

FINANCIAL ACCOUNTING & REPORTING

CPA2901US2-38

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ABOUT UPDATING SUPPLEMENT VERSION 38.2

This supplement is designed to bring the very latest information to candidates using our products in preparation for the CPA exam in the July-August 2009, and later, exam windows. Candidates with the 38th edition CPA Review textbook or the corresponding Version 12 series software will find the information in updating supplement Version 38.2 more than adequate for these exam windows.

When new information first becomes available, the examiners tend to test new or changed portions of concepts lightly. Coverage of information after that point may increase, if it is in a heavily tested area. Do not fall into the trap of attaching undue significance to new information merely because it is new.

Accounting and auditing pronouncements are eligible to be tested on the CPA exam in the testing window beginning six months after a pronouncement's *effective* date, unless early application is permitted. When early application is permitted, a new pronouncement may be tested in the window beginning 6 months after the *issuance* date. In this case, *both* the previous and the new pronouncements can be tested until the previous pronouncement has been superseded.

Remember, with the information and techniques in our material, passing the exam is an attainable goal. ***Adhere to a reasonable study plan—and pass the first time!***

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OTHER SOURCES OF INFORMATION FOR CANDIDATES

Candidates choosing to use previous editions of our books must accept responsibility for adequately updating their materials and should consider the strain that this will add to the already time-consuming process of studying for the exam. Candidates with the 36th and earlier editions are strongly encouraged to purchase new materials. Please contact a customer service representative at 1-800-280-9718.

Candidates with the 37th edition CPA Review textbook or corresponding Version 11 series software will also need FAR Updating Supplement Version 37.3. FAR Updating Supplement Version 37.3 contains summaries of GASB 52 and SFAS 141(R), 160, 161, 162, and 163. It also contains information on the FASB Accounting Standards Codification, global convergence of accounting standards, and the newest research task format used in the CPA exam. (This content is integrated into the 38th edition.)

ERRATA

The following items are in the textbook only, unless otherwise noted. If you find other items that you believe are ambiguous or in error, please contact the Bisk Education editors (editor@cpaexam.com) with details.

- Foreword: Page F-18, Diagnostic Examination, Question 10 (3279). The first sentence should start with the following phrase: "In an exchange with commercial substance,".
- Chapter 7: Page 7-41, Question 52 (4427). The correct answer is a., not c.
- Chapter 10: Page 10-54, Question 48 (9042). In the explanation, the first journal entry under December 31, year 3 should be a debit and credit for "\$32,000" instead of "\$30,000".
- Chapter 11: Page 11-33, Question 19 (6770). Answer choice a. should read "Appear as a part of discontinued operations and extraordinary items" and not include "and cumulative effect of a change in accounting principle".
- Page 11-55, Question 19 (6770). The second sentence of the explanation should read as follows: "Discontinued operations and extraordinary items are components of the income statement, reported after income from continuing operations and before net income."
- Chapter 13: Page 13-12, Exhibit 4. The bonus depreciation (179, etc.) in the IRC Tax Return column should read "250K for '08, 133K for '09;" instead of "125K for '07, 128K for '08;".
- Page 13-40, Problem 13-2, Reconciliation tab. The amount choice for F should be "\$112,500" instead of "\$120,000" and the amount choice for G should be "\$120,000" instead of "\$112,500". Also, the pretax financial income should be "\$1,000,000" instead of "\$1,200,000" for April 30, year 2 and "\$1,200,000" instead of "\$1,000,000" for April 30, year 3.
- Chapter 14: Page 14-39, Solution 14-3, Reconciliation of Net Income tab. In the explanation for number 15, the "\$80,000" figure should be "\$180,000" (25% of Zach's \$720,000 reported net income).
- Chapter 15: Page 15-32, Solution 15-3, Diluted Earnings Per Share tab. In the calculations section, the third entry, second line should read "cash proceeds" instead of "option price." Also, the explanation for number 15 should read "675,000 (cash proceeds)" instead of "\$22.50 (option price)".
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2008 RELEASED AICPA QUESTIONS AND ANSWERS

In September 2008, the AICPA released fifty multiple-choice questions and one simulation relating to the FAR section of the CPA examination. These questions and their unofficial answers are reproduced here, along with the exclusive Bisk Education explanations. The multiple-choice questions in Problems 1 and 2 were labeled *moderate* and *hard*, respectively, by the AICPA examiners. Problem 3 is the one simulation that was disclosed. The AICPA did not state if these questions ever appeared on any exam, whether they were assigned points or merely being pre-tested and earned no points if they did appear on an exam, or if they were now obsolete for some reason. These questions are intended only as a study aid and should not be used to predict the content of future exams. It is extremely unlikely that released questions will appear on future examinations. These questions have been reproduced as received from the AICPA examiners. If candidates encounter what they believe are errors or ambiguities in questions during their actual exams, they should bring them to the attention of the examiners in accordance with the procedures outlined on the AICPA's CPA Examination website.

Problem 1 MULTIPLE-CHOICE QUESTIONS (50 to 63 minutes)

1. According to the FASB conceptual framework, certain assets are reported in financial statements at the amount of cash or its equivalent that would have to be paid if the same or equivalent assets were acquired currently. What is the name of the reporting concept?

- Replacement cost
- Current market value
- Historical cost
- Net realizable value

(R/08, FAR, 0947F, #1, 8556)

2. To be relevant, information should have which of the following?

- Verifiability
- Feedback value
- Understandability
- Costs and benefits

(R/08, FAR, C04367F, #2, 8557)

3. Which of the following items is **not** classified as "other comprehensive income"?

- Extraordinary gains from extinguishment of debt
- Foreign currency translation adjustments
- Minimum pension liability equity adjustment for a defined-benefit pension plan
- Unrealized gains for the year on available-for-sale marketable securities

(R/08, FAR, 0858F, #3, 8558)

4. A company's year-end balance sheet is shown below:

<u>Assets</u>	
Cash	\$ 300,000
Accounts receivable	350,000
Inventory	600,000
Property, plant and equipment (net)	<u>2,000,000</u>
	<u>\$3,250,000</u>

Liabilities and shareholder equity

Current liabilities	\$ 700,000
Long-term liabilities	600,000
Common stock	800,000
Retained earnings	<u>1,150,000</u>
	<u>\$3,250,000</u>

What is the current ratio as of December 31?

- 1.79
- 0.93
- 0.67
- 0.43

(R/08, FAR, A1457F, #4, 8559)

5. TGR Enterprises provided the following information from its statement of financial position for the year ended December 31, year 1:

	<u>January 1</u>	<u>December 31</u>
Cash	\$ 10,000	\$ 50,000
Accounts receivable	120,000	100,000
Inventories	200,000	160,000
Prepaid expenses	20,000	10,000
Accounts payable	175,000	120,000
Accrued liabilities	25,000	30,000

TGR's sales and cost of sales for year 1 were \$1,400,000 and \$840,000, respectively. What is the accounts receivable turnover, in days?

- a. 26.1
- b. 28.7
- c. 31.3
- d. 41.7 (R/08, FAR, A0678F, #5, 8560)

6. Which inventory costing method would a company that wishes to maximize profits in a period of rising prices use?

- a. FIFO
- b. Dollar-value LIFO
- c. Weighted average
- d. Moving average (R/08, FAR, 0022F, #6, 8561)

7. At the end of the year, Ian Co. determined its inventory to be \$258,000 on a FIFO (first in, first out) basis. The current replacement cost of this inventory was \$230,000. Ian estimates that it could sell the inventory for \$275,000 at a disposal cost of \$14,000. If Ian's normal profit margin for its inventory was \$10,000, what would be its net carrying value?

- a. \$244,000
- b. \$251,000
- c. \$258,000
- d. \$261,000 (R/08, FAR, A0240F, #7, 8562)

8. The following costs pertain to Den Co.'s purchase of inventory:

700 units of product A	\$3,750
Freight-in	175
Cost of materials and labor incurred to bring product A to saleable condition	900
Insurance cost during transit of purchased goods	<u>100</u>
Total	\$4,925

What amount should Den record as the cost of inventory as a result of this purchase?

- a. \$3,925
- b. \$4,650
- c. \$4,825
- d. \$4,925 (R/08, FAR, 0677F, #8, 8563)

9. A manufacturing firm purchased used equipment for \$135,000. The original owners estimated that the residual value of the equipment was \$10,000. The carrying amount of the equipment was \$120,000 when ownership transferred. The new owners estimate that the expected remaining useful life of the equipment was 10 years, with a salvage value of \$15,000. What amount represents the depreciable base used by the new owners?

- a. \$105,000
- b. \$110,000
- c. \$120,000
- d. \$125,000 (R/08, FAR, A0645F, #9, 8564)

10. Anchor Co. owns 40% of Main Co.'s common stock outstanding and 75% of Main's non-cumulative preferred stock outstanding. Anchor exercises significant influence over Main's operations. During the current period, Main declared dividends of \$200,000 on its common stock and \$100,000 on its noncumulative preferred stock. What amount of dividend income should Anchor report on its income statement for the current period related to its investment in Main?

- a. \$ 75,000
- b. \$ 80,000
- c. \$120,000
- d. \$225,000 (R/08, FAR, 1568F, #10, 8565)

11. At the beginning of the current year, Hayworth Co. sold equipment with a two-year service contract for a single payment of \$20,000. The fair value of the equipment was \$18,000. Hayworth recorded this transaction with a debit of \$20,000 to cash and a credit of \$20,000 to sales revenue. Which of the following statements is correct regarding Hayworth's current-year financial statements?

- a. The financial statements are correct.
- b. Net income will be overstated.
- c. Total assets will be overstated.
- d. Total liabilities will be overstated.

(R/08, FAR, A1420F, #11, 8566)

12. On January 1, a company issued a \$50,000 face value, 8% five-year bond for \$46,139 that will yield 10%. Interest is payable on June 30 and December 31. What is the bond carrying amount on December 31 of the current year?

- a. \$46,139
- b. \$46,446
- c. \$46,768
- d. \$47,106

(R/08, FAR, A1726F, #12, 8567)

13. What type of bonds in a particular bond issuance will **not** all mature on the same date?

- a. Debenture bonds
- b. Serial bonds
- c. Term bonds
- d. Sinking fund bonds

(R/08, FAR, 1363F, #13, 8568)

14. In 2002, Spirit, Inc. determined that the 12-year estimated useful life of a machine purchased for \$48,000 in January 1997 should be extended by three years. The machine is being depreciated using the straight-line method and has no salvage value. What amount of depreciation expense should Spirit report in its financial statements for the year ending December 31, 2002?

- a. \$2,800
- b. \$3,200
- c. \$4,200
- d. \$4,800

(R/08, FAR, 0657F, #14, 8569)

15. On January 2, 2003, Raft Corp. discovered that it had incorrectly expensed a \$210,000 machine purchased on January 2, 2000. Raft estimated the machine's original useful life to be 10 years and its salvage value at \$10,000. Raft uses the straight-line method of depreciation and is subject to a 30% tax rate. In its December 31, 2003, financial statements, what amount should Raft report as a prior period adjustment?

- a. \$102,900
- b. \$105,000
- c. \$165,900
- d. \$168,000

(R/08, FAR, 0439F, #15, 8570)

16. Which of the following describes the appropriate reporting treatment for a change in accounting estimate?

- a. In the period of change with **no** future consideration
- b. By reporting *pro forma* amounts for prior periods
- c. By restating amounts reported in financial statements of prior periods
- d. In the period of change and future periods if the change affects both

(R/08, FAR, C01221F, #16, 8571)

17. On January 2, of the current year, Peace Co. paid \$310,000 to purchase 75% of the voting shares of Surge Co. Peace reported retained earnings of \$80,000, and Surge reported contributed capital of \$300,000 and retained earnings of \$100,000. The purchase differential was attributed to depreciable assets with a remaining useful life of 10 years. Peace used the equity method in accounting for its investment in Surge. Surge reported net income of \$20,000 and paid dividends of \$8,000 during the current year. Peace reported income, exclusive of its income from Surge, of \$30,000 and paid dividends of \$15,000 during the current year. What amount will Peace report as dividends declared and paid in its current year's consolidated statement of retained earnings?

- a. \$ 8,000
- b. \$15,000
- c. \$21,000
- d. \$23,000

(R/08, FAR, C02270F, #17, 8572)

18. A corporation issues quarterly interim financial statements and uses the lower cost or market method to value its inventory in its annual financial statements. Which of the following statements is correct regarding how the corporation should value its inventory in its interim financial statements?

- a. Inventory losses generally should be recognized in the interim statements.
- b. Temporary market declines should be recognized in the interim statements.
- c. Only the cost method of valuation should be used.
- d. Gains from valuations in previous interim periods should be fully recognized.

(R/08, FAR, A2005F, #18, 8573)

19. Steam Co. acquired equipment under a capital lease for six years. Minimum lease payments were \$60,000 payable annually at year-end. The interest rate was 5% with an annuity factor for six years of 5.0757. The present value of the payments was equal to the fair market value of the equipment. What amount should Steam report as interest expense at the end of the first year of the lease?

- a. \$0
- b. \$ 3,000
- c. \$15,227
- d. \$18,000

(R/08, FAR, 1274F, #19, 8574)

20. Which of the following expenditures qualifies for asset capitalization?

- a. Cost of materials used in prototype testing
- b. Costs of testing a prototype and modifying its design
- c. Salaries of engineering staff developing a new product
- d. Legal costs associated with obtaining a patent on a new product

(R/08, FAR, A0472F, #20, 8575)

21. What is the measurement focus and the basis of accounting for the government-wide financial statements?

<u>Measurement focus</u>	<u>Basis of accounting</u>
a. Current financial resources	Modified accrual
b. Economic resources	Modified accrual
c. Current financial resources	Accrual
d. Economic resources	Accrual

(R/08, FAR, A0008G, #21, 8576)

22. Powell City purchased a piece of equipment to be used by a department financed by the general fund. How should Powell report the acquisition in the general fund?

- a. As an expenditure
- b. Capitalize, depreciation is optional
- c. Capitalize, depreciation is required
- d. Capitalize, depreciation is **not** permitted

(R/08, FAR, 0751G, #22, 8577)

23. Hann School, a nongovernmental not-for-profit organization, spent \$1 million of temporarily restricted cash to acquire land and building. How should this be reported in the statement of activities?

- a. Increase in unrestricted net assets
- b. Increase in temporarily restricted net assets
- c. Increase in permanently restricted net assets
- d. Decrease in permanently restricted net assets

(R/08, FAR, A0147N, #23, 8578)

24. Which of the following comprise functional expense categories for a nongovernmental not-for-profit organization?

- a. Program services, management and general, and fund-raising
- b. Membership dues, fund-raising, and management and general
- c. Grant expenses, program services, and membership development
- d. Membership development, professional fees, and program services

(R/08, FAR, A0367N, #24, 8579)

25. Settam, a nongovernmental not-for-profit organization, received a donation of stock with donor-stipulated requirements as follows:

Shares valued at \$8,000,000 are to be sold with the proceeds used for renovation.

Shares valued at \$2,000,000 are to be retained with the dividends used to support current operations.

What amount should Settam include as unrestricted net assets as a result of this donation?

- a. \$0
- b. \$ 2,000,000
- c. \$ 8,000,000
- d. \$10,000,000

(R/08, FAR, 0983G, #25, 8580)

Problem 2 ADDITIONAL MULTIPLE-CHOICE QUESTIONS (50 to 63 minutes)

26. Which of the following statements is correct regarding reporting comprehensive income?

- Accumulated other comprehensive income is reported in the stockholders' equity section of the balance sheet.
- A separate statement of comprehensive income is required.
- Comprehensive income must include all changes in stockholders' equity for the period.
- Comprehensive income is reported in the year-end statements but **not** in the interim statements. (R/08, FAR, A1931F, #26, 8581)

27. How should the amortization of bond discount on long-term debt be reported in a statement of cash flows prepared using the indirect method?

- As a financing activities inflow
- As a financing activities outflow
- In operating activities as a deduction from income
- In operating activities as an addition to income (R/08, FAR, 0501F, #27, 8582)

28. Sanni Co. had \$150,000 in cash-basis pretax income for the year. At the current year end, accounts receivable decreased by \$20,000 and accounts payable increased by \$16,000 from their previous year-end balances. Compared to the accrual-basis method of accounting, Sanni's cash-basis pretax income is

- Higher by \$4,000
- Lower by \$4,000
- Higher by \$36,000
- Lower by \$36,000 (R/08, FAR, A0554F, #28, 8583)

29. Redwood Co.'s financial statements had the following information at year end:

Cash	\$ 60,000
Accounts receivable	180,000
Allowance for uncollectible accounts	8,000
Inventory	240,000
Short-term marketable securities	90,000
Prepaid rent	18,000
Current liabilities	400,000
Long-term debt	220,000

What was Redwood's quick ratio?

