the equipment to Voilex Corporation on June 30, 2020, for \$120,000.

Instructions

Prepare the necessary entries assuming Phonetic has a December 31 year-end. (Show calculations.)

Solution 11-90

<u>2018</u>	Jan 1	Machinery	151,000	
		Accounts Payable		151,000
		(\$146,000 + \$5,000)		
	Dec 31	Depreciation Expense	9,400	
		Accumulated Depreciation - Machinery		9,400
		[((\$151,000 - \$10,000) ÷ 15)]		
<u>2019</u>	Dec 31	Depreciation Expense	9,400	
		Accumulated Depreciation - Machinery		9,400
		[((\$151,000 - \$10,000) ÷ 15)]		
	Dec 31	Loss on Impairment	10,200	
		Accumulated Impairment Losses - Machinery		10,200
		Carrying value = \$151,000 - \$9,400 - \$9,400 = \$132,200		
		Impairment loss = \$132,200 - \$122,000 = \$10,200		
<u>2020</u>	Jun 30	Depreciation Expense	4,308	
		Accumulated Depreciation - Machinery		4,308
		[((\$122,000 - \$10,000) ÷ (15 - 2 years))]		
	Jun 30	Cash	120,000	
		Accumulated Depreciation - Machinery	33,308	
		Gain on Disposal		2,308
		Machinery		151,000

Accumulated depreciation/impairment losses = \$9,400 + \$9,400 + \$10,200 + \$4,308 = \$33,308

Carrying value = \$151,000 - \$33,308 = \$117,692

Gain on disposal = \$120,000 - \$117,692 = \$2,308

Difficulty: Medium

Learning Objective: Explain the issues and apply the accounting standards for capital asset impairment under both IFRS and ASPE.

Section Reference: Impairment

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 11-91 Calculation of ratios

Vulture Ltd. provides the following selected information for the calendar years 2020 and 2019:

	<u>2020</u>	<u>2019</u>
Net revenue	\$320,000	
Net income	75,000	
Accounts receivable	33,000	\$26,000
Inventory	61,000	55,000
Total assets.....	210,000	176,000
Total liabilities.....	84,000	74,000

Instructions

For 2020, calculate the following ratios to two decimals:

- Asset turnover ratio
- Profit margin ratio
- Rate of return on assets

Solution 11-91

- Asset turnover ratio = net revenue ÷ average total assets

Average total assets = (\$210,000 + \$176,000) ÷ 2 = \$193,000

ATR = \$320,000 ÷ \$193,000 = 1.66

- Profit margin ratio = net income ÷ net revenue x 100

PMR = \$75,000 ÷ \$320,000 x 100 = 23.44%

- Rate of return on assets = net income ÷ average total assets x 100

ROA = \$75,000 ÷ \$193,000 x 100 = 38.86%

Difficulty: Medium

Learning Objective: Describe the types of disclosures required for property, plant, and equipment and analysis of investment in capital assets.

Section Reference: Analysis

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

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CHAPTER 12

INTANGIBLE ASSETS AND GOODWILL

CHAPTER STUDY OBJECTIVES

- 1. *Understand the importance of goodwill and intangible assets from a business perspective and describe their characteristics.*** We have an economy that is increasingly dominated by information and service providers, and their major assets are often intangible in nature. Identifying and measuring intangible assets tends to be difficult, and as a result many intangibles are not captured on companies' statements of financial position. However, intangible assets and goodwill remain critically important for companies, and are a key focus of standard setters in North America and internationally.

Intangible assets have three characteristics: (1) they are identifiable, (2) they lack physical substance, and (3) they are nonmonetary in nature. Goodwill represents the difference between the fair value of the identifiable assets acquired and liabilities assumed and the consideration given when a company acquires another business.
- 2. *Identify and apply the recognition and measurement requirements for purchased intangible assets.*** A purchased intangible asset is recognized when it is probable that the entity will receive the expected future economic benefits and when its cost can be measured reliably. It is measured initially at cost. When several intangibles, or a combination of intangibles and other assets, are acquired in a business combination, the cost of each intangible asset is its fair value. When acquired in a business combination, the identifiable intangibles are recognized separately from the goodwill component.
- 3. *Identify and apply the recognition and measurement requirements for internally developed intangible assets.*** No costs are capitalized unless they meet the general recognition criteria concerning future benefits and measurability. Costs incurred in the research phase of developing an intangible asset internally are expensed. Costs incurred in the development phase of a project are also expensed unless the entity can demonstrate that it meets six stringent criteria. These criteria are designed to provide evidence that the asset is technically and financially feasible and that the company has the intent and ability to generate future economic benefits from it. Under ASPE, entities have a choice whether to capitalize or expense costs that meet the six criteria.

4. Explain how intangible assets are accounted for after initial recognition. Under ASPE, intangible assets are accounted for using the cost model, whereas IFRS also allows the revaluation model to be used if the asset's fair value is determined in an active market. This is not often used. An intangible with a finite or limited useful life is amortized over its useful life to the entity. Except in unusual and specific circumstances, the residual value is assumed to be zero. The amount to report for amortization expense should reflect the pattern in which the asset is consumed or used up if that pattern can be reliably determined. Otherwise, a straight-line approach is used. An intangible with an indefinite life is not amortized until its life is determined to no longer be indefinite. All intangibles are tested for impairment.

5. Identify and explain the accounting for specific types of intangible assets. Major types of intangibles include the following: (1) marketing-related intangibles that are used in the marketing or promotion of products or services, (2) customer-related intangibles that result from interactions with outside parties, (3) artistic-related intangibles that involve ownership rights to such items as plays and literary works, (4) contract-related intangibles that represent the value of rights that arise from contractual arrangements, and (5) technology-related intangible assets that relate to innovations or technological advances.

6. Explain and account for impairment of limited-life and indefinite-life intangible assets. Under ASPE, impairment is determined and applied by using the cost recovery impairment model. Impairment for *limited-life* intangible assets is based first on a recoverability test. If the carrying amount is higher than the asset's (undiscounted) net recoverable amount, then an impairment loss must be measured and recognized, based on the asset's fair value. No reversals of such losses are permitted. The procedures are the same as for property, plant, and equipment. *Indefinite-life* intangibles use only a fair value test. Under IFRS, the rational entity impairment model is used. An intangible asset is impaired only if its carrying amount is higher than its recoverable amount. The recoverable amount is defined as the greater of the asset's value in use and its fair value less costs to sell. The impairment loss is the difference between the carrying amount and the recoverable amount, if lower. The loss is reversed subsequently if economic conditions change and the recoverable amount increases. The same approach is used for both limited-life and indefinite-life intangible assets.

7. Explain how goodwill is measured and accounted for after acquisition. Goodwill is unique because, unlike all other assets, it can be identified only with the business as a whole. It is not an identifiable asset. Goodwill is recorded only when a business is purchased. To calculate goodwill in a 100% acquisition, the fair value of the identifiable assets that are acquired and liabilities that are assumed is compared with the fair value of the consideration transferred for the acquired business. The difference is goodwill. After acquisition, it is not amortized but is regularly assessed for impairment.

8. Explain and account for impairment of goodwill. Goodwill is assigned to a cash-generating group or reporting unit and the group is tested for impairment. Under ASPE, a goodwill impairment loss is recognized if the fair value of the asset group is lower than the group's carrying amount, and the loss is equal to the difference. Under IFRS, there is a goodwill impairment loss if the recoverable amount of the cash-generating unit is less than its carrying amount. The loss is equal to the difference and is applied to goodwill first. Under **both** ASPE and IFRS, goodwill impairment losses are not reversed.

9. Identify the types of disclosure requirements for intangible assets and goodwill and explain the issues in analyzing these assets. Disclosures under ASPE are limited because users can typically access additional information. Under IFRS, significant details are required to be disclosed. The disclosures allow a reader to determine how amounts invested in classes of intangibles (and goodwill) have changed over the period, with substantial information provided when fair values are used, such as under the revaluation model and all impairment calculations. For intangibles that are not amortized, companies must indicate the amount of any impairment losses that have been recognized as well as information about the circumstances that led to the write down. Goodwill must be separately reported, as must the major classes of intangible assets. Because it is difficult to measure intangibles, some resources, such as intellectual capital and other internally developed intangible assets, do not get captured on the statement of financial position. Other intangibles are recognized, but with a relatively high level of measurement uncertainty. For these reasons and because of recent changes in the accounting policy related to intangibles, care must be taken when analyzing financial statement information related to earnings and total assets.

10. Identify differences in accounting between IFRS and ASPE. There are few, but significant, differences between ASPE and IFRS regarding intangible assets and goodwill. One major difference is the accounting treatment for costs incurred in the development phase of internally generated intangible assets that meet the six stringent criteria for capitalization. Under ASPE, entities can choose whether to capitalize these costs or expense all costs associated with internally generated intangibles. Under IFRS, these costs are capitalized. The other major difference is the impairment models applied: the cost recovery model for ASPE, and the rational entity model for IFRS.

11. Explain and apply basic approaches to valuing goodwill. One method of valuing goodwill is the excess-earnings approach. Using this approach, the value of goodwill is based on discounting expected future earnings in excess of the industry average to their present value. Another method involves determining the total value of the business by capitalizing total earnings, and then deducting the fair values of the identifiable net assets. The number of

years method of valuing goodwill simply multiplies the excess earnings by the number of years of expected excess earnings. Another method of valuing goodwill is the discounted free cash flow method, which projects the future operating cash that will be generated over and above the amount needed to maintain current operating levels. The present value of the free cash flows is today's estimate of the firm's value.

MULTIPLE CHOICE

Answer	No.	Description
b	1.	Intangible assets and goodwill
b	2.	Definition of goodwill
a	3.	Characteristics of intangible assets
c	4.	Measurement of purchased intangible assets
c	5.	Capitalization of legal fees
a	6.	Recognition of goodwill
a	7.	Calculate total intangible assets.
c	8.	Capitalization of development costs
d	9.	Recognition of internally developed intangibles
a	10.	Amortization of laboratory building used in R & D
a	11.	Capitalization of certain R & D costs
d	12.	Capitalization of research expense
a	13.	Calculate development costs
c	14.	Calculate R & D expense
b	15.	Calculate capital costs
c	16.	Determining limited-life intangible asset's useful life
c	17.	Amortization of finite life of intangible asset
c	18.	Use of revaluation model
d	19.	Definition of "indefinite life"
a	20.	Amortization method for intangibles
d	21.	Accounting for a change in amortization rate
b	22.	Post-acquisition accounting for intangibles – ASPE
c	23.	Post-acquisition accounting for intangibles – IFRS
d	24.	Calculate trademark amortization
b	25.	Calculate amortization of a trademark
a	26.	Calculate amortization of a trademark
a	27.	Example of limited-life intangible asset
b	28.	Amortization of patent cost
b	29.	Accounting for computer software costs
d	30.	Patent amortization
b	31.	Legal fees associated with trademark infringement
c	32.	Accounting for internally developed trademark
d	33.	Example of artistic-related intangible
a	34.	Example of technology-related intangible
a	35.	Accounting for limited-life franchises or licences
c	36.	Calculate patent costs to capitalize
b	37.	Valuation of patent exchanged for an investment in shares
d	38.	Valuation of copyright exchanged for common shares
b	39.	Impairment of intangible asset

- a 40. Rational entity impairment model
- b 41. Impairment of intangibles under ASPE
- d 42. Impairment test for indefinite-life intangibles
- a 43. Rational entity impairment model
- b 44. Calculate amount of worthless patent to be written off
- c 45. Calculate impairment loss
- d 46. Cost of goodwill
- c 47. Example of intangible asset
- d 48. Impairment of intangibles under IFRS
- a 49. Methods of accounting for goodwill
- c 50. Internally generated goodwill
- d 51. Accounting for purchased goodwill
- b 52. Definition of negative goodwill
- d 53. Negative goodwill
- b 54. Proper accounting when fair value of net assets acquired exceeds cost
- d 55. Capitalization of goodwill costs
- c 56. Testing goodwill for impairment using APSE
- a 57. Goodwill impairment under ASPE
- c 58. Goodwill impairment under IFRS
- d 59. Reversal of goodwill impairment
- b 60. Treatment of goodwill impairment
- b 61. Impairment of goodwill
- a 62. Trends in reporting intangible assets
- b 63. Difference between market capitalization and book value
- c *64. Excess-earnings valuation approach
- d *65. Earnings normalization process
- d *66. Methods of measuring goodwill
- a *67. Calculate goodwill
- b *68. Calculate goodwill
- c *69. Calculate goodwill
- c *70. Calculate implied goodwill
- b *71. Calculate goodwill
- b *72. Calculate goodwill

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

EXERCISES

Item	Description
E12-73	Intangible assets and goodwill
E12-74	Calculating goodwill
E12-75	Intangible assets theory
E12-76	Terminology
E12-77	Journal entries for patent purchase
E12-78	Carrying value of patent
E12-79	Journal entries for patent sale
E12-80	Intangible asset impairment
E12-81	Accounting for unidentifiable intangible assets
E12-82	Capitalization of R&D costs
E12-83	Identifying R&D stage activities
E12-84	Criteria for capitalization of development costs
E12-85	Definitions
E12-86	Capitalizing versus expensing intangible-related costs
E12-87	Revaluation model limitations with intangible assets
E12-88	Indefinite versus infinite useful life
E12-89	Technology-based intangible assets
E12-90	Intangible asset impairment
E12-91	Alternative treatments of goodwill after recognition
E12-92	Acquisition of tangible and intangible assets
E12-93	Goodwill measurement and recording
E12-94	Determining impairment loss under ASPE
E12-95	Goodwill impairment
E12-96	Negative goodwill
E12-97	Reporting a patent purchase
E12-98	Disclosures required for internally generated intangible assets
*E12-99	Calculation of goodwill
*E12-100	Calculation of goodwill
*E12-101	Calculation of goodwill
*E12-102	Goodwill calculation
*E12-103	Calculation of goodwill

PROBLEMS

Item	Description
P12-104	Intangible assets
P12-105	Journal entries for impairment of intangible assets
P12-106	Calculation of and journal entries for impairment of goodwill
P12-107	Determining goodwill impairment – ASPE and IFRS

MULTIPLE CHOICE

1. Which of the following is NOT generally true of intangible assets and goodwill?
- a) Many major public companies have significant amounts of intangible assets and goodwill listed on their balance sheets.
 - b) The major assets of today's information and service providers are likely to be tangible.
 - c) The major assets of today's information and service providers are likely to be intangible.
 - d) Since identifying and measuring intangibles and goodwill is often difficult, they are not always reported on the balance sheet.

Answer: b

Difficulty: Easy

Learning Objective: Understand the importance of goodwill and intangible assets from a business perspective and describe their characteristics.

Section Reference: The Business Importance and Characteristics of Goodwill and Intangible Assets

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

2. Which of the following best describes goodwill?
- a) internal value generated by way of a brand image
 - b) the excess of fair value transferred to acquire a business over fair value amounts assigned to identifiable assets
 - c) internal value generated by way of a company's charitable activities and philanthropic acts
 - d) a company's intentions to impact the community and environment in a favourable way

Answer: b

Difficulty: Easy

Learning Objective: Understand the importance of goodwill and intangible assets from a business perspective and describe their characteristics.

Section Reference: The Business Importance and Characteristics of Goodwill and Intangible Assets

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

3. The three main characteristics of intangible assets are
- a) identifiability, non-physical existence, and nonmonetary nature.

- b) identifiability, physical existence, and separability.
- c) separability, identifiability, and nonmonetary nature.
- d) physical existence, nonmonetary nature, and identifiability.

Answer: a

Difficulty: Easy

Learning Objective: Understand the importance of goodwill and intangible assets from a business perspective and describe their characteristics.

Section Reference: The Business Importance and Characteristics of Goodwill and Intangible Assets

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

4. Which of the following is INCORRECT about the measurement of purchased intangible assets?

- a) Purchased intangible assets are measured at cost, which is their fair value at acquisition.
- b) Cost includes the acquisition cost and all expenditures necessary to make the intangible asset ready for its intended use.
- c) If an intangible asset is acquired due to a government grant, the asset is not recognized in the accounting records as there is no cost to the entity receiving the intangible asset.
- d) The cost of the intangible received in a nonmonetary exchange is the fair value of the consideration given or the fair value of the intangible received, whichever is more clearly evident.

Answer: c

Difficulty: Easy

Learning Objective: Identify and apply the recognition and measurement requirements for purchased intangible assets.

Section Reference: Recognition and Measurement of Intangible Assets

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

5. Which of the following legal fees should be capitalized?

	Legal fees to <u>obtain a franchise</u>	Legal fees to successfully <u>defend a trademark</u>
a)	No	No
b)	No	Yes

c)	Yes	Yes
d)	Yes	No

Answer: c

Difficulty: Easy

Learning Objective: Identify and apply the recognition and measurement requirements for purchased intangible assets.

Section Reference: Recognition and Measurement of Intangible Assets

Learning Objective: Explain how intangible assets are accounted for after initial recognition.