- 0.81 to 1
- 0.83 to 1
- 0.94 to 1
- 1.46 to 1 (R/08, FAR, 1373F, #29, 8584)

30. The following information was taken from Baxter Department Store's financial statements:

Inventory at January 1	\$ 100,000
Inventory at December 31	300,000
Net sales	2,000,000
Net purchases	700,000

What was Baxter's inventory turnover for the year ending December 31?

- 2.5
- 3.5
- 5
- 10 (R/08, FAR, 1553F, #30, 8585)

31. Smith Co. has a checking account at Small Bank and an interest-bearing savings account at Big Bank. On December 31, year 1, the bank reconciliations for Smith are as follows:

<u>Big Bank</u>	
Bank balance	\$150,000
Deposit in transit	5,000
Book balance	155,000

<u>Small Bank</u>	
Bank balance	\$ 1,500
Outstanding checks	(8,500)
Book balance	(7,000)

What amount should be classified as cash on Smith's balance sheet at December 31, year 1?

- \$148,000
- \$151,000
- \$155,000
- \$156,000 (R/08, FAR, A0526F, #31, 8586)

32. Seafood Trading Co. commenced operations during the year as a large importer and exporter of seafood. The imports were all from one country overseas. The export sales were conducted as drop shipments and were merely transshipped at Seattle. Seafood Trading reported the following data:

Purchases during the year	\$12.0 million
Shipping costs from overseas	1.5 million
Shipping costs to export customers	1.0 million
Inventory at year end	3.0 million

What amount of shipping costs should be included in Seafood Trading's year-end inventory valuation?

- a. \$0
- b. \$250,000
- c. \$375,000
- d. \$625,000 (R/08, FAR, C02967F, #32, 8587)

33. Fireworks, Inc. had an explosion in its plant that destroyed most of its inventory. Its records show that beginning inventory was \$40,000. Fireworks made purchases of \$480,000 and sales of \$620,000 during the year. Its normal gross profit percentage is 25%. It can sell some of its damaged inventory for \$5,000. The insurance company will reimburse Fireworks for 70% of its loss. What amount should Fireworks report as loss from the explosion?

- a. \$50,000
- b. \$35,000
- c. \$18,000
- d. \$15,000 (R/08, FAR, A0224F, #33, 8588)

34. A depreciable asset has an estimated 15% salvage value. Under which of the following methods, properly applied, would the accumulated depreciation equal the original cost at the end of the asset's estimated useful life?

	<u>Straight-line</u>	<u>Double-declining balance</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

(R/08, FAR, 0962F, #34, 8589)

35. On December 31, 2003, Moon, Inc. authorized Luna Co. to operate as a franchisee for an initial franchise fee of \$100,000. Luna paid \$40,000 on signing the agreement and signed an interest-free note to pay the balance in three annual installments of \$20,000 each, beginning December 31, 2004. On December 31, 2003, the present value of the note, appropriately discounted, is \$48,000. Services for the initial fee will be performed in 2004. In its December 31, 2003, balance sheet, what amount should Moon report as unearned franchise fees?

- a. \$0
- b. \$ 48,000
- c. \$ 88,000
- d. \$100,000 (R/08, FAR, 0039F, #35, 8590)

36. On July 28, Vent Corp. sold \$500,000 of 4%, eight-year subordinated debentures for \$450,000. The purchasers were issued 2,000 detachable warrants, each of which was for one share of \$5 par common stock at \$12 per share. Shortly after issuance, the warrants sold at a market price of \$10 each. What amount of discount on the debentures should Vent record at issuance?

- a. \$50,000
- b. \$60,000
- c. \$70,000
- d. \$74,000 (R/08, FAR, 0041F, #36, 8591)

37. Which of the following statements characterizes convertible debt?

- a. The holder of the debt must be repaid with shares of the issuer's stock.
- b. No value is assigned to the conversion feature when convertible debt is issued.
- c. The transaction should be recorded as the issuance of stock.
- d. The issuer's stock price is **less** than market value when the debt is converted.

(R/08, FAR, A0042F, #37, 8592)

38. The following is the stockholders' equity section of Harbor Co.'s balance sheet at December 31:

Common stock \$10 par, 100,000 shares authorized, 50,000 shares issued of which 5,000 have been reacquired, and are held in treasury	\$ 450,000
Additional paid-in capital common stock	1,100,000
Retained earnings	<u>800,000</u>
Subtotal	\$2,350,000
Less treasury stock	<u>(150,000)</u>
Total stockholders' equity	<u>\$2,200,000</u>

Harbor has insignificant amounts of convertible securities, stock warrants, and stock options. What is the book value per share of Harbor's common stock?

- \$31
- \$44
- \$46
- \$49 (R/08, FAR, 1413F, #38, 8593)

39. Sayon Co. issues 200,000 shares of \$5 par value common stock to acquire Trask Co. in a purchase-business combination. The market value of Sayon's common stock is \$12. Legal and consulting fees incurred in relationship to the purchase are \$110,000. Registration and issuance costs for the common stock are \$35,000. What should be recorded in Sayon's additional paid-in capital account for this business combination?

- \$1,545,000
- \$1,400,000
- \$1,365,000
- \$1,255,000 (R/08, FAR, A0725F, #39, 8594)

40. A corporation entered into a purchase commitment to buy inventory. At the end of the accounting period, the current market value of the inventory was less than the fixed purchase price, by a material amount. Which of the following accounting treatments is most appropriate?

- Describe the nature of the contract in a note to the financial statements, recognize a loss in the income statement, and recognize a liability for the accrued loss
- Describe the nature of the contract and the estimated amount of the loss in a note to the financial statements, but do **not** recognize a loss in the income statement
- Describe the nature of the contract in a note to the financial statements, recognize a loss in the income statement, and recognize a reduction in inventory equal to the amount of the loss by use of a valuation account
- Neither describe the purchase obligation, nor recognize a loss on the income statement or balance sheet

(R/08, FAR, A1264F, #40, 8595)

41. The following information is relevant to the computation of Chan Co.'s earnings per share to be disclosed on Chan's income statement for the year ending December 31:

Net income for 2002 is \$600,000.

\$5,000,000 face value 10-year convertible bonds outstanding on January 1. The bonds were issued four years ago at a discount which is being amortized in the amount of \$20,000 per year. The stated rate of interest on the bonds is 9%, and the bonds were issued to yield 10%. Each \$1,000 bond is convertible into 20 shares of Chan's common stock.

Chan's corporate income tax rate is 25%.

Chan has no preferred stock outstanding, and no other convertible securities. What amount should be used as the numerator in the fraction used to compute Chan's diluted earnings per share assuming that the bonds are dilutive securities?

- \$ 130,000
- \$ 247,500
- \$ 952,500
- \$1,070,000 (R/08, FAR, 1421F, #41, 8596)

42. Which of the following is the characteristic of a perfect hedge?

- a. No possibility of future gain or loss
- b. No possibility of future gain only
- c. No possibility of future loss only
- d. The possibility of future gain and no future loss
(R/08, FAR, C04481F, #42, 8597)

43. Gordon Ltd., a 100% owned British subsidiary of a U.S. parent company, reports its financial statements in local currency, the British pound. A local newspaper published the following U.S. exchange rates to the British pound at year end:

Current rate	\$1.50
Historical rate (acquisition)	1.70
Average rate	1.55
Inventory (FIFO)	1.60

Which currency rate should Gordon use to convert its income statement to U.S. dollars at year end?

- a. 1.50
- b. 1.55
- c. 1.60
- d. 1.70
(R/08, FAR, 1282F, #43, 8598)

44. On January 16, Tree Co. paid \$60,000 in property taxes on its factory for the current calendar year. On April 2, Tree paid \$240,000 for unanticipated major repairs to its factory equipment. The repairs will benefit operations for the remainder of the calendar year. What amount of these expenses should Tree include in its third quarter interim financial statements for the three months ended September 30?

- a. \$0
- b. \$15,000
- c. \$75,000
- d. \$95,000
(R/08, FAR, 0341F, #44, 8599)

45. Stam Co. incurred the following research and development project costs during the current year:

Equipment purchased for current and future projects	\$100,000
Equipment purchased for current projects only	200,000
Research and development salaries for current projects	400,000
Legal fees to obtain patent	50,000
Material and labor costs for prototype product	600,000

The equipment has a five-year useful life and is depreciated using the straight-line method. What amount should Stam recognize as research and development expense at year end?

- a. \$ 450,000
- b. \$1,000,000
- c. \$1,220,000
- d. \$1,350,000
(R/08, FAR, 1262F, #45, 8600)

46. A state had general obligation bonds outstanding that required payment of interest on July 1 and January 1 of each year. State law allowed for the general fund to make debt payments without the use of a fiscal agent. The fiscal year ended June 30. Which of the following accounts would have decreased when the state paid the interest due on July 1?

- a. Interest expenditures
- b. Interest payable
- c. Interest expense
- d. Fund balance
(R/08, FAR, A0034G, #46, 8601)

47. On March 1, Wag City issued \$1,000,000, ten-year, 6% general obligation bonds at par with no bond issue costs. The bonds pay interest September 1 and March 1. What amount of interest expense and bond interest payable should Wag report in its government-wide financial statements at the close of the fiscal year on December 31?

- a. Interest expense, \$50,000; interest payable, \$20,000
- b. Interest expense, \$50,000; interest payable, \$0
- c. Interest expense, \$60,000; interest payable, \$10,000
- d. Interest expense, \$30,000; interest payable, \$0
(R/08, FAR, A0090G, #47, 8602)

48. All of the following statements regarding notes to the basic financial statements of governmental entities are true **except**

- The notes contain disclosures related to required supplementary information.
- Some notes presented by governments are identical to notes presented in business financial statements.
- Notes that are considered essential to the basic financial statements need to be presented.
- It is acceptable to present notes in a very extensive format.

(R/08, FAR, A0088G, #48, 8603)

49. How should unconditional pledges received by a nongovernmental not-for-profit organization that will be collected over more than one year be reported?

- Long-term pledges receivable, valued at the expected collection amount
- Pledges receivable, valued at their present values
- Deferred revenue, valued at present value
- Pledges receivable, valued at the amount pledged (R/08, FAR, A0126N, #49, 8604)

50. How should a nongovernmental, not-for-profit organization report donor-restricted cash contributions for long-term purposes in its statement of cash flows?

- Operating activity inflow
- Investing activity inflow
- Financing activity inflow
- As a noncash transaction

(R/08, FAR, A0158N, #50, 8605)

Problem 3 SIMULATION (30 to 45 minutes)

The simulation interface consists of a horizontal bar with four buttons. From left to right, the buttons are labeled 'Situation', 'Bond Issue Price', 'Interest Expense', and 'Balance Sheet'. Each button has a small pencil icon to its left. The 'Situation' button is currently selected and has a dark shadow underneath it.

On January 2, 2003, the Lyndhurst Company, Inc. a privately-held company, issued \$1,000,000, five-year, 10.00% bonds, dated January 2, 2003. The bonds provided for semi-annual interest payments to be made on June 30 and December 31 of each year. Terms of the bond indenture allowed the company to call the bonds at 102 after one year. The bonds were issued when the market interest rate was 8.00%.

Lyndhurst Company, Inc. uses the effective interest method for amortizing bond discounts and premiums.

The bonds are term bonds that mature on December 31, 2007.

Lyndhurst Company, Inc.'s fiscal year for financial reporting purposes is December 31.

The company called the bonds at 102 on June 30, 2004.

(R/08, FAR, P3, amended, 8606)

Situation

Bond Issue Price

Interest Expense

Balance Sheet

Use the following spreadsheet to calculate the present values of the principal and interest cash flows related to the bonds, and the resulting bond issue price.

For each shaded cell in rows 2 and 3, columns B, through F, select the appropriate value or formula from the choices listed below that column.

For column E, use the compound interest tables in Appendix D to find the appropriate time value factors. Calculate the bond issue price, based on your selections, and enter it in cell F4.

Round the result of any calculations to the nearest dollar.

(Formula symbol definitions: * = multiplied by; / = divided by)

	A	B	C	D	E	F
1	<u>Payment Type</u>	<u>Compounding Period(2)</u>	<u>Interest Rate</u>	<u>Payment Amount</u>	<u>Factor</u>	<u>Present Value</u>
2	Principal					
3	Interest					
4	Bond Issue Price					\$ _____

<u>Choices for Cells B2 & B3</u>	<u>Choices for Cells C2 & C3</u>	<u>Choices for Cells D2 & D3</u>	<u>Choices for Cell E2</u>	<u>Choices for Cell F2</u>
1	0.040	\$ 40,000	0.385543	(B2*D2)/E2
2	0.050	\$ 50,000	0.463194	C2*D2
5	0.080	\$ 80,000	0.613913	D2*E2
7	0.100	\$ 100,000	0.620921	D2/E2
10		\$1,000,000	0.675564	(D2/B2)*C2
		\$1,040,000	0.680583	
		\$1,050,000	0.783526	
			0.821927	

<u>Choices for Cell E3</u>	<u>Choices for Cell F3</u>
3.790787	(B3*D3)/E3
3.992710	C3*D3
4.329477	D3*E3
4.451822	D3/E3
6.144567	(D3/B3)*C3
6.710082	
7.721735	
8.110896	

Situation

Bond Issue Price

Interest Expense

Balance Sheet

Complete the bond amortization table for the **original** Lyndhurst Company, Inc. bonds (issued 1/2/2003) **through the term** of the bonds in the following way:

- 1 The face amount of the bonds issued appears in cell G2 of the spreadsheet below.
- 2 Insert your calculation of the bond issue price (from the previous tab) in cell F2.
- 3 Calculate the amount of the unamortized (discount) or premium and insert it in cell E2.
- 4 Finish completing the bond amortization schedule in rows A through F.
- 5 Round the result of any calculations to the nearest dollar.

	A	B	C	D	E	F	G	H
1	<u>Date</u>	<u>Interest Payment</u>	<u>Interest Expense</u>	<u>Increase (Decrease) in Carrying Amount of Bonds</u>	<u>Unamortized (Discount) or Premium</u>	<u>Carrying Amount of Bonds</u>	<u>Face Amount of Bonds</u>	<u>Interest rates (%)</u>
2	01/01/03						\$1,000,000	Bond
3								10.00
4								Market
5								8.00
6								
7								
8								
9								
10								
11								
12								

Situation
 Bond Issue Price
 Interest Expense
 Balance Sheet

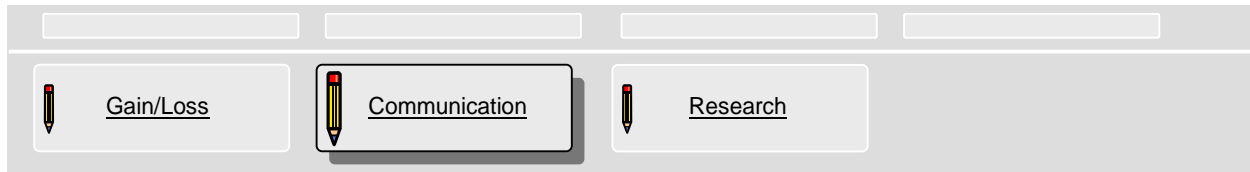
Use the values in the amortization table on the previous tab to complete the liabilities section of Lyndhurst Company, Inc.'s December 31, 2003, balance sheet and excerpts from the income statement for the year ending December 31, 2003. Insert the appropriate values in the shaded cells below.

Lyndhurst Company, Inc.			
Balance Sheet			
December 31, 2003			
Liabilities:		I	
Accounts payable and other liabilities	\$ 150,000		5
Bonds payable			6
			7
			8
Unamortized premium/discount			9
Total liabilities			10
			11
Lyndhurst Company, Inc.			12
Income Statement			13
Year ended December 31, 2003			14
			15
Sales	1,000,000		16
Expenses before interest and taxes	500,000		17
Interest expense			18
Net income before taxes			19

Gain/Loss
 Communication
 Research

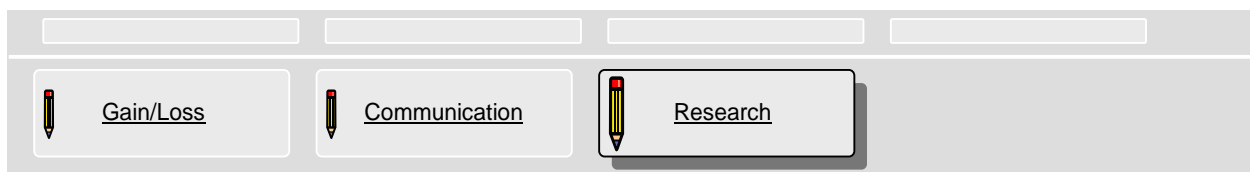
Lyndhurst Company, Inc. called the 10.00%, \$1,000,000 bonds on June 30, 2004, paying bondholders the 102 call price. Enter the appropriate values in the shaded cells below and calculate the gain or loss on this early retirement of the debt. Indicate whether the value in column C represents a gain or a loss by entering "Gain" or "Loss" in column D.

	A	B	C	D
1	<u>Carrying Amount of Debt</u>	<u>Payment Due at Call Date</u>	<u>Amount of Gain or (Loss)</u>	<u>Indicate "Gain" or "Loss"</u>
2				



Write a memo to the company's CEO explaining under what market conditions the company's bonds would be issued at a premium.

REMINDER: On the actual exam your response will be graded for both technical content and writing skills. Technical content will be evaluated for information that is helpful to the intended reader and clearly relevant to the issue. Writing skills will be evaluated for development, organization, and the appropriate expression of ideas in professional correspondence. Use a standard business memo or letter format with a clear beginning, middle, and end. Do not convey information in the form of a table, bullet point list, or other abbreviated presentation.



Lyndhurst Company, Inc. issued convertible bonds in the past and is considering a cash incentive to the bondholders as an inducement to convert the debt into equity shares. How should Lyndhurst Company, Inc. account for these incentive payments to its bondholders?

REMINDER: On the actual exam you will use a research database to find the correct authoritative literature and then select from a variety of choices dependent upon your research. Please see the AICPA's tutorial and sample tests on The Uniform CPA Examination website (www.cpa-exam.org).

Paragraph Reference Answer: _____

Solution 1 MULTIPLE-CHOICE ANSWERS

1. (a) This reporting concept is replacement cost. It is defined as the price of a new, similar item after allowance for use and depreciation. Current market value is the hypothetical selling price that could be obtained in an arm's-length transaction. Historical cost is the acquisition cost less depreciation or amortization to date. Net realizable value is the net amount expected to be received in cash. (Chapter 1-2-3, CBT Skill: Understanding, CSO: 1.1.2)

2. (b) Relevance and reliability are the two primary decision specific factors that make accounting information useful for decision making. To be relevant, information must be timely and must have either predictive or feedback value. Verifiability is a trait associated with reliability. Understandability is a user-specific quality characteristic. Costs and benefits are to be considered when determining the kind of information to be

provided. Information is only valuable to the extent that the cost of obtaining and analyzing it is less than the benefits derived from its use. (Chapter 1-6-3, CBT Skill: Understanding, CSO: 1.1.2)

3. (a) Extraordinary gains from extinguishment of debt is not classified as other comprehensive income. Foreign currency translation adjustments, pension liability adjustments for a defined benefit pension plan, and unrealized gains on available-for-sale marketable securities are all classified as other comprehensive income. (Chapter 1-2-2, CBT Skill: Understanding, CSO: 1.2.3)

4. (a) The current ratio is a primary test of the overall solvency of the enterprise and its ability to meet current obligations from current assets. It is derived by dividing the current assets by the

current liabilities. Current assets include the \$300,000 in cash, \$350,000 in accounts receivable, and \$600,000 in inventory for a total of \$1,250,000. The current liabilities are given as \$700,000. [$\$1,250,000 / \$700,000 = 1.79$] (Chapter 15-2-2, CBT Skill: Analysis, CSO: 1.4.0)

5. (b) The accounts receivable turnover in days tests the average number of days to collect receivables and is computed by taking the number of business days used in a year over the accounts receivable turnover. The accounts receivable turnover is the net credit sales over the average net accounts receivable. The number 360 is commonly used as the number of business days in a year because it is easily divisible by 12 to get a monthly number. Some analysts prefer to use 365, 300, or 250 as the number of business days in the year. The net credit sales of \$1,400,000 over the average net receivables of \$110,000 equals approximately 12.72. Using 365 days divided by 12.72 equals approximately 28.7. This question is an example of how you may have to try the different number of business days used to get to one of the answer choices. (Chapter 15-2-3, CBT Skill: Analysis, CSO: 1.4.0)

6. (a) The FIFO inventory costing method assumes that the goods first acquired are the first sold and, as such, would maximize profits in a period of rising prices. Dollar-value LIFO is based on the dollar value of inventory pools of similar items and the last items acquired would be the first sold. Weighted average and moving average inventory costing methods use an average and thus would not lead to maximizing profits in a period of rising prices. (Chapter 3-2-3, CBT Skill: Judgment, CSO: 2.3.0)

7. (b) Ian would report its inventory at the lower of cost or market. The market means current replacement cost except the market cannot exceed the net realizable value, known as the ceiling, or be less than the net realizable value minus normal profit, known as the floor. Net realizable value is the estimated selling price less reasonable costs of completion and disposal. The ceiling would be \$261,000 (\$275,000 selling price – \$14,000 disposal costs) and the floor would be \$251,000 (\$275,000 selling price – \$14,000 disposal costs – \$10,000 normal profit margin). The replacement cost is only \$230,000, so the market would be the minimum amount of \$251,000. Comparing the lower of cost (\$258,000) or market (\$251,000) shows the market is lower. So Ian's inventory would be carried

at \$251,000. (Chapter 3-2-4, CBT Skill: Analysis, CSO: 2.3.0)

8. (d) The cost of merchandise inventory is net of any discounts but includes freight-in, taxes, insurance while in transit, warehousing costs, and similar charges paid to bring the article to its existing condition and location. The cost of the inventory would be the \$3,750 purchase price, plus the \$175 freight-in charge, plus the \$900 costs of materials and labor to bring it to saleable condition, plus the \$100 insurance cost during transit for a total of \$4,925. (Chapter 3-2-2, CBT Skill: Analysis, CSO: 2.3.0)

9. (c) The asset would be recorded at \$135,000, its acquisition cost to the new owners. The salvage value would be the \$15,000 estimated by the new owners. The carrying amount and residual value of the previous owners does not matter to the new owners. The depreciable base would be \$120,000; the \$135,000 acquisition cost less the \$15,000 estimated salvage value. (Chapter 4-3-1, CBT Skill: Analysis, CSO: 2.4.0)

10. (a) Anchor would report \$75,000 in dividend income on its income statement for the current period related to its investment in Main. The \$75,000 comes from the 75% of \$100,000 dividend that Anchor would receive on the noncumulative preferred stock. Anchor would also recognize \$80,000, 40% of the \$200,000 common stock dividend, but not on the income statement. Because Anchor exercises significant influence over Main's operations, Anchor would use the equity method to account for its common stock investment in Main. Anchor would credit the Investment account since the distribution reduces the owner's equity of Main. (Chapter 2-3-5, CBT Skill: Analysis, CSO: 2.5.0)

11. (b) Of the \$20,000 Hayworth received, \$18,000 should have been for sales revenue from the equipment and \$2,000 should have been allocated to the two-year service contract. Because only one year has passed, Hayworth has only earned \$1,000 from that service contract and still has a liability for the next year. Recording the transaction the way Hayworth did means net income will be overstated, the financial statements are not correct, total assets are not affected, and total liabilities will be understated. (Chapter 7-1-3, CBT Skill: Analysis, CSO: 2.8.0)

12. (c) In determining the carrying amount of bonds, an adjustment is made for premium or

discount amortization to the date of sale. Amortization of a bond premium decreases interest expense and the carrying amount of the bond, while the amortization of a bond discount increases the issuer's interest expense and carrying amount of the bond.

Bonds payable carrying amount, 1/1	\$46,139
Effective interest rate (10% × 6/12)	<u>× 5%</u>
Interest expense, 1/1- 6/30	2,307
Interest payment	
[\$50,000 × (8% × 6/12)]	<u>(2,000)</u>
Amortization of discount, 1/2 - 6/30	307
Bonds payable carrying amount, 1/1	<u>46,139</u>
Bonds payable carrying amount, 6/30	46,446
Effective interest rate (10% × 6/12)	<u>× 5%</u>
Interest expense, 7/1 - 12/31	2,322
Interest payment	
[\$50,000 × (8% × 6/12)]	<u>(2,000)</u>
Amortization of discount, 7/1 - 12/31	322
Bonds payable carrying amount, 6/30	<u>46,446</u>
Bonds payable carrying amount, 12/31	\$46,768

\$46,139 + \$307 + \$322 = \$46,768 (Chapter 6-3-3, CBT Skill: Analysis, CSO: 2.9.0)

13. (b) Serial bonds are a set of bonds issued at the same time but having a different maturity date; thus providing a series of installments for repayment of principal. A debenture bond is just an unsecured bond. A term bond is an issue of bonds that all have the same maturity date. Most corporate bonds are term bonds. Sinking fund bonds require the debtor to periodically set aside sums to give assurance to investors and would mature normally on a set date. (Chapter 6-4-1, CBT Skill: Analysis, CSO: 2.9.0)

14. (a) Changing the estimated useful life of a machine is considered a change in accounting estimate and accounted for in the current and subsequent periods. The machine had been depreciated a total of \$20,000 thus far, 5 years at \$4,000 per year (\$48,000 / 12 years straight-line = \$4,000 per year). The original amount of \$48,000 less the \$20,000 depreciated so far equals \$28,000 worth of useful life. Extending the useful life three years means it now has 10 years of useful life left (12 years originally less the 5 years gone by plus 3 more years). So the depreciation expense is \$2,800 (\$28,000 / 10) per year. (Chapter 11-4-2, CBT Skill: Analysis, CSO: 3.1.0)

15. (b) Raft Corp. should have only expensed the depreciation expense of \$60,000 over the previous 3 years [(\$210,000 cost less \$10,000 salvage value) / 10 years useful life = \$20,000 per year]. The difference of what was expensed (\$210,000) and what should have been expensed (\$60,000) is \$150,000. The \$150,000 times the 30% tax rate = \$45,000. Therefore, \$150,000 less \$45,000 equals a prior period adjustment of \$105,000. (Chapter 11-4-4, CBT Skill: Analysis, CSO: 3.1.0)

16. (d) A change in accounting estimate is reported in the period of change and future periods if the change affects both. There are no pro forma reports for prior periods, and amounts reported in financial statements of prior periods are not restated. (Chapter 11-4-2, CBT Skill: Understanding, CSO: 3.1.0)

17. (b) Peace will report just the \$15,000 in dividends they paid during the year as dividends declared and paid in its current year's consolidated statement of retained earnings. The 75% portion of the \$8,000 in dividends paid by Surge will be treated by Peace as a reduction in the carrying amount of the investment in Surge. (Chapter 17-3-3, CBT Skill: Analysis, CSO: 3.2.0)

18. (a) The use of lower of cost or market may result in inventory losses that should not be deferred beyond the interim period in which the decline occurs. Recoveries of these losses in subsequent periods should be recognized as gains, but only to the extent of losses recognized in previous interim periods of the same fiscal year. Temporary market declines need not be recognized at the interim date since no loss is expected to be incurred in the fiscal year. The cost method of valuation need not be the only method used. (Chapter 11-5-2, CBT Skill: Judgment, CSO: 3.12.0)

19. (c) You must first calculate the present value of the minimum lease payments. The present value of the minimum lease payments is the minimum lease payment amount of \$60,000 times the annuity factor of 5.0757 equaling \$304,542. Because no payment is made until the end of the year, you would take that amount of \$304,542 times the interest rate of 5% and get interest expense of \$15,227 at the end of the first year of the lease. (Chapter 8-4-2, CBT Skill: Analysis, CSO: 3.13.0)

20. (d) The external acquisition costs of a patent, which includes the legal costs associated with obtaining a patent on a new product, qualifies for asset capitalization. Cost of materials used in prototype testing, costs of testing a prototype and modifying its design, and salaries of engineering staff developing a new product are all examples of research and development costs. These research and development costs are not capitalized, but instead expensed in the year in which incurred. (Chapter 5-2-1, CBT Skill: Understanding, CSO: 3.16.0)

21. (d) Government-wide financial statements aggregate information for all governmental and business-type activities. GASB 34 requires an economic resources measurement focus and accrual basis of accounting for all amounts in the government-wide financial statements. (Chapter 18-2-1, CBT Skill: Understanding, CSO: 4.1.1)

22. (a) The modified accrual basis of accounting is used in the governmental-type fund statements such as the general fund. Under the modified accrual basis of accounting, fixed assets are expenditures and not capitalized. (Chapter 18-1-5, CBT Skill: Understanding, CSO: 4.1.2)

23. (a) Unrestricted assets are assets from donations unrestricted by the donor and assets formerly temporarily restricted by the donors that

have since become unrestricted. The \$1 million in cash which was temporarily restricted has now been used for its purpose. This results in an increase in unrestricted net assets. There would not be an increase, but instead there would be a decrease, in temporarily restricted net assets. There would be no effect, increase or decrease, in permanently restricted assets. (Chapter 20-1-2, CBT Skill: Judgment, CSO: 5.1.2)

24. (a) There are two primary functional expense classifications; program services and support services. Program services include research, education, and community services. Support services categories are management and general, and fund-raising. Membership dues, grant expenses, membership development, and professional fees are not functional expense categories for a nongovernmental not-for-profit organization. (Chapter 20-2-3, CBT Skill: Understanding, CSO: 5.1.4)

25. (a) None of the shares would be included as unrestricted net assets. The shares valued at \$8,000,000 would be a temporarily restricted net asset with the allowable use of the income being restricted by the terms of the donation. The shares valued at \$2,000,000 would be a permanently restricted net asset. (Chapter 20-1-2, CBT Skill: Analysis, CSO: 5.2.4)

Solution 2 ADDITIONAL MULTIPLE-CHOICE ANSWERS

26. (a) An entity is required to display the accumulated balance of other comprehensive income separately from retained earnings, capital stock, and additional paid-in capital in the stockholders' equity section of a statement of financial position (balance sheet). No separate statement of comprehensive income is required, comprehensive income doesn't need to include all changes in stockholders' equity for the period, and comprehensive income is reported in the interim financial statements. (Chapter 11-3-3, CBT Skill: Judgment, CSO: 1.2.3)

27. (d) The amortization of bond discount on long-term debt is reported as an addition to income in the operating activities section of a statement of cash flows prepared using the indirect method. (Chapter 14-3-6, CBT Skill: Analysis, CSO: 1.2.4)

28. (c) Compared to the accrual basis of accounting, Sanni's cash-basis pretax income is

higher by \$36,000. Accounts receivable decreasing by \$20,000 would require a reduction of \$20,000 to derive the accrual basis. Accounts payable increasing by \$16,000 would require a reduction of \$16,000 to derive the accrual basis. (Chapter 11-4-9, CBT Skill: Understanding, CSO: 1.3.0)

29. (a) The quick ratio, also known as the acid-test ratio, provides a test of immediate solvency. It is derived by dividing the sum of cash, marketable securities, and net receivables by the current liabilities. $[(\$60,000 + \$90,000 + (\$180,000 - \$8,000)) / \$400,000 = 0.805]$ Rounding the 0.805 to two decimal places gets the quick ratio of 0.81 to 1. (Chapter 15-2-2, CBT Skill: Analysis, CSO: 1.4.0)

30. (a) The inventory turnover indicates the number of times inventory was acquired and sold during the period. It is derived by dividing the cost of goods sold by the average inventory. The

cost of goods sold is the net purchases of \$700,000 less the increase in inventory of \$200,000 for a total of \$500,000. The average inventory is generally determined by adding the beginning inventory of \$100,000 plus ending inventory of \$300,000 and dividing by two for a total of \$200,000. The $\$500,000 / \$200,000$ yields a 2.5 inventory turnover. (Chapter 15-2-3, CBT Skill: Analysis, CSO: 1.4.0)

31. (c) Smith would classify the \$150,000 bank balance and \$5,000 deposit in transit for Big Bank as cash on the balance sheet. The bank balance of \$1,500 in Small Bank is negated by the \$8,500 in outstanding checks. Overdrafts in accounts with no available cash in another account at the same bank to offset are classified as current liabilities. They are not deducted from the total amount of cash at another bank. (Chapter 2-2-2, CBT Skill: Analysis, CSO: 2.1.0)

32. (c) Merchandise inventory should include freight-in, taxes, insurance while in transit, warehousing costs, and similar charges paid by the purchaser to bring the merchandise to its existing condition and location. Thus, the \$1.5 million in shipping costs from overseas should be included in the inventory valuation. The shipping costs to export customers are a selling expense and should not be included in the cost of inventory. Seafood purchased \$12 million in inventory during the year and has \$3 million remaining in inventory at year end. The \$12 million divided by \$3 million means one-quarter of the inventory is still remaining. Thus, one-quarter of the \$1.5 million, or \$375,000, in shipping costs from overseas should be included in the year-end inventory valuation. (Chapter 3-2-2, CBT Skill: Analysis, CSO: 2.3.0)