Section Reference: Recognition and Measurement after Acquisition

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

6. Babel Corporation acquired all outstanding shares of Connor Ltd. for \$ 2.1 million. Selected information relating to Connor was as follows:

Fair value of identifiable net assets: \$ 2.0 million

Book value of identifiable net assets: \$ 1.6 million

Cash balance: \$ 0.1 million

Mindy will recognize goodwill of

- a) \$ 0.1 million.
- b) \$ 1.1 million.
- c) \$ 2.1 million.
- d) \$ 1.5 million.

Answer: a

Difficulty: Medium

Learning Objective: Identify and apply the recognition and measurement requirements for purchased intangible assets.

Section Reference: Recognition and Measurement of Intangible Assets

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: \$ 2.1 million – \$ 2.0 million = \$ 0.1 million

7. At December 31, 2020, Walker Corp.'s general ledger includes the following account balances:

Copyrights	\$ 50,000
Deposits with advertising agency (will be used to promote goodwill)	32,000
Discount on bonds payable	72,700

Excess of cost over fair value of identifiable net assets of acquired subsidiary.....	578,000
Trademarks	102,000

In the preparation of Walker's balance sheet as of December 31, 2020, what should be reported as total intangible assets?

- a) \$ 152,000
- b) \$ 730,000
- c) \$ 762,000
- d) \$ 802,700

Answer: a

Difficulty: Medium

Learning Objective: Identify and apply the recognition and measurement requirements for purchased intangible assets.

Section Reference: Recognition and Measurement of Intangible Assets

Learning Objective: Identify and explain the accounting for specific types of intangible assets.

Section Reference: Specific Intangibles

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: \$ 50,000 + \$ 102,000 = \$ 152,000

8. Development costs may be capitalized if

- a) the resulting product or service is technically feasible.
- b) the entity has sufficient resources to complete the project.
- c) all of these (all of these criteria, in addition to others, must be met in order for development costs to be capitalized).
- d) the entity intends to use or sell the resulting product or service.

Answer: c

Difficulty: Easy

Learning Objective: Identify and apply the recognition and measurement requirements for internally developed intangible assets.

Section Reference: Recognition and Measurement of Internally Developed Intangible Assets

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

9. When determining whether an internally developed intangible asset should be recognized, the process of generating the intangible is usually broken down into the

- a) research and financing elements.
- b) acquisition and disposal stages.
- c) exploitation and disposal stages.
- d) research and development phases.

Answer: d

Difficulty: Easy

Learning Objective: Identify and apply the recognition and measurement requirements for internally developed intangible assets.

Section Reference: Recognition and Measurement of Internally Developed Intangible Assets

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

10. 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) depreciation deducted as part of research and development costs.
 - b) research and development expense in the period(s) of construction.
 - c) depreciation 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.

Answer: a

Difficulty: Easy

Learning Objective: Identify and apply the recognition and measurement requirements for internally developed intangible assets.

Section Reference: Recognition and Measurement of Internally Developed Intangible Assets

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

11. 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 that 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

Answer: a

Difficulty: Easy

Learning Objective: Identify and apply the recognition and measurement requirements for internally developed intangible assets.

Section Reference: Recognition and Measurement of Internally Developed Intangible Assets

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

12. In 2020, Peterson Corporation incurred research costs as follows:

Materials and supplies	\$ 60,000
Personnel.....	65,000
Indirect costs—allocated	<u>80,000</u>
	<u>\$ 205,000</u>

These costs relate to a product that Peterson expects to market in 2021. It is estimated that these costs will be recouped by December 31, 2023. How much of these costs could be capitalized in 2020?

- a) \$ 205,000
- b) \$ 125,000
- c) \$ 80,000
- d) \$ 0

Answer: d

Difficulty: Medium

Learning Objective: Identify and apply the recognition and measurement requirements for internally developed intangible assets.

Section Reference: Recognition and Measurement of Internally Developed Intangible Assets

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: \$ 0. Research costs must be expensed.

13. Dover Inc. incurred the following costs during the year ended December 31, 2020:

Laboratory research aimed at discovery of new knowledge	\$ 80,000
Design of new products involving new technology	29,000
Testing of new products	19,000
Construction of research and development facilities	120,000

Assuming the 6 specific conditions have been demonstrated, the total amount to be classified as development costs (either deferred or capitalized) in 2020 is

- a) \$ 48,000.
- b) \$ 80,000.

- c) \$ 109,000.
- d) \$ 200,000.

Answer: a

Difficulty: Medium

Learning Objective: Identify and apply the recognition and measurement requirements for internally developed intangible assets.

Section Reference: Recognition and Measurement of Internally Developed Intangible Assets

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 29,000 + \$ 19,000 = \$ 48,000$

14. During 2020, Elysium Inc. incurred the following costs:

Research Expense	\$ 360,000
Routine design of tools, jigs, moulds, and dies	250,000
Modification of the formulation of a process.....	610,000
Development services performed by Orchard Corp. for Elysium .	325,000

Assuming the 6 specific conditions have been demonstrated, in 2020, Elysium Corp. would report development costs of

- a) \$ 1,545,000.
- b) \$ 1,295,000.
- c) \$ 935,000.
- d) \$ 610,000.

Answer: c

Difficulty: Medium

Learning Objective: Identify and apply the recognition and measurement requirements for internally developed intangible assets.

Section Reference: Recognition and Measurement of Internally Developed Intangible Assets

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 610,000 + \$ 325,000 = \$ 935,000$

15. Kingship Inc. is developing a new process that it plans to sell. During 2019 and 2020, the company capitalized \$ 1.1 million and \$ 0.2 million respectively. An additional \$ 0.3 million was spent in 2021. During 2021, it became apparent that, due to a lack of financial resources, the company would not be able to complete the project.

The total amount of capitalized costs relating to this project at the end of 2021 is

- a) nil.
- b) \$ 1.3 million.
- c) \$ 1.0 million.
- d) \$ 1.6 million.

Answer: b

Difficulty: Medium

Learning Objective: Identify and apply the recognition and measurement requirements for internally developed intangible assets.

Section Reference: Recognition and Measurement of Internally Developed Intangible Assets

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: \$ 1.1 million + \$ 0.2 million = \$ 1.3 million

16. Which of the following is NOT a factor to be considered in determining a limited-life intangible asset's useful life?

- a) the expected useful life of any related asset
- b) the effects of obsolescence
- c) all of these are correct
- d) any legal provisions that may limit the useful life

Answer: c

Difficulty: Easy

Learning Objective: Explain how intangible assets are accounted for after initial recognition.

Section Reference: Recognition and Measurement after Acquisition

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

17. Intangible assets that have a finite life are amortized over a period NOT to exceed

- a) intangible assets are not amortized.
- b) 0 years.
- c) their useful life.
- d) the legal life.

Answer: c

Difficulty: Easy

Learning Objective: Explain how intangible assets are accounted for after initial recognition.

Section Reference: Recognition and Measurement after Acquisition

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

18. The reason that the revaluation model is NOT widely used for measuring intangible assets after initial recognition is that

- a) it is not allowed under IFRS.
- b) the cost method is easier to use.
- c) it can be applied only to intangible assets with a fair value determined in an active market.
- d) it requires an extensive internal investigation to determine fair value.

Answer: c

Difficulty: Easy

Learning Objective: Explain how intangible assets are accounted for after initial recognition.

Section Reference: Recognition and Measurement after Acquisition

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

19. An “indefinite life” for an intangible asset means that

- a) the asset will last forever.
- b) unlimited amortization may be recorded for the asset.
- c) amortization is only recorded if future economic benefits can be determined.
- d) there appears to be no foreseeable limit to how long the asset will generate positive future cash flows.

Answer: d

Difficulty: Easy

Learning Objective: Explain how intangible assets are accounted for after initial recognition.

Section Reference: Recognition and Measurement after Acquisition

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

20. If the pattern in which an intangible asset’s benefits will be used up CANNOT be determined, the amortization method most likely to be used is

- a) straight-line.
- b) capital cost allowance.
- c) units of production.

d) double declining-balance.

Answer: a

Difficulty: Easy

Learning Objective: Explain how intangible assets are accounted for after initial recognition.

Section Reference: Recognition and Measurement after Acquisition

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

21. 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.

Answer: d

Difficulty: Easy

Learning Objective: Explain how intangible assets are accounted for after initial recognition.

Section Reference: Recognition and Measurement after Acquisition

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

22. Under ASPE, which of the following statements *best* describes the accounting for intangible assets *after* acquisition?

- 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) They must be amortized over a very short period, usually less than five years.

Answer: b

Difficulty: Easy

Learning Objective: Explain how intangible assets are accounted for after initial recognition.

Section Reference: Recognition and Measurement after Acquisition

Learning Objective: Identify differences in accounting between IFRS and ASPE.

Section Reference: IFRS/ASPE Comparison

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

23. Under IFRS, which of the following statements *best* describes the accounting for intangible assets *after* acquisition?

- a) They may be accounted for under either 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) They should always be accounted for under the revaluation model.

Answer: c

Difficulty: Easy

Learning Objective: Explain how intangible assets are accounted for after initial recognition.

Section Reference: Recognition and Measurement after Acquisition

Learning Objective: Identify differences in accounting between IFRS and ASPE.

Section Reference: IFRS/ASPE Comparison

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

24. On January 2, 2020, Gold Corp. bought a trademark from River Inc. for \$ 100,000. An independent research company estimated that the remaining useful life of the trademark was 25 years. At this time, the trademark's net book value in River's records was \$ 160,000. Because the trademark had a demonstrated limited life beyond 20 years, Gold decided to amortize the trademark over the maximum period, straight-line with no residual. In Gold's (calendar) 2020 income statement, what amount should be reported as amortization expense for this trademark?

- a) \$ 6,400
- b) \$ 6,000
- c) \$ 5,000
- d) \$ 4,000

Answer: d

Difficulty: Medium

Learning Objective: Explain how intangible assets are accounted for after initial recognition.

Section Reference: Recognition and Measurement after Acquisition

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 100,000 / 25 = \$ 4,000$

25. On January 1, 2020, Muhlenberg Corp. bought a trademark from Glasgow Corp. for \$ 160,000. An independent consultant retained by Muhlenberg estimated that the remaining useful life is 50 years. The trademark's carrying value on Glasgow's books was \$ 61,000. Muhlenberg decided to write off the trademark over the maximum period allowed. How much should be amortized for the year ended December 31, 2020?

- a) \$ 1,220
- b) \$ 3,200
- c) \$ 4,000
- d) \$ 8,000

Answer: b

Difficulty: Medium

Learning Objective: Explain how intangible assets are accounted for after initial recognition.

Section Reference: Recognition and Measurement after Acquisition

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 160,000 / 50 = \$ 3,200$

26. On January 1, 2016, Michigan Corp. purchased a trademark for \$ 300,000, which had an estimated useful life of 15 years. In January 2020, Michigan paid \$ 44,000 for legal fees in a successful defence of the trademark. The amortization expense for this asset for calendar 2020, should be

- a) \$ 24,000.
- b) \$ 22,933.
- c) \$ 20,000.
- d) \$ 0.

Answer: a

Difficulty: Medium

Learning Objective: Explain how intangible assets are accounted for after initial recognition.

Section Reference: Recognition and Measurement after Acquisition

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $(\$ 300,000 \div 15) + (\$ 44,000 \div 11) = \$ 24,000$

27. Which of the following is an example of a limited-life intangible asset?

- a) patent
- b) trade name

- c) goodwill
- d) trademark

Answer: a

Difficulty: Easy

Learning Objective: Identify and explain the accounting for specific types of intangible assets.

Section Reference: Specific Intangibles

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

28. The cost of a patent should be amortized over its

- a) legal life.
- b) legal life or useful life, whichever is shorter.
- c) legal life or useful life, whichever is longer.
- d) Patents are indefinite-life intangibles, and therefore not amortized.

Answer: b

Difficulty: Easy

Learning Objective: Identify and explain the accounting for specific types of intangible assets.

Section Reference: Specific Intangibles

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

29. 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.

Answer: b

Difficulty: Easy

Learning Objective: Identify and explain the accounting for specific types of intangible assets.

Section Reference: Specific Intangibles

CPA: Financial Reporting

Bloomcode: Comprehension
AACSB: Analytic

30. 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) expensed 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.

Answer: d

Difficulty: Easy
Learning Objective: Identify and explain the accounting for specific types of intangible assets.
Section Reference: Specific Intangibles
CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

31. This year, Level Ground Ltd. went to court and successfully defended its trademarked product, "Hot Gum," from infringement by a competitor. Legal costs of this defence should be charged to
- a) Trademarks and amortized over the legal life of the trademark.
 - b) Trademarks and amortized over the same period of time as the "Hot Gum" trademark.
 - c) Legal Expense and amortized over five years or less.
 - d) Legal Expense of the period.

Answer: b

Difficulty: Easy
Learning Objective: Identify and explain the accounting for specific types of intangible assets.
Section Reference: Specific Intangibles
CPA: Financial Reporting
Bloomcode: Comprehension
AACSB: Analytic

32. If a trademark is developed by the enterprise itself, the costs should be
- a) capitalized but not amortized.
 - b) capitalized only if future benefits are reasonably assured.
 - c) capitalized, but only from the point in time when all six capitalization criteria are met in the development phase.

d) capitalized as soon as the development phase starts.

Answer: c

Difficulty: Easy

Learning Objective: Identify and explain the accounting for specific types of intangible assets.

Section Reference: Specific Intangibles

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

33. A copyright is an example of a(n)

- a) customer-related intangible asset.
- b) marketing-related intangible asset.
- c) contract-based intangible asset.
- d) artistic-related intangible asset.

Answer: d

Difficulty: Easy

Learning Objective: Identify and explain the accounting for specific types of intangible assets.

Section Reference: Specific Intangibles

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

34. A patent is an example of a(n)

- a) technology-based intangible asset.
- b) marketing-related intangible asset.
- c) contract-based intangible asset.
- d) artistic-related intangible asset.

Answer: a

Difficulty: Easy

Learning Objective: Identify and explain the accounting for specific types of intangible assets.

Section Reference: Specific Intangibles

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

35. A franchise or licence with a limited life is

- a) amortized over the lesser of its legal or useful life.
- b) expensed.
- c) not amortized.
- d) always amortized over its legal life.

Answer: a

Difficulty: Easy

Learning Objective: Identify and explain the accounting for specific types of intangible assets.

Section Reference: Specific Intangibles

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

36. Cayman Corp. incurred \$ 140,000 of basic research and \$ 35,000 of development costs to develop a product for which a patent was granted on January 2, 2015. Legal fees and other costs associated with registration of the patent totalled \$ 50,000. On March 31, 2020, Cayman paid \$ 75,000 for legal fees in a successful defence of the patent. The total amount capitalized for the patent through March 31, 2020 should be

- a) \$ 300,000.
- b) \$ 265,000.
- c) \$ 160,000.
- d) \$ 125,000.

Answer: c

Difficulty: Medium

Learning Objective: Identify and explain the accounting for specific types of intangible assets.

Section Reference: Specific Intangibles

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 50,000 + \$ 75,000 + \$ 35,000 = \$ 160,000$

37. On June 30, 2020, Blue Ltd. exchanged 2,000 Ivy Corp. common shares for a patent owned by Jazz Corp. The Ivy shares were acquired in 2018 for \$ 125,000. At the exchange date, Ivy common shares have a fair value of \$ 80 per share, and the patent had a carrying value of \$ 280,000 on Jazz's books. Blue should record the patent at

- a) \$ 280,000.
- b) \$ 160,000.
- c) \$ 155,000.
- d) \$ 125,000.

Answer: b

Difficulty: Medium

Learning Objective: Identify and explain the accounting for specific types of intangible assets.

Section Reference: Specific Intangibles

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$2,000 \times \$80 = \$160,000$, since do not have a reliable fair value of the patent received

38. On May 5, 2020, Samson Corp. exchanged 4,000 of its common shares for a copyright owned by Ingleton Ltd. At this date, Samson's common shares were quoted at \$22 per share, and the copyright had a carrying value of \$100,000 on Ingleton's books. Samson should record the copyright at

- a) \$122,000.
- b) \$104,000.
- c) \$100,000.
- d) \$88,000.

Answer: d

Difficulty: Medium

Learning Objective: Identify and explain the accounting for specific types of intangible assets.

Section Reference: Specific Intangibles

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $4,000 \times \$22 = \$88,000$, since do not have a reliable fair value of the copyright received

39. An impairment of an identifiable intangible asset arises when its carrying amount exceeds the

- a) present value of the expected future net cash flows.
- b) expected future economic benefits.
- c) asset's cost.
- d) asset's fair value.

Answer: b

Difficulty: Easy

Learning Objective: Explain and account for impairment of limited-life and indefinite-life intangible assets.

Section Reference: Impairment and Derecognition

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

40. Similar to impairment models and standards that apply to long-lived tangible assets, the rational entity impairment model applies also to

- a) limited-life intangible assets for organizations using IFRS.
- b) indefinite-life intangible assets for organizations using ASPE.
- c) indefinite-life intangible asset for organizations using IFRS.
- d) limited-life intangible assets for organizations using ASPE.

Answer: a

Difficulty: Easy

Learning Objective: Explain and account for impairment of limited-life and indefinite-life intangible assets.

Section Reference: Impairment and Derecognition

Learning Objective: Identify differences in accounting between IFRS and ASPE.