33. (d) The gross margin method of inventory estimation is used to estimate inventory losses from theft and casualties. First, calculate the goods available for sale, which is the beginning inventory of \$40,000 plus purchases of \$480,000 for a total of \$520,000. Next, figure the estimated cost of goods sold, which is the net sale of \$620,000 less the gross margin of \$155,000 ($\$620,000 \times 25\%$) for a total of \$465,000. Subtracting the \$465,000 estimated cost of goods sold from the \$520,000 goods available for sale leaves \$55,000 in estimated ending inventory. Now, subtract the \$5,000 worth of damaged inventory Fireworks can sell and that leaves a \$50,000 loss from the explosion. The insurance company reimburses Fireworks for 70%

($\$50,000 \times 70\% = \$35,000$) of that loss. Fireworks would report only \$15,000 ($\$50,000 - \$35,000$) as loss from the explosion. (Chapter 3-3-1, CBT Skill: Analysis, CSO: 2.3.0)

34. (d) Under neither the straight-line method or the double-declining balance method of depreciation would the accumulated depreciation equal the original cost at the end of the asset's estimated useful life. The straight-line method depreciates the cost less salvage value evenly over the estimated useful life of the asset. The double-declining balance method uses a rate of depreciation twice that of the straight-line rate, but the asset cannot be depreciated below the salvage value. (Chapter 4-3-1, CBT Skill: Understanding, CSO: 2.4.0)

35. (c) Initial franchise fees from franchise sales ordinarily must be recognized when all material services or conditions relating to the sale have been substantially performed or satisfied by the franchisor. Because services for the initial fee won't be performed until 2004, any amounts recognized on December 31, 2003 would be reported as unearned franchise fees. Moon would report the \$40,000 cash and \$48,000 present value of the note for a total of \$88,000 as unearned franchise fees. Remember that notes receivable are recorded at their present value. Any discount or premium should be amortized over the life of the note. (Chapter 12-5-1, CBT Skill: Analysis, CSO: 2.8.0)

36. (c) When bonds are issued with detachable stock warrants there must be an allocation of the proceeds between the warrants and the debt security based on relative fair values. Vent would credit Cash \$450,000, credit Bond Payable \$500,000, and credit APIC-Stock Warrants for their fair value of \$20,000 (2,000 detachable warrants at the market price of \$10). The entry needs a \$70,000 debit to balance and that is the discount on the debentures. (Chapter 6-4-3, CBT Skill: Analysis, CSO: 2.9.0)

37. (b) Convertible debt securities are those debt securities which are convertible into common stock of the issuer or an affiliated company at a specified price at the option of the holder and which are sold at a price or have a value at issuance not significantly in excess of the face amount. The terms of such securities generally include (1) an interest rate which is lower than the issuer could establish for nonconvertible debt, (2) an initial conversion price which is greater

than the market value of the common stock at time of issuance, and (3) a conversion price which does not decrease except pursuant to antidilution provisions. No proceeds from the debt issue are to be assigned to the conversion feature (even though the convertible bonds may sell for substantially more than similar nonconvertible bonds). The reason for no allocation to equity is that the debt cannot be separated from the conversion feature, as would be the case with detachable stock warrants. The holder of the debt need not be repaid with shares of the issuer's stock and the transaction should not be recorded as the issuance of stock. (Chapter 6-4-2, CBT Skill: Understanding, CSO: 2.10.0)

38. (d) Book value per common share is used to measure the amount that common stockholders would receive if all assets were sold at their carrying values and all creditors were paid. It is derived by dividing the common stockholders' equity by the number of common shares outstanding. The number of common shares outstanding is the 50,000 shares issued less the 5,000 shares that have been reacquired and are held in treasury. Thus, $\$2,200,000 / 45,000 = \48.89 book value per share of common, rounded to the nearest dollar is \$49. (Chapter 15-2-4, CBT Skill: Analysis, CSO: 2.11.0)

39. (c) In a purchase-business combination, if the purchaser issues its own equity securities as part of the consideration the securities must be credited to additional paid-in capital based on their fair value. Costs of registering and issuing equity securities are a reduction of the fair value of the securities in additional paid-in capital. Direct acquisition costs incurred (e.g., finders fees, legal and consulting fees) must be capitalized as part of the total purchase price. Any indirect and general expenses related to the acquisition are expensed as incurred. The market value of Sayon's common stock is \$7 more than the par value ($\$12 - \$5 = \$7$). The \$7 times 200,000 shares equals \$1,400,000 Sayon would initially record, but then it must subtract the \$35,000 registration and issuance costs for a total amount of \$1,365,000 that should be recorded in Sayon's additional paid-in capital account. The \$110,000 in legal and consulting fees would be capitalized as part of the total purchase price, but would not affect the additional paid-in capital account. Under the acquisition method, as described in FAS 141(R), these legal and consulting fees would be considered acquisition-related costs which are expensed in

the periods in which the costs are incurred. (Chapter 17-3-2, CBT Skill: Analysis, CSO: 3.2.0)

40. (a) When there is a firm commitment to purchase goods in a future period at a set price, an enforceable contract exists. Any loss resulting from a drop in the market value of such goods should be recognized in the current period. There should be a note in the financial statements describing the nature of the contract. The journal entry would be a debit to Loss on Purchase Commitment and a credit to Allowance for Loss on Purchase Commitment. (Chapter 3-2-2, CBT Skill: Understanding, CSO: 3.3.0)

41. (c) Diluted earnings per share is the amount of earnings for the period available to each share of common stock outstanding during the reporting period and to each share that would have been outstanding assuming the issuance of common shares for all dilutive potential common shares outstanding during the reporting period. Earnings per share calculations have the income available to common shareholders in the numerator and the weighted average number of shares outstanding in the denominator. The income available to common stockholders starts with the net income of \$600,000. There is no preferred stock outstanding, so there is no need to worry about any deduction for preferred dividends. The if-converted method is applied to the convertible bonds in assuming they are dilutive. The conversion means the company would not have the interest expense for the debt and it should be added back to income to arrive at income available to common stockholders. The interest for the year would be the face value of the bonds times the stated interest rate plus any amortization of the discount. [$\$5,000,000 \times 9\%$] + \$20,000 = \$470,000] Taking in the effect of taxes would reduce the interest expense by 25%. [$25\% \times \$470,000 = \$117,500$; $\$470,000 - \$117,500 = \$352,500$] Adding the \$352,500 interest expense to the \$600,000 net income results in \$952,500 of income available to common stockholders in the numerator of the diluted earnings per share computation. (Chapter 15-3-3, CBT Skill: Analysis, CSO: 3.5.0)

42. (a) Hedging is a risk management strategy to protect against the possibility of loss, such as from price fluctuations. Generally, the strategy involves counterbalancing transactions in which a loss on one financial instrument or cash flow stream would be offset by a gain on the related derivative. A perfect hedge would result in no

possibility of future gain or loss. (Chapter 2-5-1, CBT Skill: Understanding, CSO: 3.8.0)

43. (b) The foreign currency income statement should conceptually use the exchange rate at the time the revenue or expense was recognized. However, due to the impracticability of this where rates change frequently, a weighted-average exchange rate for the period may be used. The current exchange rate would be used for all assets and liabilities at the balance sheet date. The historical exchange rate is used for contributed capital. There is no inventory (FIFO) exchange rate used in the financial statements. (Chapter 16-1-3, CBT Skill: Analysis, CSO: 3.9.0)

44. (d) For interim financial reporting, costs and expenses other than product costs should be charged to income in interim periods as incurred or be allocated among interim periods based on an estimate of time expired, benefit received, or activity associated with the periods. The \$60,000 in property taxes is for the entire calendar year and would be allocated evenly as \$15,000 of expenses for each quarter. The \$240,000 for major repairs happened on April 2 and will benefit operations for just the remainder of the year. The \$240,000 divided by the three remaining quarters equals \$80,000 in expenses for each of those three quarters. The \$15,000 plus \$80,000 equals \$95,000 in expenses to be reported in the third quarter of the interim financial statements for the three months ended September 30. (Chapter 11-5-2, CBT Skill: Analysis, CSO: 3.12.0)

45. (c) Future economic benefits deriving from research and development (R &D) activities, if any, are uncertain in their amount and timing. Due to these uncertainties, most R&D costs are required to be charged to expense the year in which incurred. However, any materials, equipment, facilities, or intangibles purchased that have alternative future uses should be recorded as assets. Assets recorded for R&D costs with alternative future uses should be amortized over their useful lives by periodic charges to R&D expense. Stam should recognize only the amortization amount of \$20,000 as R&D expense for the \$100,000 worth of equipment purchased for current and future projects. Stam should also recognize the \$200,000 of equipment purchased for current projects only, the \$400,000 of R&D salaries for current projects, and the \$600,000 of material and labor costs for a prototype product as R&D expense at year end for a total of \$1,220,000. The legal fees to obtain a patent

would not be included in R&D expense. Only R&D costs incurred to internally develop a patent would be expensed as incurred. (Chapter 5-2-2, CBT Skill: Analysis, CSO: 3.16.0)

46. (d) The general fund is used to account for most routine operations of the governmental entity. This fund accounts for all resources that are not required to be accounted for in other funds; in essence, it accounts for all unrestricted resources. The general fund uses modified accrual accounting. A fund balance is the difference between governmental fund assets and liabilities reported on the balance sheet. When the state paid the interest due, it would have reduced the amount of assets (cash) and as such decreased fund balance. (Chapter 19-1-2, CBT Skill: Understanding, CSO: 4.1.2)

47. (a) The government-wide financial statements use normal accrual accounting. The bond interest should be the \$1,000,000 times 0.03 (because the 6% interest is paid every 6 months) for a total of \$30,000 on each due date. The interest expense would be the \$30,000 for the period March 1 to September 1 plus \$20,000 for the four month period September 1 to December 31 ($\$30,000 \times 4/6 = \$20,000$) for a total of \$50,000. Because the \$20,000 for the last four months will not be paid until the next March 1, it would be the interest payable at the close of the fiscal year on December 31. (Chapter 18-2-1, CBT Skill: Analysis, CSO: 4.2.1)

48. (a) The notes to the basic financial statements of governmental entities do not contain disclosures related to required supplementary information. The Management's Discussion and Analysis (MD&A) is the required supplementary information in the government's general purpose external report and it is presented before the financial statements. Some notes presented by governments are identical to notes presented in business financial statements. Notes that are considered essential to the basic financial statements need to be presented and it is acceptable to present them in a very extensive format. (Chapter 18-2-3, CBT Skill: Understanding, CSO: 4.2.6)

49. (b) Unconditional pledges are reported as a receivable at their present values in the period in which they are made, net of an allowance for uncollectible amounts. They are not recorded as long-term, deferred revenue, or at

the full amount pledged. (Chapter 20-1-4, CBT Skill: Understanding, CSO: 5.2.1)

50. (c) The statement of cash flows for a nongovernmental not-for-profit organization reports the cash and cash equivalents similar to

commercial enterprises. The description of cash flows is expanded to include donor-restricted cash contributions that must be used for long-term purposes. (Chapter 20-1-3, CBT Skill: Understanding, CSO: 5.1.3)

Solution 3 SIMULATION SOLUTION

Bond Issue Price

	A	B	C	D	E	F
1	<u>Payment Type</u>	<u>Compounding Period(s)</u>	<u>Interest Rate</u>	<u>Payment Amount</u>	<u>Factor</u>	<u>Present Value</u>
2	Principal	10	0.04	\$1,000,000	0.675564	\$ 675,564
3	Interest	10	0.04	\$ 50,000	8.110896	\$ 405,545
4	Bond Issue Price					<u>\$1,081,109</u>

Explanations:

Column B, rows 2 & 3: They are five-year bonds with semi-annual interest payments. Multiplying 5 years by 2 times per year = 10 compounding periods for both principal and interest.

Column C, rows 2 & 3: Lyndhurst Company, Inc. uses the effective interest method. The bonds were issued when the market interest rate was 8.00%. With semi-annual interest payments, only half the 8.00% would be allocated to both principal and interest for each period. ($0.08 / 2 = 0.04$)

Column D, row 2: The principal payment amount is the \$1,000,000 face amount of the bond.

Column D, row 3: The interest payment amount is the face amount of the bond times the stated interest amount per period. With semi-annual interest payments, half the stated 10.00% would be paid each period. ($0.10 / 2 = 0.05$, then $0.05 \times \$1,000,000 = \$50,000$)

Column E, row 2: The factor used for the principal is the present value of \$1 for 10 periods at 4% = 0.675564

Column E, row 3: The factor used for the interest is the present value of an annuity of \$1 in arrears (because no payment was made at the beginning) for 10 periods at 4% = 8.110896

Column F, row 2: $D2 \times E2 = \$1,000,000 \times 0.675564 = \$675,564$

Column F, row 3: $D3 \times E3 = \$50,000 \times 8.110896 = \$405,545$

Column F, row 3: The bond issue price is the present value of the principal plus present value of the interest. ($\$675,564 + \$405,545 = \$1,081,109$)

Interest Expense

1	A	B	C	D	E	F	G	H
	<u>Date</u>	<u>Interest Payment</u>	<u>Interest Expense</u>	<u>Increase (Decrease) in Carrying Amount of Bonds</u>	<u>Unamortized (Discount) or Premium</u>	<u>Carrying Amount of Bonds</u>	<u>Face Amount of Bonds</u>	<u>Interest rates (%)</u>
2	01/02/03				\$81,109	\$1,081,109	\$1,000,000	Bond
3	06/30/03	\$50,000	\$43,244	(\$6,756)	\$74,353	\$1,074,353		10.00
4	12/31/03	\$50,000	\$42,974	(\$7,026)	\$67,327	\$1,067,327		Market
5	06/30/04	\$50,000	\$42,693	(\$7,307)	\$60,020	\$1,060,020		8.00
6	12/31/04	\$50,000	\$42,401	(\$7,599)	\$52,421	\$1,052,421		
7	06/30/05	\$50,000	\$42,097	(\$7,903)	\$44,518	\$1,044,518		
8	12/31/05	\$50,000	\$41,781	(\$8,219)	\$36,299	\$1,036,299		
9	06/30/06	\$50,000	\$41,452	(\$8,548)	\$27,751	\$1,027,751		
10	12/31/06	\$50,000	\$41,110	(\$8,890)	\$18,861	\$1,018,861		
11	06/30/07	\$50,000	\$40,754	(\$9,246)	\$9,615	\$1,009,615		
12	12/31/07	\$50,000	\$40,385	(\$9,615)	\$0	\$1,000,000		

Explanations:

Column A, rows 3 - 12: The dates will be June 30 and December 31 of each of the five years.

Column B, rows 3 - 12: The \$50,000 interest payment will be the same for each period.

Column C, rows 3 - 12: To calculate interest expense, multiply the carrying amount of the bonds from the previous period by the 0.04 interest rate. For example, row 3 would be $\$1,081,109 \times 0.04 = \$43,244$.

Column D, rows 3 - 12: The change in carrying amount of bonds is the difference between the interest payment and interest expense. If the interest payment is greater than interest expense there is a decrease in the carrying amount of bonds. If the interest payment is less than interest expense there is an increase in the carrying amount of the bonds. For example, row 3 would be $\$50,000 - \$43,244 =$ a \$6,756 decrease.

Column E, row 2: The unamortized (discount) or premium is the difference between the carrying amount of the bonds and the face amount of the bonds. If the carrying amount of the bonds is greater than the face amount there is an unamortized premium. If the carrying amount of the bonds is less than the face amount there is an unamortized discount. In this case, $\$1,081,109 - \$1,000,000 =$ an \$81,109 premium.

Column E, rows 3 - 12: There are two ways to calculate the unamortized premium. One is to take that amount from the previous period and increase or decrease it by the increase (decrease) in carrying amount of bonds. For example, row 3 would be $\$81,109 - \$6,756 = \$74,353$. The other is to simply take the carrying amount of the bonds and subtract the face amount. For example, row 3 would be $\$1,074,353 - \$1,000,000 = \$74,353$.

Column F, row 2: The carrying amount of the bonds starts at the bond issue price of \$1,081,109.

Column F, rows 3 - 12: The carrying amount of the bonds is calculated by applying the increase or decrease in carrying amount of the bonds to the carrying amount of bonds from the previous period. For example, row 3 would be $\$1,081,109 - \$6,756 = \$1,074,353$.

Balance Sheet

Bonds payable = \$1,000,000; the face amount of the bonds.

Unamortized premium/discount = \$67,327; the amount at December 31, 2003 (cell E4 of amortization table).

Total liabilities = \$1,217,327; the sum of \$150,000 + \$1,000,000 + \$67,327.

Interest expense = \$86,218; the \$43,244 from June 30, 2003 plus the \$42,974 from December 31, 2003.

Net income before taxes = \$431,782; the \$1,000,000 in sales – \$500,000 expenses – \$86,218 interest expense.