Section Reference: IFRS/ASPE Comparison

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

41. Under ASPE, to determine if there is an impairment loss, compare the

- a) fair value of the identifiable assets to the book value of the assets.
- b) fair value of the reporting unit to the carrying value of the reporting unit.
- c) imputed current fair value of the assets with the carrying value of the assets.
- d) imputed carrying value of the assets with the fair value of the assets.

Answer: b

Difficulty: Easy

Learning Objective: Explain and account for impairment of limited-life and indefinite-life intangible assets.

Section Reference: Impairment and Derecognition

Learning Objective: Identify differences in accounting between IFRS and ASPE.

Section Reference: IFRS/ASPE Comparison

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

42. 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

Answer: d

Difficulty: Easy

Learning Objective: Explain and account for impairment of limited-life and indefinite-life intangible assets.

Section Reference: Impairment and Derecognition

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

43. Which of the following is correct regarding the rational entity impairment model?

- a) For limited-life intangibles, IFRS requires that the rational entity impairment model be applied.
- b) For limited-life intangibles, ASPE requires that the rational entity impairment model be applied.
- c) For indefinite-life intangibles, ASPE requires that the rational entity impairment model be applied.
- d) Neither ASPE nor IFRS allow the use of the rational entity impairment model.

Answer: a

Difficulty: Easy

Learning Objective: Explain and account for impairment of limited-life and indefinite-life intangible assets.

Section Reference: Impairment and Derecognition

Learning Objective: Identify differences in accounting between IFRS and ASPE.

Section Reference: IFRS/ASPE Comparison

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

44. In January, 2015, Tillicum Corp. purchased a patent for a new consumer product for \$ 900,000. At the time of purchase, the patent was valid for 15 years. Due to the competitive nature of the product, however, the patent was estimated to have a useful life of only ten years. During 2020, the product was permanently removed from the market because of a potential health hazard. What amount should Tillicum recognize as an impairment loss for

calendar 2020, assuming amortization has been recorded annually using the straight-line method with no residual value?

- a) \$ 600,000
- b) \$ 450,000
- c) \$ 90,000
- d) \$ 60,000

Answer: b

Difficulty: Medium

Learning Objective: Explain and account for impairment of limited-life and indefinite-life intangible assets.

Section Reference: Impairment and Derecognition

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: ($\$ 900,000 \div 10$) $\times 5 = \$ 450,000$ amortization already recorded

carrying value is $\$ 900,000 - \$ 450,000 = \$ 450,000$

impairment is $\$ 0 - \$ 450,000 = \$ 450,000$

45. On January 2, 2017, Albion Corp. purchased a patent for a new consumer product for \$ 45,000. At the time of purchase, the patent was valid for 15 years. Due to the competitive nature of the product, however, the patent was estimated to have a useful life of only ten years. During 2020, the product was permanently removed from the market because of a potential health hazard. What amount should Albion recognize as an impairment loss for calendar 2020, assuming amortization has been recorded annually using the straight-line method with no residual value?

- a) \$ 4,500
- b) \$ 27,000
- c) \$ 31,500
- d) \$ 36,000

Answer: c

Difficulty: Medium

Learning Objective: Explain and account for impairment of limited-life and indefinite-life intangible assets.

Section Reference: Impairment and Derecognition

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: ($\$ 45,000 \div 10$) $\times 3 = \$ 13,500$ amortization already recorded

carrying value is $\$45,000 - \$13,500 = \$31,500$
impairment is $\$0 - \$31,500 = \$31,500$

46. Goodwill is the excess of the purchase price of the acquired enterprise over the
- a) fair value of the tangible net assets acquired.
 - b) book value of the identifiable net assets acquired.
 - c) book value of the tangible net assets acquired.
 - d) fair value of the identifiable net assets acquired.

Answer: d

Difficulty: Easy

Learning Objective: Explain how goodwill is measured and accounted for after acquisition.

Section Reference: Goodwill

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

47. All of the following are specifically identifiable intangible assets EXCEPT
- a) patents.
 - b) trademarks.
 - c) goodwill.
 - d) copyrights.

Answer: c

Difficulty: Easy

Learning Objective: Explain how goodwill is measured and accounted for after acquisition.

Section Reference: Goodwill

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

48. Under IFRS, to determine if there is an impairment of goodwill, compare the
- a) fair value of the identifiable assets to the book value of the assets.
 - b) fair value of the reporting unit to the carrying value of the reporting unit.
 - c) imputed current fair value of goodwill with the carrying value of goodwill.
 - d) carrying amount of the CGU with the recoverable amount.

Answer: d

Difficulty: Easy

Learning Objective: Explain how goodwill is measured and accounted for after acquisition.

Section Reference: Goodwill

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

49. 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.

Answer: a

Difficulty: Easy

Learning Objective: Explain how goodwill is measured and accounted for after acquisition.

Section Reference: Goodwill

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

50. Internally generated goodwill

- a) is not possible.
- b) may be capitalized or expensed.
- c) is not capitalized.
- d) is capitalized but not amortized.

Answer: c

Difficulty: Easy

Learning Objective: Explain how goodwill is measured and accounted for after acquisition.

Section Reference: Goodwill

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

51. Purchased goodwill should be

- a) expensed as soon as possible against retained earnings.
- b) expensed as soon as possible to other comprehensive income.
- c) amortized over the period benefited, but not more than 40 years.
- d) not expensed or amortized, but rather reduced only if impairment occurs.

Answer: d

Difficulty: Easy

Learning Objective: Explain how goodwill is measured and accounted for after acquisition.

Section Reference: Goodwill

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

52. 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.

Answer: b

Difficulty: Easy

Learning Objective: Explain how goodwill is measured and accounted for after acquisition.

Section Reference: Goodwill

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

53. If the fair value of the net assets acquired in a business combination is greater than the purchase price, the difference is called

- a) organizational costs.
- b) contributed surplus.
- c) purchased goodwill.
- d) negative goodwill or bargain purchase.

Answer: d

Difficulty: Easy

Learning Objective: Explain how goodwill is measured and accounted for after acquisition.

Section Reference: Goodwill

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

54. During 2020, Spokane Ltd. purchased the net assets of Tacoma Corp. for \$ 635,000. On the date of the transaction, Tacoma reported \$ 200,000 in liabilities. As well, the fair value of Tacoma's assets was:

Current assets	\$ 360,000
Noncurrent assets	<u>840,000</u>
	\$ 1,200,000

How should the difference between the fair value of the net assets acquired and the cost be accounted for by Spokane?

- a) The difference should be credited to retained earnings.
- b) The difference should be recognized as a gain in net income.
- c) The noncurrent assets should be reduced appropriately.
- d) The difference should be prorated between the current and the noncurrent assets.

Answer: b

Difficulty: Easy

Learning Objective: Explain how goodwill is measured and accounted for after acquisition.

Section Reference: Goodwill

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

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

Answer: d

Difficulty: Easy

Learning Objective: Explain how goodwill is measured and accounted for after acquisition.

Section Reference: Goodwill

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

56. The steps involved in testing goodwill for impairment using ASPE do NOT include

- a) comparing the current implied fair value of goodwill with its carrying amount.
- b) comparing the fair value of the reporting unit against its carrying amount including goodwill.
- c) all of these (all of these steps are involved in testing goodwill for impairment using ASPE).

d) calculating the implied current fair value of goodwill.

Answer: c

Difficulty: Easy

Learning Objective: Explain how goodwill is measured and accounted for after acquisition.

Section Reference: Recognition and Measurement of Goodwill

Learning Objective: Explain and account for impairment of goodwill.

Section Reference: Impairment of Goodwill

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

57. Under ASPE, which of the following statements *best* describes when goodwill should be tested for impairment?

- 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.

Answer: a

Difficulty: Easy

Learning Objective: Explain and account for impairment of goodwill.

Section Reference: Impairment of Goodwill

Learning Objective: Identify differences in accounting between IFRS and ASPE.

Section Reference: IFRS/ASPE Comparison

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

58. Under IFRS, which of the following statements *best* describes when goodwill should be tested for impairment?

- 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.

Answer: c

Difficulty: Easy

Learning Objective: Explain and account for impairment of goodwill.

Section Reference: Impairment of Goodwill

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

59. Which of the following statements *best* describes when previously recognized goodwill impairment may be reversed?

- a) Reversals are permitted under both ASPE and IFRS.
- b) Reversals are permitted under ASPE but not IFRS.
- c) Reversals are permitted under IFRS but not ASPE.
- d) Reversals are *not* permitted under either IFRS or ASPE.

Answer: d

Difficulty: Easy

Learning Objective: Explain and account for impairment of goodwill.

Section Reference: Impairment of Goodwill

Learning Objective: Identify differences in accounting between IFRS and ASPE.

Section Reference: IFRS/ASPE Comparison

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

60. Goodwill was purchased when a business was acquired. When it is determined that the goodwill is impaired, the credit is usually made to

- a) the Goodwill account.
- b) an Accumulated Impairment Loss account.
- c) a Deferred Credit account.
- d) a Shareholders' Equity account.

Answer: b

Difficulty: Easy

Learning Objective: Explain and account for impairment of goodwill.

Section Reference: Impairment of Goodwill

CPA: Financial Reporting
Bloomcode: Knowledge
AACSB: Analytic

61. On September 2020, Princes Corporation acquired Royal Mile Incorporated for a cash payment of \$ 864,300. At the time of the purchase, Royal Mile's statement of financial position showed assets of \$ 890,600, liabilities of \$ 469,700, and owners' equity of \$ 420,900. The fair value of Royal Mile's assets is estimated to be \$ 1,162,900. Assume that Princes Corporation is a public company and that the goodwill was allocated entirely to one cash-generating unit (GU). Two years later, the CGU's carrying amount is \$ 3,530,300, the value in use is \$ 3,458,200, and the fair value less costs to sell is \$ 3,058,200.

Goodwill is

- a) not impaired.
- b) impaired by \$ 72,100.
- c) impaired by \$ 472,100.
- d) Not enough information is provided to assess impairment.

Answer: b

Difficulty: Medium

Learning Objective: Explain and account for impairment of goodwill.

Section Reference: Impairment of Goodwill

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: \$ 3,530,300 carrying amount – \$ 3,458,200 value in use = \$ 72,100 amount of impairment

62. Regarding trends in intangible asset reporting, which of the following statements is NOT true?

- a) Intangible assets, along with goodwill, have been decreasing as a proportion of companies' reported assets.
- b) The most common types of intangible assets reported are broadcast rights, publishing rights, trademarks, patents, licences, customer lists, non-competition agreements, franchises, and purchased R&D.
- c) Intangibles are an important contributor to entity performance and financial position.
- d) Intangible assets, along with goodwill, have been increasing as a proportion of companies' reported assets.

Answer: a

Difficulty: Easy

Learning Objective: Identify the types of disclosure requirements for intangible assets and goodwill and explain the issues in analyzing these assets.

Section Reference: Presentation, Disclosure, and Analysis

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

63. The significant difference between market capitalization and book value of companies like Apple Inc. holding sizeable knowledge assets or intellectual capital is an example of

- a) the tradeoff between timeliness and accuracy.
- b) the tradeoff between relevance and reliability.
- c) the tradeoff between cost and fair value reporting.
- d) the decreasing emphasis on representational faithfulness.

Answer: b

Difficulty: Easy

Learning Objective: Identify the types of disclosure requirements for intangible assets and goodwill and explain the issues in analyzing these assets.

Section Reference: Presentation, Disclosure, and Analysis

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

64. Which of the following explains the rationale for using “normalized” earnings under the excess-earnings valuation approach?

- a) Historic asset values are the best reflection of the assets’ value in use.
- b) The company’s future earnings should always be higher than the past earnings.
- c) The past often provides useful information about the future; past earnings are a good starting point.
- d) Normalized earnings are not used under the excess-earnings valuation approach.

Answer: c

Difficulty: Easy

Learning Objective: Explain and apply basic approaches to valuing goodwill.

Section Reference: Valuing Goodwill (Appendix 12A)

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

65. Which of the following is NOT true of the earnings normalization process?

- a) Accounting policies applied should be consistent with those of the purchaser.

- b) Future earnings should be based on the net assets' current fair values.
- c) Amounts that are not expected to recur should be adjusted out of our calculations.
- d) All of these statements are true of the earnings normalization process.

Answer: d

Difficulty: Easy

Learning Objective: Explain and apply basic approaches to valuing goodwill.

Section Reference: Valuing Goodwill (Appendix 12A)

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

*66. Which of the following is NOT a method of calculating goodwill?

- a) excess-earnings approach
- b) total earnings approach
- c) discounted free cash flow method
- d) undiscounted free cash flow method

Answer: d

Difficulty: Easy

Learning Objective: Explain and apply basic approaches to valuing goodwill.

Section Reference: Valuing Goodwill (Appendix 12A)

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

*67. Assuming the fair value of Frosty's net assets is \$ 10.2 million, and Casper acquires a 75% share, goodwill can be calculated as

- a) \$ 1,550,000.
- b) \$ 1,243,000.
- c) \$ 1,000,000.
- d) \$ 750,000.

Answer: a

Difficulty: Medium

Learning Objective: Explain and apply basic approaches to valuing goodwill.

Section Reference: Valuing Goodwill (Appendix 12A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$9,200,000 - (75\% \times \$10,200,000) = \$1,550,000$

*68. Assuming the fair value of Frosty's net assets is \$ 12.5 million, and Casper acquires a 75% share, goodwill can be calculated as

- a) \$ 375,000.
- b) \$ 175,000 negative.
- c) \$ 175,000.
- d) \$ 0.

Answer: b

Difficulty: Medium

Learning Objective: Explain and apply basic approaches to valuing goodwill.

Section Reference: Valuing Goodwill (Appendix 12A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$9,200,000 - (75\% \times \$12,500,000) = \$175,000$ negative

*69. Icicle Corp.'s average annual net income is \$ 50,000 above the average for Icicle's industry. Snowy is interested in purchasing Icicle. Assuming Snowy estimates goodwill by capitalizing excess earnings at 13%, the estimated goodwill (to the nearest dollar) is

- a) \$ 753,846.
- b) \$ 685,162.
- c) \$ 384,615.
- d) \$ 0.

Answer: c

Difficulty: Medium

Learning Objective: Explain and apply basic approaches to valuing goodwill.

Section Reference: Valuing Goodwill (Appendix 12A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$50,000 / 0.13 = \$384,615$

*70. The owners of Dallas Electronics Store are contemplating selling the business. The cumulative earnings for the past 5 years totalled \$ 900,000, including a gain on discontinued operations 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.

Answer: c

Difficulty: Medium

Learning Objective: Explain and apply basic approaches to valuing goodwill.

Section Reference: Valuing Goodwill (Appendix 12A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\frac{\$ 900,000 - \$ 30,000 - \$ 138,000}{5} = \$ 36,000$

$$\frac{\$ 36,000}{.15} = \$ 240,000$$

Use the following information for questions *71–*72.

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 assets for industry: 10%

Reported net income for the previous six consecutive years:

<u>Year</u>	<u>Amount</u>	<u>Year</u>	<u>Amount</u>
2015	\$ 710,000	2018	\$ 745,000
2016	\$ 680,000	2019	\$ 815,000
2017	\$ 980,000	2020	\$ 835,000

Net income for 2020 included a \$ 200,000 gain from the sale of a discontinued operation.

*71. Estimated goodwill by capitalizing average excess earnings at 14% is

- a) \$ 2,029,762.
- b) \$ 1,791,667.
- c) \$ 1,654,331.
- d) \$ 760,833.

Answer: b

Difficulty: Medium

Learning Objective: Explain and apply basic approaches to valuing goodwill.

Section Reference: Valuing Goodwill (Appendix 12A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 710,000 + \$ 680,000 + \$ 980,000 + \$ 745,000 + \$ 815,000 + \$ 835,000 = \$ 4,765,000$

$[(\$ 4,765,000 - \$ 200,000) \div 6] - (\$ 5,100,000 \times .10) = \$ 250,833$

$\$ 250,833 \div .14 = \$ 1,791,667$

*72. 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.

Answer: b

Difficulty: Medium

Learning Objective: Explain and apply basic approaches to valuing goodwill.

Section Reference: Valuing Goodwill (Appendix 12A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Feedback: $\$ 250,833 \times 8 = \$ 2,006,667$

EXERCISES

Ex. 12-73 Intangible assets and goodwill

Explain the three main characteristics of intangible assets. Is goodwill an intangible asset? Why, or why not? Explain.

Solution 12-73

The three main characteristics of intangible assets are that they

1. are identifiable: Resulting from contractual or other legal rights and/or separable.
2. lack physical substance: The value of intangible assets comes from the rights and privileges granted to the company using them.
3. are nonmonetary: Do not contain a right (or claim) to receive fixed or determinable amounts of money in the future.

Goodwill is not an intangible asset because it does not meet the first criterion. It is not separable from the rest of the entity and does not result from contractual or legal rights. For example, synergies of a combined sales force or superior management team cannot be separated from an entity in order to exchange with others.

Difficulty: Easy

Learning Objective: Understand the importance of goodwill and intangible assets from a business perspective and describe their characteristics.

Section Reference: The Business Importance and Characteristics of Goodwill and Intangible Assets

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 12-74 Calculating goodwill

Explain how the amount to be recognized as goodwill can be calculated. Can goodwill be sold? If so, how? Explain.