Gain/Loss

	A	B	C	D
1	<u>Carrying Amount of Debt</u>	<u>Payment Due at Call Date</u>	<u>Amount of Gain or (Loss)</u>	<u>Indicate "Gain" or "Loss"</u>
2	\$1,060,020	\$1,020,000	\$40,020	Gain

Carrying amount of debt = \$1,060,020; the amount at June 30, 2004 (cell F5 of amortization table).

Payment due at call date = \$1,020,000; the face amount times the call price % ($\$1,000,000 \times 1.02$).

Amount of gain or (loss) = \$40,020; the difference between the carrying amount of debt and payment due at call date. This amount is a gain because the amount paid was less than the carrying amount of debt on the books.

Communication

To: CEO, Lyndhurst Company

Re: Issuing Bonds at a Premium

Bonds are contractual agreements wherein the issuer promises to pay the purchaser a principal amount at a designated future date. In addition, the issuer makes periodic interest payments based on the face amount of the bond and the stated rate of interest.

The market price of the bond is equal to the present value of the bond's interest and principal payments, discounted using the market interest rate for that type of bond. The market interest rate takes into consideration the stated (face) interest rate of the bonds, the credit worthiness of the debtor, the maturity date of the bonds, and other factors.

When market conditions are such that the stated interest rate of the bonds is higher than the current market interest rate for similar securities, the bonds may be issued at a premium. A bond premium is the amount in excess of the bond face value (sometimes called par value or maturity value) at which a bond is issued. Premiums on bonds held as a long-term investment must be amortized from date of acquisition to maturity date.

Research

FAS 84, Par. 3

3. When convertible debt is converted to equity securities of the debtor pursuant to an inducement offer described in paragraph 2 of this Statement, the debtor enterprise shall recognize an expense equal to the fair value of all securities and other consideration transferred in the transaction in excess of the fair value of securities issuable pursuant to the original conversion terms. The expense shall not be reported as an extraordinary item.

2009 RELEASED AICPA QUESTIONS AND ANSWERS

In April 2009, the AICPA released fifty multiple-choice questions and one simulation relating to the FAR section of the CPA examination. These questions and their unofficial answers are reproduced here, along with the exclusive Bisk Education explanations. The multiple-choice questions in Problems 1 and 2 were labeled *moderate* and *hard*, respectively, by the AICPA examiners. Problem 3 is the one simulation that was disclosed. The AICPA did not state if these questions ever appeared on any exam, whether they were assigned points or merely being pre-tested and earned no points if they did appear on an exam, or if they were now obsolete for some reason. These questions are intended only as a study aid and should not be used to predict the content of future exams. It is extremely unlikely that released questions will appear on future examinations. These questions have been reproduced as received from the AICPA examiners. If candidates encounter what they believe are errors or ambiguities in questions during their actual exams, they should bring them to the attention of the examiners in accordance with the procedures outlined on the AICPA's CPA Examination website.

Problem 1: Moderate

1. For the year ended December 31, Ion Corp. had cash inflows of \$25,000 from the purchases, sales, and maturities of held-to-maturity securities and \$40,000 from the purchases, sales, and maturities of available-for-sale securities. What amount of net cash from investing activities should Ion report in its cash flow statement?

- a. \$0
- b. \$25,000
- c. \$40,000
- d. \$65,000 (R/09, FAR, 0432F, #1, 8751)

2. Harland County received a \$2,000,000 capital grant to be equally distributed among its five municipalities. The grant is to finance the construction of capital assets. Harland had no administrative or direct financial involvement in the construction. In which fund should Harland record the receipt of cash?

- a. Agency fund
- b. General fund
- c. Special revenue fund
- d. Private purpose trust fund (R/09, FAR, 0745G, #2, 8752)

3. Which of the following funds should be reported as part of local government's governmental activities column in its government-wide statements?

- a. Debt service
- b. Agency
- c. Private-purpose trust
- d. Pension trust (R/09, FAR, 1224G, #3, 8753)

4. Young Corp. purchased equipment by making a down payment of \$4,000 and issuing a note payable for \$18,000. A payment of \$6,000 is to be made at the end of each year for three years. The applicable rate of interest is 8%. The present value of an ordinary annuity factor for three years at 8% is 2.58, and the present value for the future amount of a single sum of one dollar for three years at 8% is .735. Shipping charges for the equipment were \$2,000, and installation charges were \$3,500. What is the capitalized cost of the equipment?

- a. \$19,480
- b. \$21,480
- c. \$24,980
- d. \$27,500 (R/09, FAR, A0168F, #4, 8754)

5. Jordan Co. had the following gains during the current period:

Gain on disposal of business segment	\$500,000
Foreign currency translation gain	100,000

What amount of extraordinary gain should be presented on Jordan's income statement for the current period?

- a. \$0
- b. \$100,000
- c. \$500,000
- d. \$600,000 (R/09, FAR, 1758F, #5, 8755)

6. A foreign subsidiary's functional currency is its local currency, which has not experienced significant inflation. The weighted average exchange rate for the current year would be the appropriate exchange rate for translating

<u>Salaries expense</u>	<u>Sales to external customers</u>
Yes	Yes
Yes	No
No	Yes
No	No

(R/09, FAR, 1278F, #6, 8756)

7. Asp Co. appropriately uses the installment method of revenue recognition to account for its credit sales. The following information was abstracted from Asp's December 31, 2002, financial statements:

	<u>2002</u>	<u>2001</u>
Sales	\$1,500,000	\$1,000,000
Accounts receivable:		
2002 sales	900,000	
2001 sales	540,000	600,000
Deferred gross profit:		
2002 sales	252,000	
2001 sales	108,000	120,000

What was Asp's gross profit percentage for 2002 sales?

- a. 20%
 - b. 25%
 - c. 28%
 - d. 40%
- (R/09, FAR, 0521F, #7, 8757)

8. Brass Co. reported income before income tax expense of \$60,000 for 2000. Brass had no permanent or temporary timing differences for tax purposes. Brass has an effective tax rate of 30% and a \$40,000 net operating loss carryforward from 1999. What is the maximum income tax benefit that Brass can realize from the loss carryforward for 2000?

- a. \$12,000
 - b. \$18,000
 - c. \$20,000
 - d. \$40,000
- (R/09, FAR, 0468F, #8, 8758)

9. A company reports the following information as of December 31:

Sales revenue	\$800,000
Cost of goods sold	600,000
Operating expenses	90,000
Unrealized holding gain on available-for-sale securities, net of tax	30,000

What amount should the company report as comprehensive income as of December 31?

- a. \$ 30,000
 - b. \$110,000
 - c. \$140,000
 - d. \$200,000
- (R/09, FAR, A1468F, #9, 8759)

10. Ajax Corp. has an effective tax rate of 30%. On January 1, 2000, Ajax purchased equipment for \$100,000. The equipment has a useful life of 10 years. What amount of current tax benefit will Ajax realize during 2000 by using the 150% declining balance method of depreciation for tax purposes instead of the straight-line method?

- a. \$1,500
 - b. \$3,000
 - c. \$4,500
 - d. \$5,000
- (R/09, FAR, 0467F, #10, 8760)

11. Carr, Inc. purchased equipment for \$100,000 on January 1, 2002. The equipment had an estimated 10-year useful life and a \$15,000 salvage value. Carr uses the 200% declining balance depreciation method. In its 2003 income statement, what amount should Carr report as depreciation expense for the equipment?

- a. \$13,600
 - b. \$16,000
 - c. \$17,000
 - d. \$20,000
- (R/09, FAR, 0416F, #11, 8761)

12. Which of the following characteristics relates to both accounting relevance and reliability?

- a. Verifiability
 - b. Timeliness
 - c. Neutrality
 - d. Comparability
- (R/09, FAR, A0199F, #12, 8762)

13. Lion Co.'s income statement for its first year of operations shows pretax income of \$6,000,000. In addition, the following differences existed between Lion's tax return and records:

	<u>Tax return</u>	<u>Accounting records</u>
Uncollectible accounts expense	\$220,000	\$250,000
Depreciation expense	860,000	570,000
Tax-exempt interest revenue	—	50,000

Lion's current year tax rate is 30% and the enacted rate for future years is 40%. What amount should Lion report as deferred tax expense in its income statement for the year?

- \$148,000
- \$124,000
- \$104,000
- \$ 78,000 (R/09, FAR, 0768F, #13, 8763)

14. Rue Co.'s allowance for uncollectible accounts had a credit balance of \$12,000 at December 31, 2002. During 2003, Rue wrote-off uncollectible accounts of \$48,000. The aging of accounts receivable indicated that a \$50,000 allowance for uncollectible accounts was required at December 31, 2003. What amount of uncollectible accounts expense should Rue report for 2003?

- \$48,000
- \$50,000
- \$60,000
- \$86,000 (R/09, FAR, 0174F, #14, 8764)

15. A company has the following accrual-basis balances at the end of its first year of operation:

Unearned consulting fees	\$ 2,000
Consulting fees receivable	3,500
Consulting fee revenue	25,000

The company's cash-basis consulting revenue is what amount?

- \$19,500
- \$23,500
- \$26,500
- \$30,500 (R/09, FAR, A1987F, #15, 8765)

16. During the current year, Onal Co. purchased 10,000 shares of its own stock at \$7 per share. The stock was originally issued at \$6. The firm sold 5,000 of the treasury shares for \$10 per share. The firm uses the cost method to account for treasury stock. What amount should Onal report in its income statement for these transactions?

- \$0
- \$ 5,000 gain
- \$10,000 loss
- \$15,000 gain

(R/09, FAR, A0093F, #16, 8766)

17. A nongovernmental not-for-profit organization's statement of activities is similar to which of the following for-profit financial statements?

- Balance sheet
- Statement of cash flows
- Statement of retained earnings
- Income statement

(R/09, FAR, A0104N, #17, 8767)

18. After an impairment loss is recognized, the adjusted carrying amount of the intangible asset shall be its new accounting basis. Which of the following statements about subsequent reversal of a previously recognized impairment loss is correct?

- It is prohibited.
- It is required when the reversal is considered permanent.
- It must be disclosed in the notes to the financial statements.
- It is encouraged, but not required.

(R/09, FAR, PC216, #18, 8768)

19. Tang City received land from a donor who stipulated that the land must remain intact, but any income generated from the property may be used for general government services. In which fund should Tang City record the donated land?

- Special revenue
- Permanent
- Private-purpose trust
- Agency (R/09, FAR, C02392F, #19, 8769)

20. When would a company use the installment sales method of revenue recognition?

- When collectibility of installment accounts receivable is reasonably predictable
- When repossessions of merchandise sold on the installment plan may result in a future gain or loss
- When installment sales are material, and there is no reasonable basis for estimating collectibility
- When collection expenses and bad debts on installment accounts receivable are deemed to be immaterial

(R/09, FAR, A0310F, #20, 8770)

21. On January 1, Feld traded a delivery truck and paid \$10,000 cash for a tow truck owned by Baker. The delivery truck had an original cost of \$140,000, accumulated depreciation of \$80,000, and an estimated fair value of \$90,000. Feld estimated the fair value of Baker's tow truck to be \$100,000. The transaction had commercial substance. What amount of gain should be recognized by Feld?

- \$0
- \$ 3,000
- \$10,000
- \$30,000

(R/09, FAR, A2238F, #21, 8771)

22. Which of the following is reported as interest expense?

- Pension cost interest
- Amortization of discount of a note
- Deferred compensation plan interest
- Interest incurred to finance a software development for internal use

(R/09, FAR, C04494F, #22, 8772)

23. How should a nongovernmental not-for-profit organization report depreciation expense in its statement of activities?

- It should not be included.
- It should be included as a decrease in unrestricted net assets.
- It should be included as an increase in temporarily restricted net assets.
- It should be reclassified from unrestricted net assets to temporarily restricted net assets, depending on donor-imposed restrictions on the assets. (R/09, FAR, C04822F, #23, 8773)

24. Willem Co. reported the following liabilities at December 31, 2001:

Accounts payable-trade	\$ 750,000
Short-term borrowings	400,000
Mortgage payable, current portion	
\$100,000	3,500,000
Other bank loan, matures June 30, 2002	1,000,000

The \$1,000,000 bank loan was refinanced with a 20-year loan on January 15, 2002, with the first principal payment due January 15, 2003. Willem's audited financial statements were issued February 28, 2002. What amount should Willem report as current liabilities at December 31, 2001?

- \$ 850,000
- \$1,150,000
- \$1,250,000
- \$2,250,000

(R/09, FAR, 1175F, #24, 8774)

25. Arkin Corp. is a nongovernmental not-for-profit organization involved in research. Arkin's statement of functional expenses should classify which of the following as support services?

- Salaries of staff researchers involved in research
- Salaries of fundraisers for funds used in research
- Costs of equipment involved in research
- Costs of laboratory supplies used in research

(R/09, FAR, A0341N, #25, 8775)

Problem 2: Hard

26. Ian Co. is calculating earnings per share amounts for inclusion in the Ian's annual report to shareholders. Ian has obtained the following information from the controller's office as well as shareholder services:

Net income from January 1 to December 31	\$125,000
Number of outstanding shares:	
January 1 to March 31	15,000
April 1 to May 31	12,500
June 1 to December 31	17,000

In addition, Ian has issued 10,000 incentive stock options with an exercise price of \$30 to its employees and a year-end market price of \$25 per share. What amount is Ian's diluted earnings per share for the year ended December 31?

- \$4.63
- \$4.85
- \$7.35
- \$7.94 (R/09, FAR, C02303F, #26, 8776)

27. Green Co. had the following equity transactions at December 31:

Cash proceeds from sale of investment in Blue Co. (carrying value – \$60,000)	\$75,000
Dividends received on Grey Co. stock	10,500
Common stock purchased from Brown Co.	38,000

What amount should Green recognize as net cash from investing activities in its statement of cash flows at December 31?

- \$37,000
- \$47,500
- \$75,000
- \$85,500 (R/09, FAR, 1366F, #27, 8777)

28. A company has a long-lived asset with a carrying value of \$120,000, expected future cash flows of \$130,000, present value of expected future cash flows of \$100,000, and a market value of \$105,000. What amount of impairment loss should be reported?

- \$0
- \$5,000
- \$15,000
- \$20,000 (R/09, FAR, A2154F, #28, 8778)

29. When the allowance method of recognizing uncollectible accounts is used, how would the collection of an account previously written off affect accounts receivable and the allowance for uncollectible accounts?

	<u>Accounts receivable</u>	<u>Allowance for uncollectible accounts</u>
a. Increase		Decrease
b. Increase		No effect
c. No effect		Decrease
d. No effect		Increase

(R/09, FAR, 0384F, #29, 8779)

30. During 2004, a former employee of Dane Co. began a suit against Dane for wrongful termination in November 2003. After considering all of the facts, Dane's legal counsel believes that the former employee will prevail and will probably receive damages of between \$1,000,000 and \$1,500,000, with \$1,300,000 being the most likely amount. Dane's financial statements for the year ended December 31, 2003, will not be issued until February 2004. In its December 31, 2003, balance sheet, what amount should Dane report as a liability with respect to the suit?

- \$0
- \$1,000,000
- \$1,300,000
- \$1,500,000 (R/09, FAR, A0548F, #30, 8780)

31. Which format must an enterprise fund use to report cash flow operating activities in the statement of cash flows?

- Indirect method, beginning with operating income
- Indirect method, beginning with change in net assets
- Direct method
- Either direct or indirect method (R/09, FAR, 1119G, #31, 8781)

32. Nack City received a donation of a valuable painting. Nack planned to add the painting to its collection and display it in the protected exhibition area of city hall. Nack had a policy that if such donated art works were sold, the proceeds would be used to acquire other items for its collections. Which of the following would be correct regarding the donated painting?

- a. Must be capitalized and depreciated
- b. Must be capitalized but not depreciated
- c. May be capitalized, but it is not required, and it must be depreciated
- d. May be capitalized, but it is not required, and depreciation is not required

(R/09, FAR, C03149F, #32, 8782)

33. Which of the following not-for-profit entities is required to prepare a statement of functional expense?

- a. An art museum
- b. A shelter for the homeless
- c. A private foundation
- d. A public golf course

(R/09, FAR, A0297N, #33, 8783)

34. On January 1, Stunt Corp. had outstanding convertible bonds with a face value of \$1,000,000 and an unamortized discount of \$100,000. On that date, the bonds were converted into 100,000 shares of \$1 par stock. The market value on the date of conversion was \$12 per share. The transaction will be accounted for with the book value method. By what amount will Stunt's stockholders' equity increase as a result of the bond conversion?

- a. \$ 100,000
- b. \$ 900,000
- c. \$1,000,000
- d. \$1,200,000 (R/09, FAR, A1245F, #34, 8784)

35. During the current year, Wythe County levied \$2,000,000 property taxes, 1% of which is expected to be uncollectible. During the year, the county collected \$1,800,000 and wrote off \$15,000 as uncollectible. What amount should Wythe County report as property tax revenue in its government-wide statement of activities for the current year?