Solution 12-74

The amount recognized as goodwill is the difference between the fair value of the consideration transferred to acquire the business and the fair value amounts assigned to the identifiable net assets.

The only way goodwill can be sold is to sell the business. This is because goodwill is an unidentified excess or residual amount, and can only be calculated and expressed in relation to the business as whole.

Difficulty: Easy

Learning Objective: Understand the importance of goodwill and intangible assets from a business perspective and describe their characteristics.

Section Reference: The Business Importance and Characteristics of Goodwill and Intangible Assets

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 12-75 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 12-75

Intangible assets may have future revenue producing ability, like tangible assets. The costs, therefore, should be capitalized, deferred, and matched as closely as possible against those revenues. Definite-life intangible assets should be amortized over the lesser of their useful and legal lives; indefinite-life intangibles are not amortized. Both types of intangibles should be tested regularly for impairment.

Difficulty: Easy

Learning Objective: Identify and apply the recognition and measurement requirements for purchased intangible assets.

Section Reference: Recognition and Measurement of Intangible Assets

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 12-76 Terminology

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

1. In a business combination, the difference between the fair value of the consideration given and the fair values assigned to the identifiable net assets. 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. Planned investigation undertaken with the hope of gaining new scientific or technical knowledge and understanding.	4. _____
5. Translation of research findings or other knowledge into a plan or design for new or substantially improved materials, products, processes, systems or services.	5. _____
6. A database including customer names, contact information, order history, and demographic information	6. _____
7. An exclusive right that is granted for the life of the creator plus 50 years.	7. _____

Solution 12-76

1. Goodwill
2. Negative goodwill or bargain purchase
3. A favourable lease
4. Research
5. Development
6. Customer list
7. Copyright

Difficulty: Easy

Learning Objective: Identify and apply the recognition and measurement requirements for purchased intangible assets.

Section Reference: Recognition and Measurement of Intangible Assets

Learning Objective: Identify and apply the recognition and measurement requirements for internally developed intangible assets.

Section Reference: Recognition and Measurement of Internally Developed Intangible Assets

Learning Objective: Identify and explain the accounting for specific types of intangible assets.

Section Reference: Specific Intangibles

Learning Objective: Explain how goodwill is measured and accounted for after acquisition.

Section Reference: Goodwill

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

Ex. 12-77 Journal entries for patent purchase

CSI Products Ltd. purchased a patent on January 1, 2020, for \$ 1,120,000. At the time of the purchase, the patent had a remaining legal life of 20 years. In January 2023, CSI spent \$ 92,000 successfully defending the patent in court. One of the other results of the court case was the discovery that the patent would only have a remaining useful life of 9 years. CSI's year end was December 31.

Instructions

Prepare the entries on the books of CSI to record a) the purchase of the patent, b) the amortization for the first year (2020), c) the defence of the patent, and d) amortization for 2023.

Solution 12-77

a) Intangible Assets—Patents	1,120,000	
Cash.....		1,120,000
to record the purchase of the patent		
b) Patent Amortization Expense	56,000	
Accumulated Amortization—Patents		56,000
to record 2020 amortization		
c) Intangible Assets—Patents	92,000	
Cash.....		92,000
to record the legal defence of the patent		
d) Patent Amortization Expense	116,000	
Accumulated Amortization—Patents		116,000
to record 2023 amortization		

Calculations:

*\$ 56,000/ year amortization charge x 3 years = \$ 168,000

\$ 1,120,000 - \$ 168,000 = \$ 952,000 carrying value

\$ 952,000 carrying value + \$ 92,000 legal costs = \$ 1,044,000 revised cost

$\$ 1,044,000 \div 9 \text{ years} = \$ 116,000 / \text{year revised amortization}$

Difficulty: Medium

Learning Objective: Identify and apply the recognition and measurement requirements for purchased intangible assets.

Section Reference: Recognition and Measurement of Intangible Assets

Learning Objective: Explain how intangible assets are accounted for after initial recognition.

Section Reference: Recognition and Measurement after Acquisition

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 12-78 Carrying value of patent

On July 1, 2017, Dominica Corp. purchased a patent from Surama Ltd. for \$ 60,000. On July 1, 2020, Dominica paid \$ 12,000 for successful litigation in defence of the patent. Dominica 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, 2020. Label all calculations.

Solution 12-78

Cost of patent	\$ 60,000
Amortization Jul 1/17 to Jul 1/20 ($\$ 60,000 \div 15$) $\times 3$	<u>(12,000)</u>
Carrying value at Jul 1/20	48,000
Add cost of successful defence.....	<u>12,000</u>
Carrying value	60,000
Amortization Jul 1 to Dec 31/20 [$\$ 60,000 \div (15 - 3)$] $\times 1/2$	<u>(2,500)</u>
Carrying value at Dec 31/20	<u>\$ 57,500</u>

Difficulty: Medium

Learning Objective: Identify and apply the recognition and measurement requirements for purchased intangible assets.

Section Reference: Recognition and Measurement of Intangible Assets

Learning Objective: Explain how intangible assets are accounted for after initial recognition.

Section Reference: Recognition and Measurement after Acquisition

Learning Objective: Identify and explain the accounting for specific types of intangible assets.

Section Reference: Specific Intangibles

CPA: Financial Reporting

Bloomcode: Application

Ex. 12-79 Journal entries for patent sale

Amplify Inc. purchased a patent on September 1, 2020 for \$ 41,080. At the time of purchase, Amplify estimated that the patent's economic benefits would last until the end of 2024. Amplify's fiscal year end is December 31. On April 1, 2023, Amplify sold the patent to another company.

Instructions

- Prepare the journal entry to record the sale, assuming Amplify sold the patent for \$ 21,690.
- Prepare the journal entry to record the sale, assuming Amplify sold the patent for \$ 12,240.

Solution 12-79

a) Cash.....	21,690	
Accumulated Amortization	24,490	
Patents.....		41,080
Gain on Disposal – Patent		5,100
b) Cash.....	12,240	
Accumulated Amortization	24,490	
Loss on Disposal – Patent.....	4,350	
Patents.....		41,080

Difficulty: Medium

Learning Objective: Identify and apply the recognition and measurement requirements for purchased intangible assets.

Section Reference: Recognition and Measurement of Intangible Assets

Learning Objective: Explain how intangible assets are accounted for after initial recognition.

Section Reference: Recognition and Measurement after Acquisition

Learning Objective: Identify and explain the accounting for specific types of intangible assets.

Section Reference: Specific Intangibles

Learning Objective: Explain and account for impairment of limited-life and indefinite-life intangible assets.

Section Reference: Impairment and Derecognition

CPA: Financial Reporting

Bloomcode: Application

Ex. 12-80 Intangible asset impairment

Roi Inc. is a private corporation following ASPE. On Jan 2, 2020 they purchased a limited-life licence for \$ 50,000. This licence has a ten-year life and is not renewable. Straight-line amortization will be used. At December 31, 2021, Roi estimates that the undiscounted net cash flows of this license is \$ 38,000, and the fair value (discounted net future cash flows) of this licence is \$ 32,000.

Instructions

- Calculate the amount of impairment (if any) for this asset.
- Prepare the adjusting entry required to reflect any impairment.

Solution 12-80

- Carrying value at Dec 31/21 = \$ 50,000 – [(\$ 50,000/10) x 2 years] = \$ 40,000
 Recoverability test: \$ 40,000 – \$ 38,000 = \$ 2,000. Therefore, the asset is impaired.
 Impairment is \$ 40,000 – \$ 32,000 = \$ 8,000
- AJE required at Dec 31/21

Loss on Impairment— Licence	8,000	
Accumulated Impairment Losses – Licence		8,000

Difficulty: Medium

Learning Objective: Identify and apply the recognition and measurement requirements for purchased intangible assets.

Section Reference: Recognition and Measurement of Intangible Assets

Learning Objective: Explain and account for impairment of limited-life and indefinite-life intangible assets.

Section Reference: Impairment and Derecognition

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 12-81 Accounting for unidentifiable intangible assets

Explain how an entity that acquires control over one or more businesses accounts for intangible assets when they are not identifiable.

Solution 12-81

When one entity acquires control over one or more businesses, the entity has to account for all the assets that are acquired, regardless of whether or not they are recognized. Many of the assets acquired that contribute to the value of the business are intangible, but only those that are identifiable can be separately recognized. Intangibles acquired that are not identifiable assets are considered part of goodwill.

Difficulty: Easy

Learning Identify and apply the recognition and measurement requirements for purchased intangible assets.

Section Reference: Recognition and Measurement of Intangible Assets.

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension
AACSB: Communication

Ex. 12-82 Capitalization of R&D costs

Carmanah Industries Ltd. is a company in the high-technology industry. Carmanah has been working on developing a new solar panel technology. The technology meets all of the six criteria required in order to capitalize development costs. During 2020, Carmanah incurred the following costs related to research and development:

Rent of facility	\$ 250,000
Salaries of research staff	290,000
Legal costs to obtain new patent for technology	40,000
Legal costs of defending new patent in court	36,000
Materials consumed in manufacture of prototypes	13,100
Consulting fees paid for general research	45,200
Indirect costs related to research and development	9,700

Instructions

Calculate the amount that Carmanah would be allowed to capitalize as an intangible asset for 2020, assuming that Carmanah follows IFRS.

Solution 12-82

Legal costs to obtain new patent for technology	\$ 40,000
Legal costs of defending new patent in court	36,000
Materials consumed in manufacture of prototypes	<u>13,100</u>
Total capitalizable under IFRS	\$ 89,100

Difficulty: Medium

Learning Objective: Identify and apply the recognition and measurement requirements for internally developed intangible assets.

Section Reference: Recognition and Measurement of Internally Developed Intangible Assets

CPA: Financial Reporting

Bloomcode: Application

Ex. 12-83 Identifying R&D stage activities

Provide some examples of activities in each of the research and development phases. If there is uncertainty about which phase a particular activity relates to when internally creating an intangible asset, which classification should it be assigned?

Solution 12-83

Research stage activities include:

- Obtaining new knowledge
- Searching for, evaluating, and selecting ways to use research findings or knowledge

- Investigating possible alternatives for materials, products, processes, systems, and services
- Formulating, designing, evaluating, and choosing possible alternatives for new or existing materials, products, processes, systems, and services

Development stage activities include:

- Designing, constructing, and testing prototypes and models prior to production or use
- Designing tools, jigs, moulds, and dies involving new technology
- Designing, constructing, and operating pilot plants that are not economically feasible for commercial production
- Designing, constructing, and testing chosen alternatives for new or improved materials, products, processes, systems, and services.

If there is uncertainty about which phase a particular activity relates to when internally creating an intangible asset, it is classified only as a research phase activity.

Difficulty: Easy

Learning Objective: Identify and apply the recognition and measurement requirements for internally developed intangible assets.

Section Reference: Recognition and Measurement of Internally Developed Intangible Assets

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 12-84 Criteria for capitalization of development costs

List the criteria that must be met before development costs of a project may be capitalized.

Solution 12-84

The six criteria that must be met are:

1. Technical feasibility of completing the intangible asset,
2. The entity's intention to complete it for use or sale,
3. The entity's ability to use or sell it,
4. Availability of technical, financial, and other resources needed to complete, use or sell it,
5. 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,
6. The ability to reliably measure the costs associated with and attributed to the intangible asset during its development.

Difficulty: Easy

Learning Objective: Identify and apply the recognition and measurement requirements for internally developed intangible assets.

Section Reference: Recognition and Measurement of Internally Developed Intangible Assets

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

Ex. 12-85 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 12-85

1. Intangible assets are assets that are individually identifiable, lack physical substance, and are nonmonetary 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. Factors to be considered are the expected use of the asset; legal, contractual or regulatory provisions; potential obsolescence, demand, competition, and other economic factors; 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 ASPE and the latter is used in IFRS.

Difficulty: Easy

Learning Objective: Identify and apply the recognition and measurement requirements for internally developed intangible assets.

Section Reference: Recognition and Measurement of Internally Developed Intangible Assets

Learning Objective: Explain how intangible assets are accounted for after initial recognition.

Section Reference: Recognition and Measurement after Acquisition

Learning Objective: Identify and explain the accounting for specific types of intangible assets.

Section Reference: Specific Intangibles

Learning Objective: Explain and account for impairment of limited-life and indefinite-life intangible assets.

Section Reference: Impairment and Derecognition

Learning Objective: Identify differences in accounting between IFRS and ASPE.

Section Reference: IFRS/ASPE Comparison

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 12-86 Capitalization versus expensing intangible-related costs

Identify whether the following costs would be expensed (E) or capitalized (C):

___ Lawyer fees related to the successful defence of a patent

___ Routine website maintenance

___ Costs incurred to register a company's name and trademark

___ Interest or borrowing costs related to an internally generated intangible

___ Lawyer fees related to the unsuccessful defence of a patent

Solution 12-86

C Lawyer fees related to the successful defence of a patent

E Routine website maintenance

C Costs incurred to register a company's name and trademark

C Interest or borrowing costs related to an internally generated intangible

E Lawyer fees related to the unsuccessful defence of a patent

Difficulty: Easy

Learning Objective: Identify and apply the recognition and measurement requirements for internally developed intangible assets.

Section Reference: Recognition and Measurement of Internally Developed Intangible Assets.

Learning Objective: Identify differences in accounting between IFRS and ASPE.

Section Reference: IFRS/ASPE Comparison

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

Ex. 12-87 Revaluation model limitations with intangible assets

Why is the revaluation model not widely used for measuring intangible assets after initial recognition?

Solution 12-87

The reason is simply that it can be applied only to intangible assets that have a fair value determined in an active market. This limits its use to situations where the items are homogeneous (interchangeable), there is a good supply of willing buyers and sellers, and the prices are available to the public. An active securities market, such as the Toronto Stock Exchange, exists for equity securities, but active markets do not ordinarily exist for intangible assets.

Difficulty: Easy

Learning Objective: Explain how intangible assets are accounted for after initial recognition

Section Reference: Recognition and Measurement after Acquisition.

Learning Objective: Identify differences in accounting between IFRS and ASPE.

Section Reference: IFRS/ASPE Comparison

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 12-88 Indefinite versus infinite useful life

Is there a difference between assets with an indefinite useful life versus an infinite useful life?

Solution 12-88

An indefinite life does not mean “infinite”—that the asset will last forever. Instead, it means that, after looking at all relevant factors, there appears to be no foreseeable limit to how long the asset will generate positive net cash flows for the entity.

Difficulty: Easy

Learning Objective: Explain how intangible assets are accounted for after initial recognition

Section Reference: Recognition and Measurement after Acquisition.

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 12-89 Technology-based intangible assets

Provide an example of a technology-based intangible asset. Over what period should these types of assets be amortized?

Solution 12-89

Technology-based intangible assets relate to innovations or technological advances. A common example is patents. Patents are granted for products and processes that are new, workable, and ingenious. A patent gives the holder the right to exclude others from making, selling, or using a product or process for a period of 20 years from the date the patent application is filed with the Patent Office.

The cost of a patent is amortized over the shorter of its legal life or its useful life to the entity.

(Students may provide other examples, though patents are the most common way to retain ownership of specific technologies).

Difficulty: Easy

Learning Objective: Identify and explain the accounting for specific types of intangible assets.

Section Reference: Specific Intangibles

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 12-90 Intangible asset impairment

Picot Collective purchases a patent on January 1, 2015 for \$ 118,800. At the time of purchase, Picot estimated that the patent had a useful life of 12 years. Picot used the straight-line method to amortize the patent, and annual impairment tests showed no impairment of the patent's value. On January 1, 2020, Picot sold the patent for \$ 84,600.

Instructions

Prepare the journal entry to record the sale of the patent.

Solution 12-90

Jan 1. Cash	84,600	
Accumulated Amortization.....	49,500	
Patents		118,800
Gain on Disposal - Patent		15,300

Calculations:

Cost \$ 118,800 ÷ 12 years = \$ 9,900 per year amortization

\$ 9,900/year x 5 years = \$ 49,500 amortized

Cost \$ 118,800 - \$ 49,500 amortized = \$ 69,300 carrying value

Difficulty: Medium

Learning Objective: Explain and account for impairment of limited-life and indefinite-life intangible assets.

Section Reference: Impairment and Derecognition

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 12-91 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 12-91

1. 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.
2. 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.
3. Retain goodwill indefinitely at cost (i.e., do not amortize), 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.

Difficulty: Easy

Learning Objective: Explain how goodwill is measured and accounted for after acquisition.

Section Reference: Recognition and Measurement of Goodwill

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 12-92 Acquisition of tangible and intangible assets

Abe Manufacturing Corp. decided to expand further by purchasing the net assets of ERB Manufacturing Corp. ERB's statement of financial position at December 31, 2020 follows.