- a. \$1,800,000
- b. \$1,980,000
- c. \$1,985,000
- d. \$2,000,000 (R/09, FAR, 1160G, #35, 8785)

36. On December 1 of the current year, Bann Co. entered into an option contract to purchase 2,000 shares of Norta Co. stock for \$40 per share (the same as the current market price) by the end of the next two months. The time value of the option contract is \$600. At the end of December, Norta's stock was selling for \$43, and the time value of the option is now \$400. If Bann does not exercise its option until January of the subsequent year, which of the following changes would reflect the proper accounting treatment for this transaction on Bann's December 31, year-end financial statements?

- a. The option value will be disclosed in the footnotes only.
- b. Other comprehensive income will increase by \$6,000.
- c. Net income will increase by \$5,800.
- d. Current assets will decrease by \$200.

(R/09, FAR, A0729F, #36, 8786)

37. Gridiron University is a private university. A successful alumnus has recently donated \$1,000,000 to Gridiron for the purpose of funding a "center for the study of sports ethics." This donation is conditional upon the university raising matching funds within the next 12 months. The university administrators estimate that they have a 50% chance of raising the additional money. How should this donation be accounted for?

- a. As a temporarily restricted support
- b. As unrestricted support
- c. As a refundable advance
- d. As a memorandum entry reported in the footnotes (R/09, FAR, A0063N, #37, 8787)

38. A company has outstanding accounts payable of \$30,000 and a short-term construction loan in the amount of \$100,000 at year end. The loan was refinanced through issuance of long-term bonds after year end but before issuance of financial statements. How should these liabilities be recorded in the balance sheet?

- a. Long-term liabilities of \$130,000
- b. Current liabilities of \$130,000
- c. Current liabilities of \$30,000, long-term liabilities of \$100,000
- d. Current liabilities of \$130,000, with required footnote disclosure of the refinancing of the loan (R/09, FAR, A1175F, #38, 8788)

39. During the current fiscal year, Foxx, a non-governmental not-for-profit organization, received unrestricted pledges of \$300,000. Of the pledged amount, \$200,000 was designated by donors for use during the current year, and \$100,000 was designated for next year. Five percent of the pledges are expected to be uncollectible. What amount should Foxx report as restricted support (contributions) in the statement of activities for the current year?

- \$200,000
- \$190,000
- \$100,000
- \$ 95,000 (R/09, FAR, A0139N, #39, 8789)

40. A company has the following liabilities at year end:

Mortgage note payable; \$16,000 due within 12 months	\$355,000
Short-term debt that the company is refinancing with long-term debt	175,000
Deferred tax liability arising from depreciation	25,000

What amount should the company include in the current liability section of the balance sheet?

- \$0
- \$ 16,000
- \$ 41,000
- \$191,000 (R/09, FAR, A1456F, #40, 8790)

41. On October 1 of the current year, a U.S. company sold merchandise on account to a British company for 2,000 pounds (exchange rate, 1 pound = \$1.43). At the company's December 31 fiscal year end, the exchange rate was 1 pound = \$1.45. The exchange rate was 1 pound = \$1.50 on collection in January of the subsequent year. What amount would the company recognize as a gain(loss) from foreign currency translation when the receivable is collected?

- \$0
- \$ 100
- \$ 140
- \$(140) (R/09, FAR, A0347F, #41, 8791)

42. After three profitable years, Dodd Co. decided to offer a bonus to its branch manager, Cone, of 25% of income over \$100,000 earned by his branch. For the year 2002, income for Cone's branch was \$160,000 before income taxes and Cone's bonus. Cone's bonus is computed on income in excess of \$100,000 after deducting the bonus, but before deducting taxes. What is Cone's bonus for the year 2002?

- \$12,000
- \$15,000
- \$25,000
- \$32,000 (R/09, FAR, 1414F, #42, 8792)

43. Wall Co. sells a product under a two-year warranty. The estimated cost of warranty repairs is 2% of net sales. During Wall's first two years in business, it made the following sales and incurred the following warranty repair costs:

<u>Year 1</u>	
Total sales	\$250,000
Total repair costs incurred	4,500

<u>Year 2</u>	
Total sales	\$300,000
Total repair costs incurred	5,000

What amount should Wall report as warranty expense for year 2?

- \$1,000
- \$5,000
- \$5,900
- \$6,000 (R/09, FAR, C02166F, #43, 8793)

44. A company issued a bond with a stated rate of interest that is less than the effective interest rate on the date of issuance. The bond was issued on one of the interest payment dates. What should the company report on the first interest payment date?

- An interest expense that is less than the cash payment made to bondholders
- An interest expense that is greater than the cash payment made to bondholders
- A debit to the unamortized bond discount
- A debit to the unamortized bond premium (R/09, FAR, A2170F, #44, 8794)

45. Tam Co. reported the following items in its year-end financial statements:

Capital expenditures	\$1,000,000
Capital lease payments	125,000
Income taxes paid	325,000
Dividends paid	200,000
Net interest payments	220,000

What amount should Tam report as supplemental disclosures in its statement of cash flows prepared using the indirect method?

- \$ 545,000
- \$ 745,000
- \$1,125,000
- \$1,870,000 (R/09, FAR, 1237F, #45, 8795)

46. Which of the following statements describes the proper accounting for losses when nonmonetary assets are exchanged for other nonmonetary assets?

- A loss is recognized immediately, because assets received should not be valued at more than their cash equivalent price.
- A loss is deferred so that the asset received in the exchange is properly valued.
- A loss, if any, which is unrelated to the determination of the amount of the asset received should be recorded.
- A loss can occur only when assets are sold or disposed of in a monetary transaction.
(R/09, FAR, PC677, #46, 8796)

47. How should a company report its decision to change from a cash-basis of accounting to accrual-basis of accounting?

- As a change in accounting principle, requiring the cumulative effect of the change (net of tax) to be reported in the income statement
- Prospectively, with no amounts restated and no cumulative adjustment
- As an extraordinary item (net of tax)
- As a prior-period adjustment (net of tax), by adjusting the beginning balance of retained earnings (R/09, FAR, A0671F, #47, 8797)

48. Baker Co. began its operations during the current year. The following is Baker's balance sheet at December 31:

Baker Co.	
BALANCE SHEET	
<u>Assets</u>	
Cash	\$192,000
Accounts receivable	<u>82,000</u>
Total assets	<u>\$274,000</u>
<u>Liabilities and stockholders' equity</u>	
Accounts payable	\$ 24,000
Common stock	200,000
Retained earnings	<u>50,000</u>
Total liabilities and stockholders' equity	<u>\$274,000</u>

Baker's net income for the current year was \$78,000 and dividends of \$28,000 were declared and paid. Common stock was issued for \$200,000. What amount should Baker report as cash provided by operating activities in its statement of cash flows for the current year?

- \$ 20,000
- \$ 50,000
- \$192,000
- \$250,000 (R/09, FAR, 1664F, #48, 8798)

49. Which of the following is a characteristic of a capital lease?

- The lease term is substantially less than the estimated economic life of the leased property.
- The lease contains a bargain-purchase option.
- The present value of the minimum lease payments at the beginning of the lease term is 75% or more of the fair value of the property at the inception of the lease.
- The future obligation does not appear in the balance sheet of the lessee.
(R/09, FAR, C00674F, #49, 8799)

50. A company issues bonds at 98, with a maturity value of \$50,000. The entry the company uses to record the original issue should include which of the following?

- A debit to bond discount of \$1,000
- A credit to bonds payable of \$49,000
- A credit to bond premium of \$1,000
- A debit to bonds payable of \$50,000
(R/09, FAR, A1550F, #50, 8800)

Situation

Deferred Tax Worksheet

Balance Sheet - Deferred Taxes

Communication

Stanhope, Inc., a C corporation, is a distributor of personal electronics and has reported a net income for each year since inception. Its taxable income has consistently resulted in an effective tax rate of 33%. (Ignore state income taxes.)

You have been assigned to compute the company's deferred portion of federal income taxes for inclusion in its financial statements for year 2 and to provide the company's controller with a schedule that supports your computation. Your schedule should identify deductible and taxable temporary differences and components of the deferred tax computations.

The controller has provided you with the following reconciliation of Stanhope's pretax accounting income to taxable income for year 2 and the additional information shown below. Use this information to answer the subsequent questions.

Stanhope, Inc.
Reconciliation of Pretax Accounting Income to Taxable Income
Year ended December 31, year 2

Pretax accounting income		\$678,000
Expenses recorded on books this year not deductible for tax purposes:		
Meals and entertainment expenses	12,000	
Bad debts expense provision	<u>15,000</u>	<u>27,000</u>
Subtotal		705,000
Income recorded on books this year not subject to tax:		
Tax-exempt interest income	15,000	
Unrealized gain (loss) on trading securities	8,000	
Deductions on tax return not charged against book income this year:		
Depreciation expense	63,000	
Bad debts written off and charged against allowance account	<u>5,000</u>	<u>91,000</u>
Taxable income		<u>\$614,000</u>

1. The Allowance for doubtful accounts (bad debts) as of December 31, year 1, was \$11,000. During year 2, uncollectible accounts totaling \$5,000 were written off and charged against the allowance account. A provision for bad debts of \$15,000 was charged to operations at the end of the year to result in an Allowance for doubtful accounts balance at December 31, year 2, of \$21,000.
2. At the end of the year, there were net unrealized gains on trading securities of \$8,000. There were no unrealized gains/losses on trading securities at the beginning of the year.
3. The company uses straight-line depreciation for financial reporting (GAAP) purposes and accelerated methods for income tax purposes. Balances and activity in the accumulated depreciation account for GAAP and income tax purposes are summarized below:

	GAAP	Tax	Difference
Accumulated depreciation, December 31, year 1	1,314,000	2,018,000	704,000
Year 2 depreciation expense	196,000	259,000	63,000
Accumulated depreciation, December 31, year 2	1,510,000	2,277,000	767,000

(R/09, FAR, P3, amended, 8749)

[Situation](#)

[Deferred Tax Worksheet](#)

[Balance Sheet - Deferred Taxes](#)

[Communication](#)

Use the information contained in the Situation to prepare the deferred tax computations and supporting components by completing the following worksheet.

- In column A, select a line item that will result in a temporary difference.
- In column B, enter the total temporary difference that would result in a deferred tax asset or liability.
- Enter the total deferred tax asset or liability in the appropriate column, C or D, based on the temporary difference you recorded in column B.

Round all answers to the nearest whole dollar.

Stanhope, Inc.
Worksheet for Deferred Income Taxes
Year ended December 31, year 2

	A	B	C	D
1	Description of temporary differences	Temporary differences	Deferred tax assets	Deferred tax liabilities
2				
3				
4				
5				
6				
7				
8				
9	Totals			

Selection list for description of temporary differences

Accumulated depreciation, excess of tax over GAAP	Unrealized gain (loss) on trading securities
Accumulated depreciation, excess of GAAP over tax	Meals and entertainment expenses
Allowance for doubtful accounts	Tax-exempt interest income
Bad debts expense provision	Bad debts written off

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Situation

Deferred Tax Worksheet

Balance Sheet - Deferred Taxes

Communication

Use the information from your completed worksheet for deferred income taxes (Deferred Tax Worksheet tab) to prepare the applicable line items for Stanhope, Inc.'s balance sheet as of December 31, year 2. If there is no balance in a particular account, enter a value of zero (0).

Assets:	
Deferred taxes, current asset	
Deferred taxes, noncurrent asset	
Liabilities:	
Deferred taxes, current liability	
Deferred taxes, noncurrent liability	

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Situation

Deferred Tax Worksheet

Balance Sheet - Deferred Taxes

Communication

The engagement partner asked you to explain to the vice president of Stanhope, Inc. why accounting for deferred income taxes is required by GAAP. Write a memorandum to the vice president that explains the general nature of deferred income taxes. The memorandum should include an explanation of the different objectives of income tax and financial reporting, as well as an explanation of temporary differences.

REMINDER: On the actual exam your response will be graded for both technical content and writing skills. Technical content will be evaluated for information that is helpful to the intended reader and clearly relevant to the issue. Writing skills will be evaluated for development, organization, and the appropriate expression of ideas in professional correspondence. Use a standard business memo or letter format with a clear beginning, middle, and end. Do not convey information in the form of a table, bullet point list, or other abbreviated presentation.

[] [] [] []

Research

The management of Stanhope, Inc. inquired whether changes in tax laws and rates during the current year would affect the computation of Stanhope's deferred tax liabilities and deferred tax assets. Find authoritative guidance that responds to this inquiry.

REMINDER: On the actual exam you will use a research database to find the correct authoritative literature and then select from a variety of choices dependent upon your research. Please see the AICPA's tutorial and sample tests on The Uniform CPA Examination website (www.cpa-exam.org).

Paragraph Reference Answer: _____

Solution 1 MULTIPLE-CHOICE ANSWERS (Moderate)

1. (d) Cash flows from investing activities includes purchases, sales, and maturities of debt and equity securities; excluding those acquired specifically for resale. This would include available-for-sale and held-to-maturity securities. (\$25,000 + \$40,000 = \$65,000) (Chapter 14-2-2, CBT Skill: Analysis, CSO: 1.2.4)

2. (a) Harland should record the receipt of cash received from the capital grant in the agency fund. Agency funds are used to account for the custodial activities of a government serving as an agent for other governments, private organizations, or individuals. Harland is serving as an agent for its five municipalities. The general fund is used to account for most routine operations of the governmental entity. General fund revenues primarily consist of taxes, licenses, fines, and interest. The special revenue fund is used to account for revenues that are externally restricted or designated by the legislative body for specific general government purposes other than capital projects. Private purpose trust funds are used to account for fiduciary responsibilities and activities in managing other trust arrangements that benefit individuals, private organizations, or other governments. (Chapter 19-3-5, CBT Skill: Judgment, CSO: 4.1.2)

3. (a) The debt service fund should be reported as part of local government's governmental activities column in its government-wide statements. Reporting capital assets and long-term liabilities is required in the government-wide statements. Agency, private purpose trust, and pension trust funds are all fiduciary funds. Fiduciary activities are not included in the government-wide statements because the assets and liabilities cannot be used to support the government's own programs. (Chapter 18-2-3, CBT Skill: Understanding, CSO: 4.2.1)

4. (c) Assets are to be recorded at their acquisition cost. Acquisition cost is defined as the cash price, or its equivalent, plus all the costs reasonably necessary to bring it to the location and to make it ready for its intended use. The cash price, or its equivalent, would be the \$4,000 down payment plus the \$15,480 present value of the \$6,000 payments, an ordinary annuity, $(2.58 \times \$6,000)$. Add to that price of \$19,480 the \$2,000 in shipping charges to get the equipment to its location and the \$3,500 of installation

charges to get it ready for its intended use. (Chapter 4-2-1, CBT Skill: Analysis, CSO: 2.4.0)

5. (a) Gains on disposal of a business segment and foreign currency translations are in most cases considered normal events and transactions affecting operations. For an occurrence of an underlying event or transaction to be classified as extraordinary it must meet both of the following criteria: 1) unusual in nature in that it possesses a high degree of abnormality and be of the type clearly unrelated to, or incidentally related to, the ordinary and typical activities of the entity, taking into account the environment in which the entity operates and 2) infrequent in occurrence in that it be of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the entity operates. The scenario does not indicate anything that would classify the gains as extraordinary. (Chapter 11-2-3, CBT Skill: Analysis, CSO: 3.7.0)

6. (a) Foreign currency financial statements should be translated by means of the following rates: all assets and liabilities at the current exchange rate at the balance sheet date; revenues and expenses at the exchange rate at the time the revenue or expense was recognized, however due to the impracticability of this where rates change frequently, a weighted-average exchange rate for the period may be used; contributed capital at the historical exchange rate; and retained earnings at the translated amount of retained earnings for the prior period, plus (less net income(loss) at the weighted-average rate, less dividends declared during the period at the exchange rate when declared. The weighted average exchange rate would be an appropriate exchange rate for salaries expense and sales to external customers. (Chapter 16-1-3, CBT Skill: Understanding, CSO: 3.9.0)

7. (c) The installment method is an exception of normal GAAP revenue recognition and not allowed unless certain circumstances exist such that collection of sales is not reasonably assured. The installment method allows revenue to be deferred and recognized each year in proportion to the receivables collected that year. Income recognized generally equals cash collected multiplied by the gross profit percentage applicable to those sales. Receivable accounts and gross profit accounts must be kept separately for each year

because the gross profit rate will often vary from year to year. The gross profit percentage can be computed by either dividing the realized gross profit by collections or dividing the deferred gross profit by receivables for a particular year. The \$252,000 deferred gross profit in 2002 divided by the \$900,000 accounts receivable in 2002 equals a gross profit percentage of 28% for 2002 sales. (Chapter 12-1-1, CBT Skill: Analysis, CSO: 2.8.0)

8. (a) Future realization of the tax benefit of an existing deductible temporary difference or carryforward ultimately depends on the existence of sufficient taxable income of the appropriate character within the carryback, carryforward period available under law. Whatever amount is allowed is multiplied by the effective tax rate to come up with the tax benefit realized. Brass had \$60,000 reported income which was sufficient income to cover the entire \$40,000 net operating loss carryforward. With an effective tax rate of 30%, Brass can realize an income tax benefit of \$12,000 ($\$40,000 \times 30\%$). (Chapter 13-4-1, CBT Skill: Analysis, CSO: 3.10.0)

9. (c) Comprehensive income includes all changes in equity during a period except those resulting from investments by owners and distributions to owners. Comprehensive income is divided into net income and other comprehensive income (OCI). It would include \$110,000 from net income ($\$800,000 - \$600,000 - \$90,000$) and \$30,000 from OCI (the unrealized holding gain on available-for-sale securities). (Chapter 11-3-2, CBT Skill: Analysis, CSO: 1.2.3)

10. (a) Using the straight-line method of depreciation, Ajax would have a depreciation expense of \$10,000 ($\$100,000$ purchase price / 10 years). The current tax benefit would be \$3,000 ($\$10,000$ depreciation expense \times 30% effective tax rate). Using the 150% declining balance method of depreciation, Ajax would have a depreciation expense of \$15,000 ($\$100,000$ purchase price / 10 years \times 150%). The current tax benefit would be \$4,500 ($\$15,000$ depreciation expense \times 30% effective tax rate). The amount of tax benefit realized by using the 150% declining method instead of the straight-line method would be the difference ($\$4,500 - \$3,000$). (Chapter 13-1-4, CBT Skill: Analysis, CSO: 3.10.0)

11. (b) The straight-line (SL) depreciation method is a fixed charge method where an equal amount of depreciable cost is allocated to each

period. The SL formula is (historical cost – salvage value) / estimated useful life. The 200% declining balance depreciation method, also known as double-declining balance (DDB), uses a rate of depreciation twice the SL rate applied to the book value (i.e., declining balance) of the asset to obtain the depreciation expense for the period. The salvage value is not used in the calculation except as a lower bound for the asset's book value. The DDB formula is $(2 / \text{estimated useful life}) \times (\text{historical cost} - \text{accumulated depreciation})$.

2002: $(2/10) \times (\$100,000 - 0) = \$20,000$

2003: $(2/10) \times (\$100,000 - \$20,000) = \$16,000$

(Chapter 4-3-1, CBT Skill: Analysis, CSO: 2.4.0)

12. (d) Comparability, which includes consistency, is a secondary quality that interacts with both relevance and reliability to contribute to the usefulness of information. Information about a particular enterprise gains greatly in usefulness if it can be compared with similar information about other enterprises and with similar information about the same enterprise for some other period or some other point in time. Verifiability is a characteristic of reliability only in that information can be said to be verifiable when a large number of independent observers derive similar results using the same measurement methods. Timeliness is a characteristic of relevance only in that information is timely if it is available to a decision maker before it loses its capacity to influence decisions. Neutrality is a characteristic of reliability only in that the information is free from bias towards a predetermined result. (Chapter 1-5-2, CBT Skill: Understanding, CSO: 1.1.2)

13. (c) Deferred tax liabilities or assets are recognized for the future tax consequences of, among other things, revenues, expenses, gains, or losses that are included in taxable income of an earlier or later year than the year in which they are recognized. The difference in uncollectible accounts expense between the tax return and the accounting records would result in a \$30,000 deferred tax asset. The difference in depreciation expense between the tax return and the accounting records would result in a \$290,000 deferred tax liability. The difference in tax-exempt interest revenue between the tax return and the accounting records results in no tax asset or liability because the revenue was tax exempt. This results in a net future tax liability of \$260,000. The \$260,000 times the future tax rate of 40% equals

\$104,000. (Chapter 13-2-2, CBT Skill: Analysis, CSO: 3.10.0)

14. (d) Under the aging of accounts receivable method, after the desired ending balance of the allowance group is determined, the amount of uncollectible accounts (bad debt) expense recognized is the difference between the existing balance in the allowance account and the desired ending balance. The allowance account started the year with a credit balance of \$12,000. The write-offs during the year would have been a credit to accounts receivable and a debit to allowance for uncollectible accounts of \$48,000 thus bringing the allowance account to a \$36,000 debit balance at year-end. To get the allowance account to the desired \$50,000 credit balance there would need to be a credit to allowance for uncollectible accounts and debit to uncollectible accounts expense for \$86,000. (Chapter 2-6-2, CBT Skill: Analysis, CSO: 2.2.0)

15. (b) In cash-basis accounting, the effects of transactions and other events on the assets and liabilities of a business enterprise are recognized and reported only when cash is received or paid; while in accrual accounting, these effects are recognized and reported in the time periods to which they relate. Cash-basis accounting does not attempt to match revenues and the expenses associated with those revenues. The unearned consulting fees amount means the company received cash for services they have not yet performed so it wouldn't be counted in consulting fee revenue. The consulting fees receivable amount means the company has earned the revenue but has not yet received the cash. The cash-basis consulting revenue would be the \$25,000 consulting fee revenue plus the \$2,000 unearned consulting fees less the \$3,500 consulting fees receivable for a total of \$23,500. (Chapter 11-4-9, CBT Skill: Analysis, CSO: 1.3.0)

16. (a) Treasury stock is the corporation's common or preferred stock that has been reacquired by purchase, by settlement of an obligation to the corporation, or through donation. The cost method views the purchase and subsequent disposition of stock as one transaction. The treasury stock is recorded (debited), carried, and reissued at the acquisition cost. If the stock is reissued at a price in excess of the acquisition cost, such as in this situation, the excess is credited to an appropriately titled paid-in capital account. There are no gains or losses reported in the income statement

for these transactions. (Chapter 10-5-2, CBT Skill: Analysis, CSO: 2.11.0)

17. (d) A nongovernmental not-for-profit organization's statement of activities is similar to a for-profit entity's income statement. The change in net assets is reported in the statement of activities. The revenues, gains, and losses are classified into three groups: unrestricted, temporarily restricted, and permanently restricted. All expenses are reported as decreases in unrestricted net assets. (Chapter 20-1-3, CBT Skill: Understanding, CSO: 5.1.2)

18. (a) An impairment loss is recognized if the carrying amount of an intangible asset is not recoverable and its carrying amount exceeds its fair value. After an impairment loss is recognized, the adjusted carrying amount of the asset is its new accounting basis. Subsequent reversal of a previously recognized impairment loss is prohibited. (Chapter 5-1-3, CBT Skill: Understanding, CSO: 2.6.0)

19. (b) A permanent fund is used to account for nonexpendable resources that may be used for the government's programs to generate and disperse money, such as the land in this situation, to benefit the reporting entity or its citizens. The name of the fund comes from the purpose of the fund: a sum of equity used to permanently generate payments to maintain some financial obligation. A fund can only be classified as a permanent fund if the money is used to report the status of a restricted financial resource. The resource is restricted in the sense that only earnings from the resource are used and not the principal. A special revenue fund is used to account for revenues that are externally restricted or designated by the legislative body for specific general government purposes other than capital projects. Private-purpose trust funds are used to account for fiduciary responsibilities and activities in managing trust arrangements that benefit individuals, private organizations, or other governments. An agency fund is used to account for the custodial activities of a government serving as an agent for other governments, private organizations, or individuals. Agency funds are purely custodial. (Chapter 19-1-6, CBT Skill: Understanding, CSO: 4.1.2)

20. (c) The installment method is an exception of normal GAAP revenue recognition and not allowed unless certain circumstances exist such that collection of sales is not reasonably assured.

This method is permitted when receivables are collected over an extended period of time and, because of the terms of transactions or other conditions, there is no reasonable basis for estimating the degree of collectibility. The installment method allows revenue to be deferred and recognized each year in proportion to the receivables collected that year. (Chapter 12-1-1, CBT Skill: Understanding, CSO: 2.8.0)

21. (d) In general, accounting for non-monetary transactions (those involving nonmonetary assets or liabilities) should be based on the fair values (FV) of the assets involved. The acquisition is recorded at the FV of the asset surrendered or the FV of the asset received, whichever is more clearly determinable, and gains or losses should be recognized. Nonmonetary exchanges should be based on recorded amounts, rather than FV, of the exchanged assets if any of the following apply: 1) neither the FV of the assets received nor FV of the assets surrendered is reasonably determinable, or 2) the transaction is an exchange of a product or property held for sale in the ordinary course of business for a product or property to be sold in the same line of business to facilitate sales to customers, or 3) the exchange lacks commercial substance. This situation does not fall into any category warranting the exchange to be based on recorded amounts so it would be based on FV. Feld would realize a gain of \$30,000 on this transaction. The entry would be:

Equipment (tow truck FV)	100,000	
Accumulated Depreciation	80,000	
Cash		10,000
Equipment (delivery truck)		140,000
Gain		30,000

(Chapter 4-2-1, CBT Skill: Analysis, CSO: 3.14.0)

22. (b) Amortization of a bond premium decreases interest expense and the carrying amount of the bond for the issuer, while the amortization of a bond discount increases the issuer's interest expense and the carrying amount of the bond. Pension cost interest is part of net pension expense. Deferred compensation plan interest is part of compensation expense. Interest incurred to finance a software development for internal use is capitalized as part of the cost of the software. (Chapter 6-3-3, CBT Skill: Understanding, CSO: 3.11.0)

23. (b) A nongovernmental not-for-profit organization's statement of activities is similar to a for-profit entity's income statement. The change in net assets is reported in the statement of activities. The revenues, gains, and losses are classified into three groups: unrestricted, temporarily restricted, and permanently restricted. All expenses, which would include depreciation expense, are reported as decreases in unrestricted net assets. (Chapter 20-1-3, CBT Skill: Understanding, CSO: 5.1.2)

24. (c) The term current liabilities is used principally to designate obligations whose liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets, or the creation of other current liabilities. Short-term obligations are those scheduled to mature within one year or operating cycle, whichever is longer, and generally are classified as current liabilities. However, if they are to be refinanced on a long-term basis they will be appropriately classified as long-term liabilities. Exclusion from current liabilities requires two conditions be met; 1) the enterprise must intend to refinance the obligation on a long-term basis, and 2) the enterprise must have the ability to consummate the financing. A refinancing that occurs after the balance sheet date but before the issuance of the balance sheet is evidence of intent and ability. The \$1,000,000 bank loan would not be reported as part of current liabilities because it was refinanced on a long-term basis. The accounts payable-trade, short-term borrowings, and current portion of mortgage payable would be reported as current liabilities (\$750,000 + \$100,000 + \$400,000 = \$1,250,000). (Chapter 7-2-4, CBT Skill: Analysis, CSO: 1.2.2)

25. (b) The statement of functional expenses provides information about expenses reported by their functional classifications, such as major classes of program services and support services, as well as information about expenses by their natural classification, such as salaries, rent, electricity, interest expense, depreciation awards and grants to others, and professional fees, in a matrix format. Program services are the activities that result in goods and services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the organization exists. Those services are the major purpose for and the major output of the organization and often relate to several major programs. Examples include research, education, and community services, among others. Support

services are all activities of a not-for-profit organization other than program services. Generally, they include management and general, fundraising, and membership-development activities.

The salaries of fundraisers, even though the funds raised may be used in research, are classified as support services. (Chapter 20-1-3, CBT Skill: Understanding, CSO: 5.1.4)

Solution 2 MULTIPLE-CHOICE ANSWERS (Hard)

26. (d) Calculating diluted earnings per share (EPS) is a two step process. The first step is to compute basic EPS and the second is to determine the per share effect of each dilutive security. Basic EPS is computed by dividing income available to shareholders (IAC) by the weighted average number of shares outstanding during the period.

<u>Shares Outstanding</u>	<u>Months Outstanding</u>	<u>Weighted Average</u>
15,000	3/12	3,750
12,500	2/12	2,083.333
17,000	7/12	9,916.667
<i>Totals</i>	12/12	15,750

Basic EPS would be $\$125,000 / 15,750 = \7.94 . The incentive stock options are potentially dilutive securities. A security is only dilutive if the inclusion of the security in the computation of EPS results in a smaller EPS or increases the loss per share. If the average market price is higher than the exercise price the options are dilutive. If the average market price is less than the exercise price the options are anti-dilutive. Since the market price of \$25 is less than the exercise price of \$30 these options are anti-dilutive and have no per share effect. The diluted EPS is the same as basic EPS. (Chapter 15-3-3, CBT Skill: Analysis, CSO: 3.5.0)

27. (a) Cash flows from investing activities include 1) making and collecting loans (excluding those acquired specifically for resale), 2) acquiring and disposing of property, plant and equipment, and other productive assets, and 3) purchases, sales, and maturities of debt and equity securities (excluding those acquired specifically for resale). The sale of investment in Blue Co. would be an investing activity cash inflow of \$75,000 and the common stock purchase from Brown Co. would be an investing activity cash outflow of \$38,000. The \$75,000 cash in less \$38,000 cash out equals net \$37,000 cash from investing activities. Dividends received on stock are classified as cash flows from operating activities. (Chapter 14-2-2, CBT Skill: Analysis, CSO: 1.2.4)

28. (c) An impairment loss shall be recognized only if the carrying amount of a long-lived asset, or asset group, is not recoverable and exceeds its fair value. The carrying amount (book value) is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset. The amount of an impairment loss is the difference between an asset's book and fair value. The \$120,000 carrying value of the company's long-lived does not exceed the \$130,000 undiscounted future cash flows expected to result from the asset so there is no impairment loss. (Chapter 4-4-1, CBT Skill: Analysis, CSO: 2.4.0)

29. (d) Journal entries to record the collection of an account previously written off as uncollectible are as follows:

Accounts Receivable—Joe Doe	XX
Cash	XX
<i>To reopen account to balance when written off.</i>	
Cash	XX
Accounts Receivable—Joe Doe	XX
<i>To record receipt of cash payment of receivable.</i>	

These entries would increase cash and allowance for uncollectible accounts. They would have no net effect on net accounts receivable, net income, current assets, or working capital. (Chapter 2-6-2, CBT Skill: Understanding, CSO: 2.2.0)

30. (c) Contingent liabilities arise from events or circumstances occurring before the balance sheet date, the resolution of which is contingent on a future event or circumstance. Pending or threatened litigation is one example of a contingent liability. The accounting treatment depends on the likelihood that future events will confirm the contingent loss and whether the amount can be reasonably estimated. Where the likelihood of confirmation of a loss is considered probable and the loss can be reasonably estimated, the estimated loss should be accrued by a charge to income and the nature of the contingency should be disclosed. If, however, only a range of possible loss can be estimated, with no amount in the

range better than any other, the minimum amount in the range should be accrued. The wrongful termination event took place in 2003 and because a loss from it is considered probable it should be reported in the December 31, 2003, balance sheet. The most likely amount (reasonably estimated) would be reported. (Chapter 7-1-6, CBT Skill: Analysis, CSO: 3.3.0)

31. (c) An enterprise fund is one of the governmental proprietary funds. Governments should present a statement of cash flows for proprietary funds based on the provisions of GASB statements. The GASB states the direct method of presenting cash flows from operating activities (including a reconciliation of operating cash flows to operating income) should be used. (Chapter 18-2-5, CBT Skill: Judgment, CSO: 4.2.4)

32. (d) Governments are encouraged, but not required, to capitalize a collection of works of art or historical treasures (and all additions to that collection) whether donated or purchased that meets all of the following conditions. The collection is 1) held for public exhibition, education, or research in furtherance of public service rather than financial gain, 2) protected, kept encumbered, cared for, and preserved, and 3) subject to an organizational policy that requires the proceeds from sales of collection items to be used to acquire other items for collections. Capitalized collections or individual items that are exhaustible, such as exhibits whose useful lives are diminished by display or educational or research applications, should be depreciated over their estimated useful lives. Depreciation is not required for collections or individual items that are inexhaustible. (Chapter 18-2-3, CBT Skill: Understanding, CSO: 4.1.2)

33. (b) A statement of functional expenses is required only for voluntary health and welfare organizations (VHWOs). VHWOs offer free or low cost services to the general public or to certain segments of society, and are supported primarily by public contributions. A shelter for the homeless would be considered a VHWO. A private foundation is not public. An art museum and a public golf course charge fees. (Chapter 20-2-3, CBT Skill: Understanding, CSO: 5.1.4)