ERB MANUFACTURING CORP.
Statement of Financial Position
December 31, 2020

<u>Assets</u>		<u>Liabilities and Equities</u>	
Cash	\$ 210,000	Accounts payable	\$ 325,000
Receivables.....	450,000	Common shares	800,000
Inventory	275,000	Retained earnings	<u>835,000</u>
Plant assets (net).....	<u>1,025,000</u>		
Total assets.....	<u>\$ 1,960,000</u>	Total equities.....	<u>\$ 1,960,000</u>

An appraisal, agreed to by both parties, indicated that the fair value of the inventory was \$ 320,000 and the fair value of the plant assets was \$ 1,225,000. The fair value of the receivables and payables 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 owners of ERB

Instructions

Calculate the amount of goodwill (if any) implied in the purchase price of \$ 3 million. Show calculations.

Solution 12-92

Purchase price	\$ 3,000,000
Less tangible net assets acquired:	
Cash	\$ 210,000
Receivables (FV)	450,000
Inventory (FV)	320,000
Plant assets (FV)	1,225,000
Less accounts payable (FV).....	<u>(325,000)</u>
Total fair market value of tangible net assets acquired	<u>1,880,000</u>
Implied goodwill	<u>\$ 1,120,000</u>

Difficulty: Medium

Learning Objective: Explain how goodwill is measured and accounted for after acquisition.

Section Reference: Recognition and Measurement of Goodwill

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 12-93 Goodwill measurement and recording

Snoopy Inc. is considering purchasing the net assets of Woodstock Corporation. Following is the statement of financial position of Woodstock as at December 31, 2020.

WOODSTOCK CORPORATION	
Statement of Financial Position	
As at December 31, 2020	
Current assets	\$ 231,400
Buildings and equipment	753,000
Accumulated amortization	(113,000)
Land	173,000
Total assets	\$ 1,044,400
Current liabilities	\$ 187,000
Common shares	577,000
Retained earnings	280,400
Total liabilities and equity	\$ 1,044,400

Following are the fair values of Woodstock's net assets as at December 31, 2020.

Current assets	\$ 225,500
Buildings and equipment	482,600
Land	313,500
Current liabilities	(166,300)
	\$ 855,300

Instructions

Calculate the value of goodwill that would be recorded by Snoopy if it offered \$ 2,060,300 for the net assets of Woodstock Corporation.

Solution 12-93

Fair value of consideration transferred \$ 2,060,300

Fair value of identifiable net assets:

Current assets \$ 225,500

Building and equipment	482,600	
Land	313,500	
Current liabilities	(166,300)	855,300
Value assigned to goodwill		<u>\$ 1,205,000</u>

Difficulty: Medium

Learning Objective: Explain how goodwill is measured and accounted for after acquisition.

Section Reference: Recognition and Measurement of Goodwill

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 12-94 Determining impairment loss under ASPE

On September 1, 2020, Humble Corporation acquired Roots Media for a cash payment of \$ 859,100. At the time of purchase, Roots' statement of financial position showed assets of \$ 899,600, liabilities of \$ 462,300, and owner's equity of \$ 437,300. The fair value of Roots' assets is estimated to be \$ 1,163,900.

Instructions

- Assuming that Humble Corporation is a private entity, explain how goodwill will be tested for impairment.
- If the unit's carrying amount (including goodwill) is \$ 3,617,400 and its fair value is \$ 3,553,200, what is the impairment loss, if any, under ASPE?

Solution 12-94

a) Under ASPE, goodwill is assigned to a reporting unit at the acquisition date. Goodwill is tested for impairment when events or changes in circumstances indicate impairment may exist.

There is an impairment loss if the carrying amount of the reporting unit (including goodwill) exceeds the fair value of the reporting unit.

b)

Carrying amount of unit	\$ 3,617,400
Fair value of unit	<u>3,553,200</u>
Impairment loss	\$ 64,200

Difficulty: Medium

Learning Objective: Explain how goodwill is measured and accounted for after acquisition.

Section Reference: Recognition and Measurement of Goodwill

Learning Objective: Explain and account for impairment of goodwill.

Section Reference: Impairment of Goodwill

Learning Objective: Identify differences in accounting between IFRS and ASPE.

Section Reference: IFRS/ASPE Comparison

CPA: Communication

CPA: Financial Reporting

Bloomcode: Application

AACSB: Communication

Ex. 12-95 Goodwill impairment

On September 1, 2020, Piper Corporation acquired Darcy Enterprises for a cash payment of \$ 850,000. At the time of purchase, Darcy's statement of financial position showed assets of \$ 890,000, liabilities of \$ 450,000, and owner's equity of \$ 440,000. The fair value of Darcy's assets is estimated to be \$ 1,150,000. Assume that Piper is a public company and the goodwill was allocated entirely to one cash-generating unit (CGU). Two years later, the CGU's carrying amount is \$ 3,450,000; its value in use is \$ 3,380,000; the fair value less costs to sell is \$ 2,980,000.

Instructions

Determine if goodwill is impaired, and calculate the goodwill impairment loss.

Solution 12-95

Under IFRS, the recoverable amount of the CGU is compared with its carrying amount to determine if there is any impairment.

Based on the information provided, the recoverable amount of the CGU is the greater of:

- Fair value – costs to sell = \$ 2,980,000
- Value in use = \$ 3,380,000

Recoverable amount of CGU	\$ 3,380,000
Carrying amount of CGU	\$ 3,450,000

The goodwill is impaired because the carrying amount of the CGU > the recoverable amount of the CGU. The goodwill impairment loss is \$ 70,000 (\$ 3,450,000 – \$ 3,380,000).

Difficulty: Medium

Learning Objective: Explain how goodwill is measured and accounted for after acquisition.

Section Reference: Recognition and Measurement of Goodwill

Learning Objective: Explain and account for impairment of goodwill.

Section Reference: Impairment of Goodwill

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 12-96 Negative goodwill

What is negative goodwill and why does it occur?

Solution Ex. 12-96

Negative goodwill arises when the total of the fair value of the identifiable net assets acquired is higher than the fair value of the consideration transferred for those net assets. This situation is a result of market imperfection (or a poor decision by the seller) because the seller would be better off to sell the assets individually than in total.

Difficulty: Easy

Learning Objective: Explain how goodwill is measured and accounted for after acquisition.

Section Reference: Goodwill

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

Ex. 12-97 Reporting a patent purchase

Comox Corporation has a December 31 fiscal year end. Comox purchased a patent from Courtney Inc. for \$ 400,000 on January 1, 2017. The patent expires on January 1, 2025. Comox has been amortizing it over its legal life. During 2020, Comox determined that the patent's economic benefits would not last longer than six years from the date of acquisition.

Instructions

Determine the amount that will be reported on

- Comox's December 31, 2019 and 2020, statements of financial position.
- Comox's 2020 income statement. Be specific about the account name and the account.

Solution 12-97

a) Assets: Patent Dec. 31, 2019 \$ 250,000 Dec. 31, 2020 \$ 166,667

Patent	Cost	Amortization	Carrying Amount
Purchase price Jan. 1, 2017	\$ 400,000		
Amortization 2017 (1)		\$ 50,000	
Amortization 2018		50,000	
Amortization 2019		50,000	
Balance Dec. 31, 2019			\$ 250,000
Amortization 2020 (2)		\$ 83,333	
Balance Dec. 31, 2020			\$ 166,667

- (1) Amortization 2017 ($\$ 400,000 \div 8 \text{ years}$) \$ 50,000
 (2) Amortization 2020 $\text{Carrying amount} \div (6 - 3 \text{ years}) = \$ 250,000 \div 3$ \$ 83,333

b)

COMOX CORPORATION
Income Statement (Partial)
For the year ended December 31, 2020

Operating Expenses	
Amortization Expense—Patents	\$ 83,333

Difficulty: Medium

Learning Objective: Identify the types of disclosure requirements for intangible assets and goodwill and explain the issues in analyzing these assets.

Section Reference: Presentation, Disclosure, and Analysis

CPA: Communication

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 12-98 Disclosures required for internally generated intangible assets
 Briefly outline what information is required to be disclosed for each class of intangible asset.
 What is the goal of these disclosures for publicly accountable entities?

Solution 12-98

For each class of intangible asset, and separately for internally generated intangibles and other intangible assets, the following information is required:

- Whether their lives are indefinite or finite (limited), useful life, methods and rates of amortization, and the line where amortization is included on the statement of comprehensive income;
- The carrying amount of intangible assets with an indefinite life, and the reasons supporting an assessment of an indefinite life;
- A reconciliation of the opening and ending balance of their carrying amount and accumulated amortization and impairment losses, separately identifying each reason for an increase or decrease; and
- Impairment losses and reversals of impairment losses and where they are reported in the statement of comprehensive income.

The goal of these disclosures for publicly accountable entities is basically to allow readers to understand the significance of intangibles and goodwill to the operations of the business.

Difficulty: Easy

Learning Objective: Identify the types of disclosure requirements for intangible assets and goodwill and explain the issues in analyzing these assets.

Section Reference: Presentation, Disclosure, and Analysis

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

Ex. 12-99 Calculation of goodwill

Great Corporation is interested in purchasing Big World Company Ltd. The total of Big World's net income amounts over the past five years is \$ 745,000. During one of those years, Big World reported a gain on discontinued operations of \$ 93,000. The fair value of Big World's net identifiable assets is \$ 684,000. A normal rate of return is 14%, and Great Corporation wants to capitalize excess earnings at 19%.

Instructions

Calculate the estimated value of goodwill.

Solution 12-99

Average earnings $[(\$ 745,000 - \$ 93,000) \times 1/5]$	130,400
Normal earnings $(\$ 684,000 \times 14\%)$	(95,760)
Excess earnings	34,640
Capitalization rate	19%
Estimated goodwill	182,316

Difficulty: Medium

Learning Objective: Explain and apply basic approaches to valuing goodwill.

Section Reference: Valuing Goodwill (Appendix 12A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Ex. 12-100 Calculation of goodwill

Saje Corporation's pre-tax accounting income of \$ 726,000 for the year 2020 included the following items:

Amortization of identifiable intangibles	\$ 140,000
Depreciation of building	119,000
Loss from discontinued operations	46,000
Unusual, non-recurring gains	157,000

Profit-sharing payments to employees 69,300

Lush Industries Ltd. would like to purchase Saje Corporation. In trying to measure Saje's normalized earnings for 2020, Lush determines that the building's fair value is triple the book value and that its remaining economic life is double the life that Saje is using. Lush would continue the profit-sharing payments to employees, with the payments being based on income from continuing operations before amortization and depreciation.

Instructions

Calculate the 2020 normalized earnings amount of Saje Corporation that Lush would use to calculate goodwill.

Solution 12-100

Pre-tax accounting income		\$
		726,000
Add: Loss from discontinued operations		46,000
		<u>772,000</u>
Deduct: Additional depreciation based on fair value and extended life	\$ *	
	59,500	
Unusual, non-recurring gains	<u>157,000</u>	<u>216,500</u>
Normalized earnings		\$
		<u><u>555,500</u></u>
* Adjusted depreciation for year on building \$ 119,000 × 3 × 1/2 (remaining life doubled)		\$
		178,500
Less: Depreciation per year based on book value and original life		<u>119,000</u>
Increase in annual depreciation		<u><u>\$ 59,500</u></u>

The amortization of identifiable intangibles and the profit-sharing payments to the employees are not part of the income adjustment because they are recurring expenses.

Difficulty: Medium

Learning Objective: Explain and apply basic approaches to valuing goodwill.

Section Reference: Valuing Goodwill (Appendix 12A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

***Ex. 12-101** Calculation of goodwill

Waikiki Corp. 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 12-101**

Present value of \$ 24,000 for 16 periods at 5%; $10.83777 \times \$ 24,000 = \$ 260,106$.

OR 16 N 5 I 24000 PMT CPT PV = \$ 260,106

Difficulty: Medium

Learning Objective: Explain and apply basic approaches to valuing goodwill.

Section Reference: Valuing Goodwill (Appendix 12A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

***Ex. 12-102** Goodwill calculation

The net assets of Ohana Ltd., excluding goodwill, have a total fair value of \$ 4 million, and earnings for the past five years total \$ 2.2 million. Included in the latter figure are non-recurring 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 12-102**

Goodwill is \$ 175,000.

Earnings for 5 years.....	\$ 2,200,000
Less non-recurring gains.....	<u>200,000</u>
	2,000,000
Add non-recurring losses.....	<u>140,000</u>
Adjusted 5-year total earnings	<u>\$ 2,140,000</u>
 Average earnings (\$ 2,140,000 ÷ 5)	\$ 428,000
Normal earnings (\$ 4,000,000 × .10)	<u>400,000</u>
Excess annual earnings.....	<u>\$ 28,000</u>
 Excess earnings capitalized at 16% (\$ 28,000 ÷ .16)	<u>\$ 175,000</u>

Difficulty: Medium

Learning Objective: Explain and apply basic approaches to valuing goodwill.

Section Reference: Valuing Goodwill (Appendix 12A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

***Ex. 12-103** Calculation of goodwill

The owners of Amazon Corp. are planning to sell the business. The cumulative earnings for the past five years are \$ 600,000 including non-recurring 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 12-103**

$$(\$ 600,000 + \$ 100,000) \div 5 = \$ 140,000$$

Average earnings.....	\$ 140,000

Normal earnings.....	<u>80,000</u>

Excess earnings	<u>\$ 60,000</u>

Goodwill (\$ 60,000 ÷ .12).....	<u>\$ 500,000</u>

Difficulty: Medium

Learning Objective: Explain and apply basic approaches to valuing goodwill.

Section Reference: Valuing Goodwill (Appendix 12A)

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

PROBLEMS

Pr. 12-104 Intangible assets

The following transactions involving intangible assets of Falkland Corporation occurred on or near December 31, 2020. Complete the chart below by preparing the journal entry(ies) needed at that date to record the transaction, and at December 31, 2021 to record any resultant amortization. If no entry is required at a particular date, write "None needed."

	<u>On Date of Transaction</u>	<u>On December 31, 2021</u>
1. Falkland paid Jericho Company \$ 200,000 for the exclusive right to market a particular product, using the Jericho name and logo in promotional material. The franchise runs for as long as Falkland is in business. Falkland decided to amortize the franchise over 25 years.		
2. Falkland 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, 2021, Falkland'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 Falkland for 10 years.		
4. Falkland incurred \$ 90,000 in successfully defending another of its patents in an infringement suit. The patent expires during December 2024.		
5. Falkland 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. Falkland paid Mexico Laboratories \$ 52,000 for research work performed by Mexico under contract for Falkland.

Solution 12-104

<u>On Date of Transaction</u>		<u>On December 31, 2021</u>	
1. Franchise	200,000	1. Franchise Amort. Exp. ..	8,000
Cash	200,000	Acc Amortization Franchise	8,000
2. Deferred		2. Devel. Cost	
Devel. Costs	300,000	Amortization Expense ...	30,000
Cash	300,000	Deferred	
.....		Devel. Costs ..	30,000
3. Patents.....	35,000	3. Patent Amortization	
Cash	35,000	Expense.....	3,500
		Acc Amortization Patents	3,500
4. Patents.....	90,000	4. Patent Amortization	
Cash	90,000	Expense.....	22,500
		Acc Amortization Patents	22,500
5. Legal Fees Exp.	200,000	5. None needed.	
Cash	200,000		
Loss on Impairment –			
Patent	99,000		
Acc impairment losses	99,000		
6. Research Expense	52,000	6. None needed.	
Cash	52,000		

Difficulty: Medium

Learning Objective: Identify and apply the recognition and measurement requirements for purchased intangible assets.

Section Reference: Recognition and Measurement of Intangible Assets

Learning Objective: Identify and apply the recognition and measurement requirements for internally developed intangible assets.

Section Reference: Recognition and Measurement of Internally Developed Intangible Assets

Learning Objective: Explain how intangible assets are accounted for after initial recognition.

Section Reference: Recognition and Measurement after Acquisition

CPA: Financial Reporting
 Bloomcode: Application
 AACSB: Analytic

Pr. 12-105 Journal entries for impairment of intangible assets

Patagonia Corp., a large, 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.

Patagonia 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
	<u>\$ 711,000</u>	

*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 has carried out a recoverability test that indicates that the patent's carrying value is higher than its undiscounted future net cash flows. The patent's fair value has now been 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 Patagonia's records as would be required under ASPE.

Solution 12-105

To record impairment loss on patent:

Loss on Impairment - Patent	42,000	
Accumulated Impairment Losses - Patent.....		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, by definition, do not meet the criteria that are required to recognize these costs as an asset. As a result, they should be expensed.

Difficulty: Medium

Learning Objective: Explain how intangible assets are accounted for after initial recognition.

Section Reference: Recognition and Measurement after Acquisition

Learning Objective: Explain and account for impairment of limited-life and indefinite-life intangible assets.

Section Reference: Impairment and Derecognition

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 12-106 Calculation of and journal entries for impairment of goodwill

Gandaph Corporation purchased a division five years ago for \$ 3 million. The division has been identified as a reporting unit that is cash-generating under IFRS. Management is reviewing the division for impairment of goodwill and has estimated the fair value of the reporting unit to be \$ 3.2 million and the unit's value in use to be \$ 3.3 million. In addition, there would be \$ 75,000 in direct costs should the company decide to sell. The carrying amounts of the division's net assets, including the associated goodwill of \$ 1,350,000, are listed below.