34. (b) Convertible bonds provide the bondholder the option of converting the bond to capital stock, typically common stock. Using the book value method, the conversion of the bonds into common stock is generally recorded by crediting

the paid-in capital accounts for the carrying amount of the debt at the date of the conversion, less any cost associated with the conversion. The carrying amount of the bonds on the date of conversion is the \$1,000,000 face value less the \$100,000 unamortized discount. The market value is not considered when using the book value method. The journal entry:

Bonds Payable	1,000,000	
Bond Discount		100,000
Common Stock (100,000 × \$1 par)		100,000
APIC (to balance)		800,000

The \$100,000 credit to common stock and \$800,000 credit to APIC would increase stockholders' equity \$900,000. (Chapter 6-4-2, CBT Skill: Analysis, CSO: 2.11.0)

35. (b) Imposed nonexchange revenues represent assessments imposed on non-governmental entities and include property taxes and fines or forfeitures. Governments should recognize revenues from property taxes, net of estimated refunds and estimated uncollectible amounts, in the period for which the taxes are levied, even if the enforceable legal claim arises or the due date for payment occurs in a different period. All other imposed nonexchange revenues should be recognized in the same period that the assets are recognized unless the enabling legislation includes time requirements. If so, revenues should be recognized in the period when the resources are required to be used or when use is first permitted. (Resources received or recognized as receivable before that period should be reported as deferred revenues.) The \$1,980,000 is derived by from the total \$2,000,000 levied less \$20,000 (the 1% of \$2,000,000) expected to be uncollectible. The \$15,000 written off as uncollectible does not factor anywhere in the equation. (Chapter 18-3-1, CBT Skill: Analysis, CSO: 4.2.1)

36. (c) An option contract is a derivative. Derivatives are recognized as assets or liabilities on the financial statements and measures using fair value. Changes in fair value of non-hedge securities are reported as gains or losses in earnings. On December 1, Bann would initially record the option contract at \$80,600 (2,000 shares × \$40 market price on December 1 + \$600 time value). At the end of December, the fair value of the option contract was \$86,400 (2,000 shares × \$43 market price on December 31 + \$400 time value). Bann would report this change in fair value

which would result in net income increasing by \$5,800. (Chapter 2-5-2, CBT Skill: Analysis, CSO: 3.8.0)

37. (c) Conditional promises to give, which depend on the occurrence of a specified future and uncertain event to bind the promisor, shall be recognized when the conditions on which they depend are substantially met. A conditional promise to give is considered unconditional if the possibility that the condition will not be met is remote. A transfer of assets with a conditional promise to contribute them shall be accounted for as a refundable advance until the conditions have been substantially met. (Chapter 20-1-4, CBT Skill: Analysis, CSO: 5.1.1)

38. (c) The term current liabilities is used primarily to designate obligations whose liquidation is reasonably expected to require the use of existing resources classified as current assets, or the creation of other current liabilities. Accounts payable is a type of current liability. Short-term obligations are those scheduled to mature within one year or operating cycle, whichever is longer, and generally are classified as current liabilities. However, if they are to be refinanced on a long-term basis they will be appropriately classified as long-term liabilities. Exclusion from current liabilities requires two conditions be met; 1) the enterprise must intend to refinance the obligation on a long-term basis, and 2) the enterprise must have the ability to consummate the financing. A refinancing that occurs after the balance sheet date but before the issuance of the balance sheet is evidence of intent and ability. (Chapter 7-2-4, CBT Skill: Analysis, CSO: 1.2.2)

39. (d) Pledges are reported in the period in which they are made, net of an allowance for uncollectible amounts. If part of a pledge is to be applied during some future period, that part is reported as restricted revenue. Although the \$300,000 of pledges received during the current year was unrestricted as to its use, there was a time restriction (designated for next year) on \$100,000. The \$100,000 less \$5,000, for the 5% expected to be uncollectible, equals \$95,000 to be reported as restricted support. (Chapter 20-1-4, CBT Skill: Analysis, CSO: 5.2.1)

40. (b) The term current liabilities is used primarily to designate obligations whose liquidation is reasonably expected to require the use of existing resources classified as current assets, or the creation of other current liabilities. Long-term

liabilities are all obligations not expected to be liquidated by the use of existing current assets or by the creation of current liabilities. Short-term obligations are those scheduled to mature within one year or operating cycle, whichever is longer, and generally are classified as current liabilities. However, if they are to be refinanced on a long-term basis they will be appropriately classified as long-term liabilities. Income taxes payable within the next period, or operating cycle, are classified as current liabilities. A deferred tax liability is over a longer period of time and not considered a current liability. The only amount that would be reported is the \$16,000 due within 12 months from the mortgage note payable. (Chapter 7-1-3, CBT Skill: Analysis, CSO: 1.2.2)

41. (b) The exchange rate to be used for translation of foreign currency transactions is as follows. At the date the transaction is recognized, each asset, liability, revenue, expense, gain, or loss arising from the transaction should be measured and recorded in the functional currency of the recording entity by use of the exchange rate in effect at that date. At each balance sheet date, recorded balances that are denominated in a currency other than the functional currency of the recording entity should be adjusted to reflect the current exchange rate. These adjustments should be currently recognized as transaction gains or losses and reported as a component of income from continuing operations. Upon settlement, a transaction gain or loss, measured from the transaction date or the most recent intervening balance sheet date (whichever is later), should be included as a component of income from continuing operations for the period in which the transaction is settled. The U.S. company would recognize a gain of \$100 when the receivable is collected (settlement date) based on 2,000 pounds \times \$0.05, the increase in the exchange rate of \$1.45 on the balance sheet date to \$1.50 on the settlement date. (Chapter 16-2-2, CBT Skill: Analysis, CSO: 3.9.0)

42. (a) The amount of the bonus is determined by solving the proper equation that describes the terms of the bonus agreement. Using B to represent the bonus, B equals 25% of the total of income before taxes less \$100,000 less B. The answer is computed as follows:

$B = 0.25 \times (\$160,000 - \$100,000 - B)$; setup
 $B = 0.25 \times (\$60,000 - B)$; reduced \$ figure
 $B = \$15,000 - .25B$; simplified right-side
 $1.25B = \$15,000$; added .25B to both sides
 $B = \$12,000$; divided both sides by 1.25

(Chapter 7-1-4, CBT Skill: Analysis, CSO: 2.12.0)

43. (d) A warranty or guarantee is a promise made by the seller to the buyer to make good certain deficiencies in the product during a specified period of time after the sale. Obligations related to product warranties and product defects are an example of loss contingencies. An estimated loss from a loss contingency shall be accrued by a charge to income if both of the following conditions are met; 1) information available prior to the issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements, and 2) the amount of the loss can be reasonably estimated. It is probable that repairs are required and the 2% of net sales is a reasonable estimate so there is a charge to income through warranty expense. Proper accrual of the warranty expense for year 2 would be 2% of the net sales from year 2 ($0.02 \times \$300,000 = \$6,000$). (Chapter 7-1-5, CBT Skill: Analysis, CSO: 2.10.0)

44. (b) A bond that is issued with a stated rate of interest that is less than the effective rate on the issuance date is a bond issued with a discount. A bond issued at a discount will have an increasing carrying value and an increasing amount of interest expense. On the first interest payment date the company should report an interest expense that is greater than the cash payment made to bondholders. (Chapter 6-2-3, CBT Skill: Judgment, CSO: 2.9.0)

45. (a) Net cash flow from operating activities may be reported under the indirect method by adjusting net income to reconcile it to net cash flow from operating activities. The reconciliation of net income to net cash flow from operating activities should separately report all major classes of reconciling items. In addition, when the direct method is used, amounts of interest paid (net of amounts capitalized) and income taxes paid during the period should be provided in related disclosures. The \$325,000 income taxes paid plus the \$220,000 net interest payments total \$545,000. (Chapter 14-1-3, CBT Skill: Analysis, CSO: 1.2.4)

46. (a) In general, accounting for non-monetary transactions (those involving nonmonetary assets or liabilities) should be based on the fair values of the assets involved. The acquisition is recorded at the fair value of the asset surrendered or the fair value of the asset received, whichever is more clearly determinable, and gains or losses should be recognized. The rationale associated with immediate gain/loss, recording the transactions at fair value, is that the exchange represents the culmination of the earnings process associated with the assets surrendered. The best statement describing the proper accounting for losses when nonmonetary assets are exchanged is that a loss is recognized immediately, because assets received should not be valued at more than their cash equivalent price. (Chapter 4-2-1, CBT Skill: Judgment, CSO: 3.14.0)

47. (d) The change from cash-basis accounting to accrual-basis accounting is a change in accounting principle. A change in accounting principle results from the adoption of a generally accepted accounting principle (GAAP) different from the GAAP previously used for reporting purposes. A change in accounting principle is reported through retrospective application of the new accounting principle to all prior periods, unless it is impracticable to do so. Retrospective application requires the following: 1) the cumulative effect of the change to the new accounting principle on periods prior to those presented shall be reflected in the carrying amounts of assets and liabilities as of the beginning of the first period presented or earliest period to which the new accounting principle can be applied, 2) an offsetting adjustment, if needed, shall be made to the opening balance of retained earnings for that period, 3) financial statements for each individual prior period presented shall be adjusted to reflect the period-specific effects of applying the new principle, and 4) only the direct effects of a change in accounting principle are included in retrospective application, including any related income tax effects. (Chapter 11-4-1, CBT Skill: Judgment, CSO: 3.1.0)

48. (a) Cash flows from operating activities are generally the cash effects of transactions and other events that enter into the determination of net income. Both the \$28,000 from dividends that were declared and paid and the \$200,000 from issuance of common stock are cash flows from financing activities, not operating. With the limited information provided it is best to use the

indirect method to compute the cash provided by operating activities. Computation under this method is done by converting net income to net cash flow from operating activities. Start with net income and then make adjustments to reconcile net income to net cash provided by operating activities. Take the \$78,000 net income less the \$82,000 increase in accounts receivable plus the \$24,000 increase in accounts payable and the result is \$20,000 net cash provided by operating activities. (Chapter 14-3-3, CBT Skill: Analysis, CSO: 1.2.4)

49. (b) A lease is classified as a capital lease if at the date of the lease agreement the lease satisfies at least one of the following four criteria: 1) the lease transfers ownership of the property to the lessee by the end of the lease, or 2) the lease contains a bargain purchase option, or 3) the lease term is equal to 75% or more of the estimated economic life of the leased property, or 4) the present value of the minimum lease payments equals or exceeds 90% of the fair value of the leased property at lease inception. (Chapter 8-2-1, CBT Skill: Understanding, CSO: 3.13.0)

50. (a) A bond issued at 98 indicates the bond was issued at a 2% discount. The entry the company would use to record the original issue would be a debit to cash for \$49,000, a debit to bond discount for \$1,000 and a credit to bonds payable for \$50,000. (Chapter 6-2-3, CBT Skill: Analysis, CSO: 2.9.0)

Solution 3 SIMULATION ANSWERS

Deferred Tax Worksheet

Stanhope, Inc.
Worksheet for Deferred Income Taxes
Year ended December 31, year 2

	A	B	C	D
1	Description of temporary differences	Temporary differences	Deferred tax assets	Deferred tax liabilities
2	Allowance for doubtful accounts	21,000	6,930	
3	Accumulated depreciation, excess of tax over GAAP	767,000		253,110
4	Unrealized gain (loss) on trading securities	8,000		2,640
5				
6				
7				
8				
9	Totals		6,930	255,750

Explanations:

Row 2: The Allowance for doubtful accounts (bad debts) is a temporary difference in that for financial reporting an allowance method is used to record bad debts expense for the year whereas for income tax purposes a direct write off method is used. The amount of the temporary difference is \$21,000; the \$11,000 starting balance less \$5,000 actually written off plus the additional \$15,000 charged. This results in a deferred tax asset of \$6,930, $\$21,000 \times 33\%$ (the enacted tax rate), because this amount is expected to be written off for income tax purposes in future years,

Row 3: The Accumulated depreciation, excess of tax over GAAP is a temporary difference in that for financial reporting the straight-line depreciation rate is used and for income tax purposes accelerated methods are used. The amount of the temporary difference is \$767,000 (the amount provided as the difference at December 31, year 2). This results in a deferred tax liability of \$253,110, the \$767,000 × 33% (the enacted tax rate), because more income will be taxable in future years.

Row 4: The Unrealized gain (loss) on trading securities is a temporary difference in that for financial reporting the unrealized gain (loss) is reported in current income and for income tax purposes it is not. The amount of the temporary difference is \$8,000 (the amount provided at December 31, year 2). This results in a deferred tax liability of \$2,640, \$8,000 × 33% (the enacted tax rate), because more income will be taxable in future years.

Row 9, columns C and D: The total sum of deferred tax assets and deferred tax liabilities, respectively.

Balance Sheet – Deferred Taxes

Assets:		
Deferred taxes, current asset	4,290	[1]
Deferred taxes, noncurrent asset	-	[2]
Liabilities:		
Deferred taxes, current liability	-	[3]
Deferred taxes, noncurrent liability	253,110	[4]

[1] The allowance for doubtful accounts and unrealized gain on trading securities are allowance-type accounts that will be reviewed annually and as such are considered current. They equal a net \$4,290 asset.

[2] There are no noncurrent deferred tax assets.

[3] There are no current deferred taxes liabilities

[4] No information was given stating the depreciable asset's carrying amount will be recovered through use or sale within the next year so it is implied that it is noncurrent.

Communication

To: Vice president, Stanhope, Inc.

Re: Deferred Income Taxes

The objective of accounting for income taxes is to recognize the amount of taxes payable or refundable for the current year. A second objective is to recognize deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an enterprise's financial statements or tax returns. A current tax liability or asset is recognized for the estimated taxes payable or refundable on tax returns for the current year. A deferred tax liability or asset is recognized for the estimated future tax effects attributable to temporary differences and carryforwards. The measurement of current and deferred tax liabilities and assets is based on provisions of the enacted tax law; the effects of future changes in tax laws or rates are not anticipated. The measurement of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that, based on available evidence, are not expected to be realized. Deferred tax liabilities and assets must be adjusted in the period of enactment for the effect of an enacted change in tax laws or rates. The effect is included in income from continuing operations.

The objective of general purpose external financial reporting is to provide information that is useful to present and potential investors and creditors and others in making investment, credit, and similar resource allocation decisions. To help achieve its objective, financial reporting should provide information to help present and potential investors and creditors and others to assess the amounts, timing, and uncertainty of the entity's future cash inflows and outflows (the entity's future cash flows). To help present and potential

investors and creditors and others in assessing an entity's ability to generate net cash inflows, financial reporting should provide information about the economic resources of the entity (its assets) and the claims to those resources (its liabilities and equity). Information about the effects of transactions and other events and circumstances that change resources and claims to them is also essential.

Tax laws often differ from the recognition and measurement requirements of financial accounting standards, and differences can arise between (a) the amount of taxable income and pretax financial income for a year and (b) the tax bases of assets or liabilities and their reported amounts in financial statements. Differences between the years in which transactions affect taxable income and the years in which they enter into the determination of pretax financial income are called timing differences. Timing differences create differences (sometimes accumulating over more than one year) between the tax basis of an asset or liability and its reported amount in financial statements. Other events such as business combinations may also create differences between the tax basis of an asset or liability and its reported amount in financial statements. All such differences collectively are referred to as temporary differences.

Temporary differences ordinarily become taxable or deductible when the related asset is recovered or the related liability is settled. A deferred tax liability or asset represents the increase or decrease in taxes payable or refundable in future years as a result of temporary differences and carryforwards at the end of the current year. A deferred tax liability is recognized for temporary differences that will result in taxable amounts in future years. A deferred tax liability is recognized in the current year for the related taxes payable in future years. A deferred tax asset is recognized for temporary differences that will result in deductible amounts in future years and for carryforwards. A deferred tax asset is recognized in the current year for the reduction in taxes payable in future years. A valuation allowance is recognized if, based on the weight of available evidence, it is more likely than not that some portion or all of the deferred tax asset will not be realized.

Research

FAS 109, Par. 27 or FAS 109, par.112

27. Deferred tax liabilities and assets shall be adjusted for the effect of a change in tax laws or rates. The effect shall be included in income from continuing operations for the period that includes the enactment date.

112. A change in tax law or rate or a change in the tax status of an enterprise is an event that has economic consequences for an enterprise in the year that the change occurs, that is, in the year that a change in tax law or rate is enacted or a change in tax status is approved. As a result of the change, deferred tax consequences become larger or smaller. Conceptually, it could be argued that an enterprise should anticipate the tax effect of an expected future change in tax law or rate or a change in tax status on its deferred tax liability or asset at the end of the current year. The Board believes, however, that recognition of those tax consequences in the year that a change occurs permits a more reliable measurement of the economic effects of an enacted change in tax law or rate or a change in the tax status of an enterprise.