Carrying Amount of Net Assets Including Goodwill

Cash	\$ 300,000
Receivables	450,000
Inventory	1,050,000
Property, plant, and equipment (net)	1,200,000
Goodwill	1,350,000
Less: Accounts and notes payable	<u>(750,000)</u>
Net assets, at carrying amounts	<u>\$ 3,600,000</u>

Instructions

Determine if goodwill is impaired and provide the related journal entries, if any, under both ASPE and IFRS.

Solution 12-106

Under **ASPE**, a loss on impairment of \$ 400,000 is indicated as follows:

Carrying amount of unit, including goodwill	\$ 3,600,000
Fair value of unit	<u>3,200,000</u>
Goodwill - loss on impairment	<u>\$ 400,000</u>

Under **IFRS**, a loss on impairment of \$ 300,000 is indicated:

Carrying amount of unit, including goodwill	\$ 3,600,000
Recoverable amount of unit: higher of	
Value in use	3,300,000
and	3,125,000
Fair value less costs to sell	(3,300,000)
Goodwill - loss on impairment	<u>\$ 300,000</u>

Under ASPE

Loss on Impairment	400,000
Accumulated Impairment Losses —Goodwill	400,000

Under IFRS

Loss on Impairment	300,000
Accumulated Impairment Losses —Goodwill	300,250

Difficulty: Medium

Learning Objective: Explain and account for impairment of goodwill.

Section Reference: Impairment of Goodwill

Learning Objective: Identify differences in accounting between IFRS and ASPE.

Section Reference: IFRS/ASPE Comparison

CPA: Financial Reporting

Bloomcode: Application

AACSB: Analytic

Pr. 12-107 Determining goodwill impairment – ASPE and IFRS

Gandaph Corporation purchased a division five years ago for \$ 3 million. The division has been identified as a reporting unit that is cash-generating under IFRS. Management is

reviewing the division for impairment of goodwill and has estimated the fair value of the reporting unit to be \$ 3.8 million and the unit's value in use to be \$ 3.9 million. In addition, there would be \$ 75,000 in direct costs should the company decide to sell. The carrying amounts of the division's net assets, including the associated goodwill of \$ 1,350,000, are listed below.

Carrying Amount of Net Assets Including Goodwill

Cash	\$ 300,000
Receivables	450,000
Inventory	1,050,000
Property, plant, and equipment (net)	1,200,000
Goodwill	1,350,000
Less: Accounts and notes payable	<u>(750,000)</u>
Net assets, at carrying amounts	<u>\$ 3,600,000</u>

Instructions

Would goodwill be considered impaired under ASPE? Would your answer change under IFRS?

Solution 12-107

Under **ASPE**, the goodwill is not impaired. The asset group's \$ 3.6-million carrying value is less than its fair value of \$ 3.8 million. Under **IFRS**, goodwill is not considered impaired either. The recoverable amount of the unit is \$ 3.9 million—the higher of its value in use (\$ 3.9 million) and its fair value less costs to sell (\$ 3,800,000 – \$ 75,000)—and this exceeds the unit's carrying amount of \$ 3.6 million.

Difficulty: Medium

Learning Objective: Explain and account for impairment of goodwill.

Section Reference: Impairment of Goodwill

Learning Objective: Identify differences in accounting between IFRS and ASPE.

Section Reference: IFRS/ASPE Comparison

CPA: Communication

CPA: Financial Reporting

Bloomcode: Application

AACSB: Communication

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COMPREHENSIVE EXAMINATION A

PART 1

(CHAPTERS 1–6)

Problem	CPA	Topics	Blooms	Approximate Time
A-1	cpa-t001	Multiple Choice (Various Topics)	1, 3, 6, 8, 10—blooms001 2, 4, 5, 7, 9—blooms002	15 min.
A-2	cpa-t001	Adjusting and Reversing* Entries	blooms003	30 min.
A-3	cpa-t001 cpa-e003	Definitions and Key Concepts	blooms002	10 min.
A-4	cpa-t001	Discontinued Operations	blooms003	10 min.
A-5	cpa-t001	Financial Statement Classifications	blooms002	10 min.

A-6	cpa-t001	Income and Retained Earnings Statement	blooms003	35 min.
A-7	cpa-t001	Percentage-of-Completion Method	blooms003	10 min.
				<u>120 min.</u>

All questions are AACSB: Analytic and Question A-3 is AACSB: Communication and Analytic

Problem A-1 Multiple Choice (Various Topics)

Choose the *best* answer for each of the following questions and enter the identifying letter in the space provided.

- ___1. Which of the following entities is *least likely* to be a major player in developing financial reporting standards in Canada?
 - a. International Accounting Standards Board
 - b. (Canadian) Accounting Standards Board
 - c. The Federal government
 - d. Financial Accounting Standards Board
- ___2. 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.
- ___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. to promote information asymmetry
- ___4. A local businessman 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 principle or assumption?
- a. full disclosure
 - b. periodicity
 - c. economic entity
 - d. matching
- ___5. When knowledgeable, independent users achieve similar results or reach consensus regarding the accounting for a particular transaction, which enhancing qualitative characteristic is said to exist?
- a. comparability
 - b. verifiability
 - c. relevance
 - d. understandability
- ___6. A trial balance
- a. is a list of general ledger account names.
 - b. proves that all transactions have been recorded.
 - c. can be used for the preparation of financial statements.
 - d. can never be used for the preparation of financial statements.
- ___7. Which of the following is correct regarding income statement presentation?
- a. Income from continuing operations is the last line shown on the income statement.
 - b. IFRS does not allow the use of a single-step income statement.
 - c. Unusual gains or losses must be presented in a separate section after income from continuing operations.
 - d. IFRS requires that both basic and diluted earnings per share be presented, whereas ASPE does not.
- ___8. IFRS requires that expenses are 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.
- ___9. Which of the following should *not* be considered as a current asset on the statement of financial position?
- a. instalment notes receivable due over 18 months in accordance with normal trade practice
 - b. prepaid taxes that cover assessments of the following operating cycle of the

- business
- c. equity or debt securities held to finance future construction of additional facilities
 - d. spare parts and supplies inventories
- ___10. The discrete earnings process is one that
- a. takes place over several accounting periods.
 - b. has a critical event.
 - c. where substantial completion can be deferred.
 - d. must be accounted for by the completed-contract method.

***Problem A-2** Adjusting and Reversing Entries

At December 31, 2020, Hazelnut Corp.'s *unadjusted* trial balance was as follows:

Cash	\$ 39,590	
Accounts Receivable.....	69,000	
Allowance for Doubtful Accounts		\$ 500
Merchandise Inventory	54,720	
Prepaid Rent.....	24,000	
Investment in Pecan Corp. Bonds.....	70,000	
Plant and Equipment.....	156,000	
Accumulated Depreciation		14,740
Accounts Payable.....		11,370
Bonds Payable.....		90,000
Common Shares.....		170,000
Retained Earnings		97,180
Sales Revenue		222,000
Cost of Goods Sold.....	154,400	
Transportation-Out.....	11,000	
Salaries and Wages Expense.....	32,000	
Interest Expense.....	2,040	
Rent Revenue.....		14,400
Miscellaneous Expense.....	890	
Insurance Expense	6,550	
	<u>\$620,190</u>	<u>\$620,190</u>

Additional data:

1. The balance in the *Insurance Expense* account contains the premium costs of three policies:
 Policy 1, remaining cost of \$2,550, 1-yr. term, effective May 1, 2019;
 Policy 2, original cost of \$2,700, 3-yr. term, effective Oct. 1, 2020;
 Policy 3, original cost of \$1,300, 1-yr. term, effective Jan. 1, 2020.
2. On September 30, 2020, Hazelnut received \$14,400 rent from a lessee for an 18-month lease beginning on that date, which was credited to the Rent Revenue account.
3. All depreciable assets are depreciated at 10% per year. However, any acquisitions and disposals during the year are depreciated at half this rate. There were no acquisitions of PPE during 2020. On December 31, 2019, the balance in the Plant and Equipment account was \$230,000.

4. On December 28, 2020, the bookkeeper incorrectly credited Sales Revenue for a receipt on account from a regular customer of \$10,000.
5. At December 31, 2020, salaries accrued but unpaid were \$4,200.
6. Based upon an aging of the accounts, Hazelnut estimates that 5% of the Accounts Receivable balance on December 31, 2020 will become uncollectible.
7. On August 1, 2020, Hazelnut purchased, as a temporary investment, \$70,000, 6% bonds of Pecan Corp. at par. The bonds mature on August 1, 2023. Interest payment dates are July 31 and January 31.
8. On April 30, 2020, Hazelnut rented a warehouse for \$2,000 per month, paying \$24,000 in advance.

Instructions

- a. Record the necessary correcting and adjusting entries.
- b. Indicate which of the adjusting entries may be reversed at the beginning of 2021.

Problem A-3 Definitions and Key Concepts

Provide clear, concise answers for the following:

1. Explain the difference between permanent accounts and temporary accounts.
2. Identify the 5-step process that companies should use to ensure that revenue is measured and reported correctly under the asset-liability approach.
3. Explain the difference between the traditional and expected cash flow approaches within the discounted cash flow model.
4. Explain the merits of classified financial statements.
5. Explain the concept of free cash flow.
6. Explain the conceptual difference between the earnings and asset-liability (contract-based) approaches to accounting for revenues

Problem A-4 Discontinued Operations

During calendar 2020, Macadamia Ltd. entered into an agreement to sell its Trucking Division to Poodle Ltd., in order to focus its efforts on expansion of its other divisions. For purposes of income statement reporting, the Trucking Division qualifies as a separate component of the business. The Trucking Division incurred a net loss of \$250,000 from the beginning of the year to the date of sale, December 15, 2020. The combined assets of the Trucking Division had a book value of \$7,340,000 and were sold for \$9,000,000 on December 15, 2020. Assume Macadamia has an income tax rate of 40%.

Instructions

Calculate the amounts Macadamia should report for the following items in the Discontinued Operations section of the December 31, 2020 income statement:

- a. Loss on Operation of Trucking Division.
- b. Gain/Loss on Disposal of Trucking Division.

Problem A-5 Financial Statement Classifications

Financial statement classifications used by Cashew Corp. follow:

Statement of Financial Position

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

Income or Retained Earnings Statement

- j. Sales Revenue
- k. Cost of Goods Sold
- l. Operating Expenses
- m. Other Revenues and Gains
- n. Other Expenses and Losses
- o. Retained Earnings
- p. Not on the statements

Instructions

Specify, to the left of each account or item below, the letter of the financial statement classification the account would appear in. Use only the classifications shown.

_____ 1. Preferred Shares	_____ 16. Merchandise Inventory
_____ 2. Loss on Disposal of Equipment	_____ 17. Salaries and Wages Expense
_____ 3. Buildings	_____ 18. Merchandise on order with supplier
_____ 4. Office Supplies Expense	_____ 19. Interest Revenue
_____ 5. Allowance for Doubtful Accounts	_____ 20. Selling Expense
_____ 6. Notes Payable—Short Term	_____ 21. Interest Expense
_____ 7. Accum. Depreciation—Buildings	_____ 22. Taxes Payable
_____ 8. Mortgage Payable due 2027	_____ 23. Insurance Expense
_____ 9. Depletion Expense	_____ 24. Advertising Expense
_____ 10. Freight-Out	_____ 25. Long-Term Investments
_____ 11. Sales	_____ 26. Accounts Receivable
_____ 12. Dividends Declared	_____ 27. Land
_____ 13. Retained Earnings	_____ 28. Accounts Payable
_____ 14. Cash	_____ 29. Error made in calculating prior
year's	depreciation expense

____ 15. Sales Discounts

____ 30. Gain from early retirement of debt

Problem A-6 Income and Retained Earnings Statements

Peanut Corporation is a private corporation using ASPE. At December 31, 2020, an analysis of the accounts and discussions with company officials included the following account balances and other information:

Accounts receivable	\$ 102,000
Accrued interest payable.....	1,000
Dividend revenue	9,000
Sales	600,000
Purchase discounts	9,000
Purchases	360,000
Accounts payable.....	30,000
Loss from fire (net of \$7,000 tax).....	21,000
Selling expenses.....	64,000
Common shares (20,000 issued; no change during 2020).....	200,000
Accumulated depreciation	90,000
Long-term note payable (due Oct 1, 2024).....	100,000
Inventory, Jan 1, 2020.....	76,000
Inventory, Dec 31, 2020	62,500
Supplies inventory	40,000
Unearned service revenue.....	3,000
Land	370,000
Cash	60,000
Franchise	100,000
Retained earnings, Jan 1, 2020	135,000
Interest expense.....	8,500
Cumulative effect of change from straight-line to accelerated depreciation (net of \$6,000 tax).....	(18,000)
General and administrative expenses.....	80,000
Dividends declared and paid.....	15,000
Allowance for doubtful accounts.....	5,000
Machinery and equipment	225,000

Unless indicated otherwise, you may assume a 25% income tax rate.

General and administrative expenses include depreciation.

There are no preferred shares issued.

Instructions

- Prepare, in good form, a multiple-step income statement.
- Prepare, in good form, a retained earnings statement.

Problem A-7 Journal Entries—Percentage-of-Completion

Walnut Corp. was awarded a contract to build a bridge in a suburb of Vancouver at a total

contract price of \$10,000,000. The estimated total costs to complete the project were \$8,000,000. Walnut uses the percentage-of-completion method for all such contracts.

Instructions

- a. Prepare the entry to record construction costs of \$4,800,000, on construction in process to date.
- b. Prepare the entry to record progress billings of \$2,200,000.
- c. Prepare the entry to recognize the profit that can be recognized to date.

Solutions—Comprehensive Examination A**Problem A-1 Solution**

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

Problem A-2 Solution

a.

1. Prepaid Insurance.....	2,475	
Insurance Expense		2,475

Explanation: Both Policies 1 and 3 have expired, so their costs stay in Insurance Expense.

The monthly premium for Policy 2 is $\$2,700 \div 36 = \$75$. At Dec 31/20, the unexpired portion is 33 months $\times \$75 = \$2,475$, and needs to be transferred to the asset account.

2. Rent Revenue.....	12,000	
Unearned Rent		12,000

Explanation: Monthly rent is $\$14,400 \div 18 = \$800$. At Dec 31/20, 15 months $\times \$800 = \$12,000$ remains unearned, and needs to be transferred to the liability account.

3. Depreciation Expense	19,300	
Accumulated Depreciation		19,300

Explanation: Equipment retired during 2020 = $\$230,000 - \$156,000 = \$74,000$.

10% of $\$156,000 = \$15,600$

5% of $\$74,000 = \underline{3,700}$

Total depreciation = $\$19,300$

4. Sales Revenue	10,000	

Accounts Receivable		10,000
5. Salaries and Wages Expense.....	4,200	
Salaries and Wages Payable		4,200
6. Bad Debts Expense	2,450	
Allowance for Doubtful Accounts.....		2,450
Explanation: Corrected ending A/R balance: \$69,000 – \$10,000 = \$59,000. 5% x \$59,000 = \$2,950. Since the unadjusted Allowance is \$500 Cr, the adjustment is \$2,950 – \$500 = \$2,450		
7. Interest Receivable.....	1,750	
Interest Revenue		1,750
Explanation: $\$70,000 \times .06 \times 5 \div 12 = \$1,750$		
8. Rent Expense	16,000	
Prepaid Rent.....		16,000
Explanation: 8 months expired at \$2,000 per month = \$16,000		

b. Items 1, 2, 5, and 7:

Items No. 1 and No. 2 represent prepaid items that were initially recorded in temporary accounts. Items No. 5 and No. 7 represent accrued items.

Problem A-3 Solution

- Permanent accounts (also called real accounts) are assets, liability, and equity accounts. Temporary accounts include revenue, expense, and dividend accounts. Permanent accounts are not closed, while temporary accounts are closed at the fiscal year end.
- The 5-step process under the asset-liability approach includes the following:
 - Identify the contract with customers.
 - Identify the separate performance obligations in the contract.
 - Determine the transaction price.
 - Allocate the transaction price to the separate performance obligations.
 - Recognize revenue when each performance obligation is satisfied.
- Traditional approach: The discount rate reflects all risks in the cash flows but the cash flows are assumed to be certain. This is sometimes referred to as the “discount rate adjustment technique.”

Expected cash flow approach: A risk-free discount rate is used to discount cash flows that have been adjusted for uncertainty. This is sometimes referred to as the “expected present value technique.”
- Classification in financial statements increases their information content and aids in the ease of analysis. This is accomplished through the grouping of items with similar characteristics and separating items with different characteristics.

5. 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.
6. The earnings approach focuses on the earnings process itself and how value is added. The asset-liability (contract-based) approach focuses on the creation of contractual rights and obligations that are created by sales contracts.

Problem A-4 Solution

- a. Amount reported for "Loss on Operation of Trucking Division" equals loss incurred from beginning of year to date of sale (Dec 15/20), net of tax.

Loss on Operation of Trucking Division \$150,000
(net of tax of \$100,000, $(\$250,000 \times 40\%)$)

- b. Amount reported for "Gain/Loss on Disposal of Trucking Division" equals the gain or loss on the sale of the assets.

Gain on Disposal of Trucking Division \$996,000
(net of tax of \$664,000, $(\$1,660,000 \times 40\%)$)

Problem A-5 Solution

1. h
2. n
3. c
4. l
5. a
6. f
7. c
8. g
9. k or l
10. l
11. j
12. o
13. i and o

- 14. a
- 15. j
- 16. a
- 17. l
- 18. p
- 19. m
- 20. l
- 21. n
- 22. f
- 23. l
- 24. l
- 25. b
- 26. a
- 27. c
- 28. f
- 29. p
- 30. m

Problem A-6 Solution

a.

PEANUT CORPORATION
Income Statement
For the Year Ended December 31, 2020

Sales	\$600,000
Cost of goods sold:	
Merchandise inventory, Jan. 1	\$76,000
Purchases	360,000

Less purchase discounts.....	(9,000)	
Net purchases.....	<u>351,000</u>	
Merchandise available for sale	427,000	
Less merchandise inventory, Dec. 31	<u>(62,500)</u>	
Cost of goods sold		<u>364,500</u>
Gross profit on sales.....		235,500
Operating expenses:		
Selling expenses.....	64,000	
General and administrative expenses.....	<u>80,000</u>	
Total operating expenses		<u>144,000</u>
Income from operations		91,500
Other revenues and gains:		
Dividend revenue.....		9,000
Other expenses and losses		
Interest expense.....	(8,500)	
Loss from fire*.....	<u>(28,000)</u>	<u>(36,500)</u>
Income before income tax.....		64,000
Income tax**.....		<u>(16,000)</u>
Net income for the year.....		<u>\$ 48,000</u>
Earnings per common share (optional)***		<u>\$2.40</u>

* actual loss \$21,000 + \$7,000 = \$28,000

** \$64,000 x 25% = \$16,000

*** \$48,000 ÷ 20,000 = \$2.40

b.

PEANUT CORPORATION
Retained Earnings Statement
For the Year Ended December 31, 2020

Retained earnings, January 1, as reported.....	\$135,000
Cumulative effect of change in depreciation method, net of applicable taxes of \$6,000	<u>(18,000)</u>
Retained earnings, January 1, as adjusted.....	117,000
Add: Net income	<u>48,000</u>
Subtotal	165,000
Deduct: Dividends declared and paid	<u>(15,000)</u>
Retained earnings, December 31, 2020	<u>\$150,000</u>

Problem A-7 Solution

a. Construction in Process	4,800,000	
Materials, Cash, Payables, etc.		4,800,000
b. Accounts Receivable—Construction in Process.....	2,200,000	

	Billings on Construction in Process.....	2,200,000
c.	Construction Expenses.....	4,800,000
	Construction in Process (60% complete).....	1,200,000
	Revenue from Long-term Contract.....	6, 0000,000

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COMPREHENSIVE EXAMINATION B

PART 2

(CHAPTERS 7–8)

Problem	CPA	Topics	Blooms	Approximate Time
B-1	cpa-t001	Multiple Choice (Various Topics)	1, 5, 6—blooms001 2-4, 7-10—blooms003	15 min.
B-2	cpa-t001 cpa-e003	Key Concepts and Definitions	blooms002	10 min.
B-3	cpa-t001	Note Receivable	blooms002	20 min.
B-4	cpa-t001 cpa-e003	FIFO – Perpetual vs. Periodic	blooms002	20 min.
B-5	cpa-t001	Year-end Inventory Cut off	blooms002	25 min.
B-6	cpa-t001	Gross Profit Method	blooms002	10 min.

B-7 cpa-t001 Bank Reconciliation*

blooms002

20 min.

120 min.

All questions are AACSB Analytic and Questions B-2 and B-4 are Communication and Analytic .

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

Problem B-1 Multiple Choice (Various Topics)

For each of the following questions, select the letter of the statement that *best* answers the question and write it on the line to the left of the question.

- ___1. When a customer account is recognized as uncollectible and written off, under the allowance method
- it is always debited to Allowance for Doubtful Accounts.
 - it is always debited to Bad Debt Expense.
 - it may be debited to Bad Debts Expense if the amount is immaterial.
 - it is only debited to Allowance for Doubtful Accounts under IFRS.

- ___2. The following information is available for Steelhead Company:
- | | |
|--|----------|
| Allowance for doubtful accounts at December 31, 2019 | \$ 8,000 |
| Credit sales during 2020 | 400,000 |
| Accounts receivable deemed worthless and written off during 2020 | 9,000 |

As a result of a review and aging of accounts receivable in early January 2021, it has been determined that an allowance for doubtful accounts of \$7,500 is needed at December 31, 2020. What amount should Steelhead record as bad debt expense for the year ended December 31, 2020?

- \$6,500
 - \$7,500
 - \$8,500
 - \$15,500
- ___3. The stated interest rate is also referred to as the
- effective interest rate.
 - yield.
 - market rate.
 - coupon rate.
- ___4. When the stated rate is higher than the effective interest rate,
- the note is exchanged at a discount.
 - the excess is amortized by debiting Notes Receivable and crediting the amount of interest income that is recognized.
 - the note's fair value is more than its face value.
 - the note's fair value is equal to its future value.
- ___5. "Net realizable value" of an inventory item is now strictly defined as
- the estimated selling price of the item.
 - the estimated selling price less estimated costs to sell and complete the item.
 - the estimated selling price plus estimated costs to sell and complete the item.
 - the original cost price less estimated costs to sell and complete the item.

- ___6. In a period of rising prices, the inventory method that tends to give the highest reported inventory value on the statement of financial position is
- FIFO.
 - moving average.
 - specific identification.
 - weighted-average.
- ___7. The following information is available for Varden Inc. for last year:
- | | |
|------------------------|-----------|
| Freight-in | \$ 20,000 |
| Purchase returns..... | 62,000 |
| Selling expenses..... | 110,000 |
| Ending inventory | 310,000 |
- If the cost of goods sold is equal to 400% of selling expenses, what was the cost of goods available for sale?
- \$390,000
 - \$420,000
 - \$720,000
 - \$750,000
- ___8. Since it began operations ten years ago, Carp Corp. has been using the weighted average method of inventory valuation. Its 2020 ending inventory was \$28,000, but it would have been \$70,000 if FIFO had been used. Thus, if FIFO had been used, Carp's income before income taxes would have been
- \$42,000 less over the ten-year period.
 - \$42,000 greater over the ten-year period.
 - \$42,000 greater in 2020.
 - \$42,000 less in 2020.
- ___9. The 2020 financial statements of Bass Ltd. reported beginning inventory of \$260,000, ending inventory of \$290,000, and cost of goods sold of \$1,300,000 for the year. To one decimal, Bass's inventory turnover ratio for 2020 is
- 0.2 times.
 - 4.5 times.
 - 4.7 times.
 - 5.0 times.
- ___*10. 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
- \$48,800.
 - \$40,800.
 - \$40,200.
 - \$40,000.

Problem B-2 Definitions and Key Concepts

Provide clear, concise answers for the following:

1. What are cash and cash equivalents and how are they reported?
2. Identify the main differences between ASPE and IFRS with respect to the accounting for receivables.
3. Identify the inventory categories of a manufacturing company and describe how they are related.

Problem B-3 Note Receivable

On December 31, 2019, Tangerine Corp. sold product to Orange Limited, accepting a 3%, four-year promissory note of \$400,000 in exchange. Interest is payable annually on December 31, starting December 31, 2020. Tangerine Corp. normally pays 6% interest to borrow funds. Orange Limited, however, normally pays 8% to borrow funds. The product sold is carried on Tangerine's books at a manufactured cost of \$255,000. Assume Tangerine uses the perpetual inventory system.

Instructions

On Tangerine's books:

- a. Prepare the required journal entries to record the transaction at December 31, 2019. Assume that the effective interest method is used. Use the interest tables on the following page (if needed) and round all values to the nearest dollar.
- b. Prepare all appropriate entries for 2020 in relation to this note.
- c. Prepare all appropriate entries for 2021 in relation to this note.

For use on Problem B-3 (if needed)

Table 1
Future Value of 1

Periods	2%	3%	4%	6%	8%
1	1.02000	1.03000	1.04000	1.06000	1.08000
2	1.04040	1.06090	1.08160	1.12360	1.16640
3	1.06121	1.09273	1.12486	1.19102	1.25971
4	1.08243	1.12551	1.16986	1.26248	1.36049
5	1.10408	1.15927	1.21665	1.33823	1.46933

Table 2
Present Value of 1

Periods	2%	3%	4%	6%	8%
1	0.98039	0.97087	0.96154	0.94340	0.92593
2	0.96117	0.94260	0.92456	0.89000	0.85734
3	0.94232	0.91514	0.88900	0.83962	0.79383
4	0.92385	0.88849	0.85480	0.79209	0.73503

5	0.90573	0.86261	0.82193	0.74726	0.68058

Table 3
Future Value of Ordinary Annuity of 1

Periodic Rents	2%	3%	4%	6%	8%
1	1.00000	1.00000	1.00000	1.00000	1.00000
2	2.02000	2.03000	2.04000	2.06000	2.08000
3	3.06040	3.09090	3.12160	3.18360	3.24640
4	4.12161	4.18363	4.24646	4.37462	4.50611
5	5.20404	5.30914	5.41632	5.63709	5.86660

Table 4
Present Value of Ordinary Annuity of 1

Periodic Rents	2%	3%	4%	6%	8%
1	0.98039	0.97087	0.96154	0.94340	0.92593
2	1.94156	1.91347	1.88609	1.83339	1.78326
3	2.88388	2.82861	2.77509	2.67301	2.57710
4	3.80773	3.71710	3.62990	3.46511	3.31213
5	4.71346	4.57971	4.45182	4.21236	3.99271

Problem B-4 Journal Entries for Perpetual and Periodic Inventory Systems

Lime Corporation is a supplier of electronic components used in the manufacture of computers. The company uses the FIFO cost flow method. During the month of September 2020, Lime's inventory records for part LIM-0325, showed the following transactions:

Date	Transaction	Units Purchased	Unit Cost	Units Sold	Unit Selling Price
Sep. 1	Balance	900	\$1.65		
Sep. 8	Purchase	400	\$1.67		
Sep. 17	Sale			(800)	\$4.25
Sep. 23	Sale			(250)	\$4.30
Sep. 30	Purchase	650	\$1.75		

Instructions

- Assuming Lime uses a *perpetual* inventory system; prepare the journal entries for each of the above listed transactions.
- Assuming Lime uses a *periodic* inventory system; *explain* how the journal entries as compared to part a. would differ. Be specific. Do not prepare journal entries.
- What would be the difference in total cost of goods sold between parts a. and b.? Explain your answer.

Problem B-5 Year-end Inventory Cut-off

Lemon Corp.'s business year ends on December 31. They use the periodic inventory system. Listed below are purchase transactions that occurred during the last few days of 2020 or during the first few days of 2021. The inventory, determined by physical count, was taken after the close of business on December 31, 2020. The only adjusting entry recorded to date has been to enter the December 31 physical inventory on the books and to remove the beginning inventory.

Instructions

- a. On the accompanying chart, indicate the effect of each of the following transactions on the ending inventory and on reported net income for 2020, by writing the words overstated, understated, or no effect in the appropriate column. *Both* columns must be answered for each transaction.
- b. Prepare all necessary correcting entries for 2020.

	Dec. 31/20 Physical <u>Inventory</u>	2020 <u>Income</u>
1. An invoice for \$6,000, terms f.o.b. shipping point, was received and recorded on Dec. 30. The invoice shows that the merchandise was shipped on Dec. 29, and the receiving report indicates the merchandise was received on Jan. 2.	_____	_____
2. An invoice for \$250, terms f.o.b. shipping point, was received and recorded on Dec. 30. The invoice shows that merchandise was shipped on Dec. 29, and the receiving report shows the merchandise was received on Dec. 31.	_____	_____
3. An invoice for \$1,000, terms f.o.b. shipping point, was received and recorded on Jan. 2. The invoice shows the merchandise was shipped on Dec. 30, and the receiving report indicates the merchandise was received on Dec. 31.	_____	_____
4. An invoice for \$800, terms f.o.b. destination, was received and recorded on Dec. 30. The receiving report shows the merchandise was received on Jan. 2.	_____	_____
5. An invoice for \$150, terms f.o.b. destination, was received and entered Dec. 29. The receiving report indicates that the merchandise was received Dec. 31.	_____	_____
6. An invoice for \$400, terms f.o.b. destination, was received and recorded on Jan. 2. The receiving report indicates the merchandise was received on Dec. 31.	_____	_____
7. Merchandise costing \$14,000 and with a selling price of		

\$20,000 was on consignment to Grapefruit Ltd., and was on that company's premises on Dec. 31. No entry has been yet been made regarding this consignment.

Problem B-6 Gross Profit Method

On December 31, 2020, the entire inventory of Clementine Corp. was destroyed by a flood. Sales and purchases for the year had been \$2.6 million and \$1.2 million, respectively. The beginning inventory (Jan. 1, 2020) was \$450,000. In the past, Clementine's gross profit has averaged 40%. Clementine uses the periodic inventory system.

Instructions

- Calculate the estimated cost of inventory destroyed.
- Prepare journal entries at December 31, 2020 to close the sales and related cost of goods sold accounts.

*Problem B-7 Bank Reconciliation

Following is the general format of a bank reconciliation with the various categories numbered (1) through (4).

Balance per bank statement	\$XX,XXX
Items to be added:	(1)
Items to be deducted:	(2)
Corrected bank balance	<u>\$YY,YYY</u>
Balance per books	\$AA,AAA
Items to be added:	(3)
Items to be deducted:	(4)
Corrected cash balance	<u>\$YY,YYY</u>

Instructions

- To the left of the following items, write the number of the place in which the reconciling items would appear on a November bank reconciliation. If any items would not appear on the bank reconciliation, put an NA beside the item.

- _____ 1. The October bank service charge of \$25 was recorded in the books in November.
- _____ 2. An NSF cheque for \$450 was returned with the November bank statement. This cheque will be redeposited in December. The firm has not yet made an entry for this.
- _____ 3. The first \$5,000 deposit shown on the November bank statement was recorded in the books on October 31.
- _____ 4. The November bank service charge of \$21 is included on the November bank statement.

- _____ 5. The bank collected a \$4,500 note receivable for the firm during November plus \$125 interest. The firm has not yet recorded this receipt.
 - _____ 6. \$15,000 of cheques written in November have not cleared the bank by November 30.
 - _____ 7. All \$18,000 of cheques written in October, which had not cleared the bank at October 31, cleared the bank in November.
 - _____ 8. A cheque written in November was recorded in the books at \$1,330. However, this cheque cleared the bank in November for \$1,303 (which was the correct amount). This cheque was issued as a payment on account.
 - _____ 9. A \$15,000 deposit in transit at November 30 is included in the books, but does not show on the bank statement.
 - _____ 10. The bank, in error, credited the firm's account for \$300 in November for another firm's deposit.
- b. Prepare any journal entries required by the information contained in a. above.

Solutions — Comprehensive Examination B**Problem B-1 Solution**

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

Solutions to Computational Multiple Choice Questions:

2. $\$9,000 - \$8,000 + \$7,500 = \$8,500$
7. $\$310,000 + (400\% \times \$110,000) = \$750,000$
9. $\$1,300,000 \div (260,000 + \$290,000) \div 2 = 4.7$
- *10. $\$49,000 - \$16,000 + \$7,000 + \$800 = \$40,800$

Problem B-2 Solution

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 under current assets as “cash and cash equivalents” in the statement of financial position, unless the funds are restricted or otherwise encumbered.
2. 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 (required by IFRS, but optional under ASPE).

3. Manufacturing companies typically have three inventory categories: raw materials, work-in-process, and finished goods. Amounts for goods and materials that are on hand but have not yet gone into production are reported as **raw materials inventory**. The cost of the raw material on which production has started but is not yet complete, plus the direct labour cost applied specifically to this material and its applicable share of manufacturing overhead costs, make up the **work-in-process inventory**. The costs associated with the completed but still unsold units on hand are reported as **finished goods inventory**.

Problem B-3 Solution

a. Dec 31/19

Notes Receivable	333,758	
Sales Revenue		333,758
Cost of Goods Sold	255,000	
Inventory		255,000

Computation of PV of note: (using 8%)*

$\$400,000 \times .73503 =$	\$294,012
$400,000 \times 3\% = 12,000 \times 3.31213 =$	<u>39,746</u>
Present value of note	333,758
Face value of note	<u>400,000</u>
Amount of discount	<u>\$ 66,242</u>

OR 4 N 8 I 12000 PMT 400000 FV CPT PV = 333,757

*8% is used because it represents the borrowing rate at which Orange can obtain financing. In similar transactions, this is the rate that an independent borrower and lender would consider reasonable as it represents the market's estimation of the riskiness of the customer.

b. Dec 31/20

Cash	12,000	
Interest Income		12,000
Notes Receivable	14,701	
Interest Income		14,701
$\$333,758 \times .08 = \$26,701 - \$12,000 = \$14,701$		

c. Dec 31/21

Cash	12,000	
Interest Income		12,000
Notes Receivable	15,877	
Interest Income		15,877
$(\$333,758 + \$14,701) \times .08 = \$27,877 - \$12,000 = \$15,877$		

Problem B-4 Solution

a.

Sep 1

Balance would have been carried over from previous month. No entry required.

Sep 8

Inventory.....	668	
Accounts Payable.....		668
To account for purchase (400 x \$1.67 = \$668)		

Sep 17

Accounts Receivable.....	3,400	
Sales.....		3,400
To record sale (800 x \$4.25 = \$3,400)		

Cost of Goods Sold.....	1,320	
Inventory		1,320
To update inventory and cost of goods sold (800 x \$1.65 = \$1,320)		

Sep 23

Accounts Receivable.....	1,075	
Sales.....		1,075
To record sale (250 x \$4.30 = \$1,075)		

Cost of goods sold.....	415.50	
Inventory		415.50
To update inventory and cost of goods sold (100 x \$1.65) + (150 x \$1.67) = \$415.5		

Sep 30

Inventory	1,137.50	
Accounts Payable.....		1,137.50
To account for purchase (650 x \$1.75 = \$1,137.50)		

- b. Under the periodic system, the entries to account for purchases would include a debit to *purchases*, rather than *inventory*. This is an expense account and is closed at the end of the accounting period.

Under the periodic system, there would be no interim entries to update inventory and cost of goods sold. These entries are deferred until the end of the accounting period when cost of goods sold is recognized as a residual amount.

- c. Total cost of goods sold would *not* differ between parts a. and b. Lime uses the FIFO cost flow formula, which assumes that older goods are sold first. This cost flow is the same under

both the perpetual and the periodic systems.

Problem B-5 Solution

- a.
1. Understated/Understated
 2. No effect/No effect
 3. No effect/Overstated
 4. No effect/Understated
 5. No effect/No effect
 6. No effect/Overstated
 7. Understated/Understated
- b.
1. Inventory 6,000
 Cost of Goods Sold..... 6,000
 2. None
 3. Purchases 1,000
 Accounts Payable 1,000
 Note that the Jan. 2 entry would need to be reversed.
 4. Accounts Payable 800
 Purchases. 800
 (This JE should be reversed in 2021)
 5. None
 6. Purchases 400
 Accounts Payable 400
 Note that the Jan. 2 entry would need to be reversed.
 7. Inventory 14,000
 Cost of Goods Sold..... 14,000

Problem B-6 Solution

a.

Beginning inventory.....	\$ 450,000
Add: Purchases.....	<u>1,200,000</u>
Cost of goods available	1,650,000
Sales	\$2,600,000
Less 40%	<u>(1,040,000)</u>
Estimated inventory lost	<u>\$ 90,000</u>

b.

Sales	2,600,000	
Income Summary		2,600,000
Cost of Goods Sold	1,560,000	
Inventory Loss from Fire	90,000	
(Beginning) Inventory		450,000
Purchases		1,200,000

***Problem B-7 Solution**

a.

1. NA
2. 4
3. NA
4. 4
5. 3
6. 2
7. NA
8. 3
9. 1
10. 2

b.

2. Accounts Receivable	450	
Cash		450
4. Bank Charges Expense	21	
Cash		21
5. Cash	4,625	
Notes Receivable		4,500
Interest Revenue		125
8. Cash	27	
Accounts Payable		27

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COMPREHENSIVE EXAMINATION C

PART 3

(CHAPTERS 9–12)

Problem	CPA	Topics	Blooms	Approximate Time
C-1	cpa-t001	Multiple Choice (Various Topics)	3—blooms001 1, 4, 5, 10-13, 17—blooms002 2, 6-9, 14-16, 18-21—blooms003	35 min.
C-2	cpa-t001	Assignment of Costs	blooms002	10 min.
C-3	cpa-t001 cpa-e003	Key Concepts and Definitions	blooms002	15 min.
C-4	cpa-t001	Rational Entity Impairment Model	blooms003	25 min.
C-5	cpa-t001	Depreciation Methods	blooms003	20 min.

C-6 cpa-t001 Equity Investment

blooms003

15 min.

120 min.

All questions are AACSB Analytic and Question C3 is Communication and Analytic.

Problem C-1 Multiple Choice (Various Topics)

Choose the *best* answer for each of the following questions and enter the identifying letter in the space provided.

- ____1. When the declining-balance method is used, depreciation expense for a given asset will
- decline by a constant amount each year.
 - be the same each year.
 - decrease rapidly at first, then slowly over the life of the asset.
 - vary from year to year in relation to changes in output.

- ____2. Norway Corporation acquired land, buildings, and equipment from a bankrupt competitor at a lump-sum price of \$132,000. At the time of acquisition, Norway paid \$12,000 to have the assets appraised. The appraisal disclosed the following fair values:

Land.....	\$96,000
Buildings	76,800
Equipment	19,200

What costs should be assigned to the land, buildings, and equipment, respectively?

- \$96,000, \$76,800, and \$19,200
- \$66,000, \$52,800, and \$13,200
- \$72,000, \$57,600, and \$14,40
- \$48,000, \$48,000, and \$48,000

- ____3. Current Canadian practice indicates that the maximum period over which an intangible asset should be amortized is
- 20 years.
 - 28 years.
 - 40 years.
 - its useful life or legal life, whichever is shorter.
- ____4. Purchased goodwill represents
- the excess of the price paid over the fair value of the net assets obtained in a business combination.
 - the excess of the price paid over the book value of the net assets obtained in a business combination.
 - the difference in the aggregate amount of the market prices of the shares of the combining companies.
 - a tangible asset.
- ____5. As it is generally used in accounting, what is depreciation?
- It is a process of asset valuation for balance sheet purposes.
 - It applies only to long-lived intangible assets.
 - It is used to indicate a decline in market value of a long-lived asset.
 - It is an accounting process that allocates long-lived asset cost to accounting periods.

Use the following data to answer questions 6–9.

On July 1, 2020, Bosnia Corp. purchased a new piece of equipment for \$300,000. The equipment has an estimated useful life of 5 years and an estimated residual value of \$25,000. Bosnia uses the calendar year as its fiscal year, and records depreciation to the nearest month.

- ____6. What would the straight-line depreciation be for fiscal 2020?
- \$60,000
 - \$55,000
 - \$30,000
 - \$27,500
- ____7. What would be the double declining-balance depreciation for 2021?
- \$72,000
 - \$96,000
 - \$110,000
 - \$120,000
- ____8. If Bosnia expensed the total cost of the equipment at the time of purchase, what was the effect on 2020 and 2021 income before taxes, assuming Bosnia uses straight-line depreciation?
- \$245,000 understated and \$55,000 overstated
 - \$270,000 understated and \$30,000 overstated
 - \$272,500 understated and \$55,000 overstated

- d. \$300,000 understated and \$30,000 overstated
- ___ 9. If, at the beginning of 2022, Bosnia decides the equipment still has five more years of life beyond December 31, 2021, with the same residual value, what would be the straight-line depreciation for 2022? (Assume straight-line used in all years.)
- a. \$30,000
 - b. \$32,083
 - c. \$38,500
 - d. \$55,000
- ___ 10. Other comprehensive income includes changes in equity
- a. related to non-owner sourced transactions.
 - b. related to payment of dividends.
 - c. due to errors of other years.
 - d. due to unusual gains and losses of the current year.
- ___ 11. 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.
- ___ 12. When an investor is using the equity method and the investee reports net income, the journal entry on the investor's books will include a
- a. debit to the Investment account.
 - b. credit to Retained Earnings.
 - c. credit to the Investment account.
 - d. debit to Investment Income or Loss.
- ___ 13. Under IFRS, which of the following is a condition for an investment to be classified as current?
- a. It must be a cash equivalent.
 - b. It must be accounted for under the cost model.
 - c. It is held primarily for trading purposes.
 - d. It may be held for trading purposes, but could be held for long-term appreciation as well.
- ___ 14. Russia Inc. owns bonds that are accounted for under the fair value through net income model. On December 31, 2020, the bonds have a carrying value of \$248,700. The fair value at that date is \$245,000. The entry to record the year-end adjustment will include a debit to
- a. FV–NI Investments.
 - b. Investment Income or Loss.
 - c. Unrealized Holding Loss on FV–OCI Investments.
 - d. Other Comprehensive Income.

- ____ 15. If Latvia Inc. acquired a 30% interest in Lithuania Ltd. on January 1, 2020 for \$90,000, and during 2020 Lithuania reported net income of \$50,000 and paid a total cash dividend of \$20,000, applying the equity method would result in an increase (decrease) to Latvia's Investment in Lithuania Ltd. account for 2020 of
- \$50,000.
 - \$30,000.
 - \$9,000.
 - \$(20,000).
- ____ 16. A replacement, which extended the life of a PPE asset, but did not increase the quality or quantity of units produced by the asset, cost \$20,000. This expenditure should be debited to
- the related asset account.
 - the related asset's accumulated depreciation account.
 - an expense account.
 - retained earnings.
- ____ 17. Property, plant, and equipment are conventionally presented in the balance sheet at
- historical cost less residual value.
 - historical cost less accumulated depreciation.
 - fair value less residual value.
 - fair value less book value.

Use the following information for questions 18–19.

Mongolia Corp. is considering acquiring Tibet Corp. The following information relates to Tibet Corp.:

Net tangible assets at cost	\$5,000,000
Net tangible assets at fair value	\$5,500,000
Average net income for the past four years	\$ 475,000
Normal rate of return for the industry.....	8%

- ____ *18. What is the amount of goodwill if average excess earnings for the past four years are to be capitalized at the normal rate of return for the industry?
- \$400,000
 - \$437,500
 - \$440,000
 - \$500,000
- ____ *19. What is the total amount that Mongolia should be willing to pay for Tibet if average excess earnings for the past four years are to be capitalized at 14%?
- \$5,750,000
 - \$5,700,000
 - \$5,250,000
 - \$4,600,000

Use the following information for questions 20–21.

On July 1, 2020, Bosnia Corp. purchased a new piece of equipment for \$300,000. The equipment has an estimated useful life of 5 years and an estimated residual value of \$25,000. Bosnia uses the calendar year as its fiscal year. The equipment is a Class 8 asset with a maximum CCA rate of 20%.

____ *20. What is the maximum CCA for 2020?

- a. \$60,000
- b. \$55,000
- c. \$30,000
- d. \$27,500

____ *21. Assuming maximum CCA was claimed in 2020, what is the maximum CCA for 2021?

- a. \$48,000
- b. \$49,500
- c. \$54,000
- d. \$54,500

* This topic is dealt with in an Appendix.

Problem C-2 Assignment of Costs

Match the following cost items with the appropriate accounts:

a. Land	c. Land Improvements
b. Buildings	d. Other

- ____ 1. Interest cost incurred during building construction.
- ____ 2. Back taxes on land purchased to be used for building site.
- ____ 3. Assessment by city for drainage system.
- ____ 4. Building permits.
- ____ 5. Landscaping shrubs planted after building has been constructed.
- ____ 6. Demolition costs of building on land bought for plant site.
- ____ 7. Interest costs incurred after completion of building construction.
- ____ 8. Recording fees for land.
- ____ 9. Architect's fees.
- ____ 10. Grading and filling building site.
- ____ 11. Parking lots.
- ____ 12. Fences.

Problem C-3 Key Concepts and Definitions

Provide clear, concise answers for the following:

- 1. What are the major categories of intangible assets?
- 2. What are the two models that are used to account for the impairment of intangible assets?
Which method provides better information and why?

3. Define depreciation accounting.
4. Does depreciation accounting provide funds? If not, what does provide funds? What does depreciation accounting do related to funds?

Problem C-4 Rational Entity Impairment Model

Thyme Corporation's balance sheet includes the following asset:

Equipment.....	\$110,000
Less: Accumulated depreciation.....	<u>(20,000)</u>
Carrying amount (book value).....	\$90,000

After performing its annual review for impairment, Thyme obtains the following data:

Asset value in use	\$64,000
Fair value less selling costs.....	67,000

Instructions

Assuming Thyme uses the rational entity impairment model:

- a. Calculate the recoverable amount.
- b. Calculate the impairment loss.
- c. Prepare the entry to record the impairment loss.

Problem C-5 Depreciation Methods

A machine costing \$180,000 has an estimated residual value of \$15,000 and an estimated service life of ten years. What is the annual depreciation for each of the first two full years under the following methods?

1. Double declining-balance:
 - a. Year one \$ _____
 - b. Year two \$ _____
2. Units of production. Lifetime production is estimated at 110,000 units; the machine produced 12,000 units in Year one and 18,000 in Year two:
 - a. Year one \$ _____
 - b. Year two \$ _____
3. Straight-line depreciation method:
 - a. Year one \$ _____
 - b. Year two \$ _____
- *4. CCA (assume this is a Class 10 asset with a 30% CCA rate):
 - a. Year one \$ _____
 - b. Year two \$ _____.

Problem C-6 Equity Investments

On January 2, 2020, Basil Corp. invested \$4,150,000 in Oregano Inc. for 40% of its outstanding common shares. At this time, the book value (equity) of Oregano Inc. was \$8,400,000. Oregano's pays out 25% of its net income in dividends each year. Basil elects two of five members of Oregano's board of directors. During 2020, Basil received a cash dividend of \$250,000 from Oregano Inc.

Instructions

- a. Record the initial purchase of the Oregano Inc. shares by Basil Corp. in 2020.
- b. Calculate Oregano Inc.'s net income for 2020.
- c. Record the additional 2020 journal entries related to this investment on Basil's books.

Solutions — Comprehensive Examination C**Problem C-1 Solution**

1. c

2. b

3. d

4. a

5. d

6. d

7. b

8. c

9. c

10. a

11. c

12. a

13. c

14. b

15. c

16. a

17. b

*18.b

*19.a

*20.c

*21.c

Solutions to Computational Multiple Choice Questions:

2. Total fair value is \$192,000; paid \$132,000, which is 68.75% of FV
Land: $\$96,000 \times 68.75\% = \$66,000$
Building: $\$76,800 \times 68.75\% = 52,800$
Equipment: $\$19,200 \times 68.75\% = 13,200$
6. $(\$300,000 - \$25,000) \times \frac{1}{5} \times \frac{1}{2} = \$27,500$
7. 2020: $\$300,000 \times 2 \div 5 \times \frac{1}{2} = \$60,000$
2021: $\$300,000 - \$60,000 \times 2 \div 5 = \$96,000$
8. 2020: understated by cost of \$300,000 and overstated by lack of depreciation expense of \$27,500 = net of \$272,500 understated
2021: overstated by depreciation expense not recorded of \$55,000
9. $(\$300,000 - \$27,500 - \$55,000 - \$25,000) \div 5 = \$38,500$
15. $(\$50,000 - \$20,000) \times 30\% = \$9,000$ (increase)
- *18. Normal rate of return $\$5,500,000 \times 8\% = \$440,000$; excess is $\$475,000 - \$440,000 = \$35,000$. Goodwill = $\$35,000 \div 8\% = \$437,500$
- *19. $\$5,500,000$ (FV) + $(\$35,000 \div 14\%) = \$5,750,000$
- *20. $\$300,000 \times 20\% \times \frac{1}{2} = \$30,000$
- *21. $(\$300,000 - \$30,000) \times 20\% = \$54,000$

Problem C-2 Solution

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

10. a

11. c

12. c

Problem C-3 Solution

1. The major categories are marketing-related, customer-related, artistic-related, contract-based, and technology-based intangible assets.
2. The two models are the cost recovery impairment model and the rational entity impairment model. The first is used for ASPE and the latter is used in IFRS. Overall, the rational entity model used under IFRS provides better information for users: it provides better representational faithfulness as it is more neutral; it is more relevant; it provides more timely information; and it better reflects the time value of money and the fair value of impaired assets.
3. Depreciation accounting is the systematic and rational allocation of the cost of plant assets to the periods benefited from the use of the assets.
4. Depreciation accounting does not provide funds. Revenues provide funds. Depreciation accounting retains funds by reducing income taxes and dividends.

Problem C-4 Solutiona. 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 \$67,000. Thus, the recoverable amount is \$67,000.

b. Impairment loss:

Carrying amount	\$90,000
Recoverable amount	<u>67,000</u>
Impairment loss.....	\$23,000

c. Journal entry:

Loss on impairment	23,000	
Accumulated impairment loss		23,000

Problem C-5 Solution

1.
 - a. $\$180,000 \times 2 \div 10 = \$36,000$
 - b. $(\$180,000 - \$36,000) \times 2 \div 10 = \$28,800$
2. Depreciation per unit $(\$180,000 - \$15,000) \div 110,000 = \$1.50$
 - a. $12,000 \times \$1.50 = \$18,000$
 - b. $18,000 \times \$1.50 = \$27,000$

3. a. & b. (same both years) $(\$180,000 - \$15,000) \div 10 = \$16,500$

*4. a. $\$180,000 \times 30\% \times \frac{1}{2} = \$27,000$

b. $(\$180,000 - \$27,000) \times 30\% = \$45,900$

Problem C-6 Solution

a.	Investment in Associate.....	4,150,000	
	Cash		4,150,000
b.	Total dividend paid by Oregano = $\$250,000 \div 40\% = \$625,000$ Therefore, net income for year = $\$625,000 \div 25\% = \$2,500,000$		
c.	Investment in Associate. (40% x \$2,500,000).....	1,000,000	
	Investment Income or Loss.....		1,000,000
	Cash	250,000	
	Investment in Associate.....		250,000

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