1984

# Accounting Theory: selected questions and unofficial answers indexed to content specification outline, Uniform CPA Examination/May 1979-November 1983

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# accounting theory

## Selected Questions And Unofficial Answers Indexed To Content Specification Outline

edited by James D. Blum and Charles A. Rhuda

AICPA
American Institute of Certified Public Accountants

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**FOREWORD**

The Uniform CPA Examination is prepared by the Board of Examiners of the American Institute of Certified Public Accountants, and is used by the examining boards of all fifty states of the United States, the District of Columbia, Puerto Rico, Guam, and the Virgin Islands, as a prerequisite for issuance of CPA certificates.

This booklet contains selected questions and unofficial answers from the last ten Accounting Theory sections of the Uniform Certified Public Accountant Examination. The questions and unofficial answers have been indexed in accordance with the Accounting Theory Content Specification Outline for the Uniform Certified Public Accountant Examination.

All questions are identified by a boldface code indicating the month—May **(M)** or November **(N)**—the year **(79** through **83)**, and the question number in the original examination. Within the content specification areas and groups, questions and answers have been arranged in reverse chronological order.

Each individual multiple choice question is indexed according to the area and group it tests. In some cases, a common fact pattern is used for two or more multiple choice questions. In such cases, where different areas and groups are being tested by questions referring to a common fact pattern, the fact pattern is repeated to accompany the questions indexed in each applicable area or group.

Where essay questions and their answers involve more than one part—for example, part a. and part b.—the essays have been separated and indexed according to areas tested. Thus, all parts of a question and its answer may not appear in their original examination sequence.

Although the questions and unofficial answers may be used for many purposes, the principal reason for their publication is to aid candidates in preparing to take the examination. Candidates are also encouraged to read *Information for CPA Candidates,* which describes the content, grading, and other administrative aspects of the Uniform CPA Examination.

The unofficial answers were prepared by the staff of the Examinations Division and reviewed by the Board of Examiners but are not purported to be official positions of the American Institute of Certified Public Accountants.

William C. Bruschi, *Vice President—Examinations and Regulation*
American Institute of Certified Public Accountants

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## MULTIPLE CHOICE ITEMS — SELECTED QUESTIONS

### I. General Concepts, Principles, Terminology, Environment, and Other Professional Standards

#### C. Conceptual Framework

**N83#1.** Under Statement of Financial Accounting Concepts No. 3, comprehensive income includes which of the following?

| | *Losses* | *Contribution margin* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | Yes |
| d. | Yes | No |

**N83#2.** Under Statement of Financial Accounting Concepts No. 3, the term recognized is synonymous with the term

a. Recorded.
b. Realized.
c. Matched.
d. Allocated.

**M83#1.** Under Statement of Financial Accounting Concepts No.2, feedback value is an ingredient of the primary quality of

| | *Relevance* | *Reliability* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | Yes |
| d. | Yes | No |

**M83#2.** Under Statement of Financial Accounting Concepts No. 2, which of the following interacts with both relevance and reliability to contribute to the usefulness of information?

a. Comparability.
b. Timeliness.
c. Neutrality.
d. Predictive value.

**M83#3.** Under Statement of Financial Accounting Concepts No. 3, interrelated elements that are directly related to measuring performance and status of an enterprise include

| | *Distribution to owners* | *Notes to financial statements* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |

**M83#4.** Under Statement of Financial Accounting Concepts No. 3, gains on assets unsold are identified, in a precise sense, by the term

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

**N82#1.** Under Statement of Financial Accounting Concepts No. 2, the ability through consensus among measurers to ensure that information represents what it purports to represent is an example of the concept of

a. Relevance.
b. Verifiability.
c. Comparability.
d. Feedback value.

**N82#29.** Under Statement of Financial Accounting Concepts No. 2, which of the following is an ingredient of the primary quality of relevance?

a. Predictive value.
b. Materiality.
c. Understandability.
d. Verifiability.

**N82#30.** Under Statement of Financial Accounting Concepts No. 2, which of the following is an ingredient of the primary quality of reliability?

a. Understandability.
b. Verifiability.
c. Predictive value.
d. Materiality.

**M82#14.** Which of the following is considered a pervasive constraint by Statement of Financial Accounting Concepts No. 2?

a. Benefits/costs.
b. Conservatism.
c. Timeliness.
d. Verifiability.

**M82#15.** According to Statement of Financial Accounting Concepts No. 2, an interim earnings report is expected to have which of the following?

| | *Predictive value* | *Feedback value* |
|---|---|---|
| a. | No | No |
| b. | Yes | Yes |
| c. | Yes | No |
| d. | No | Yes |

**M82#33.** According to Statement of Financial Accounting Concepts No. 2, relevance and reliability are the two primary qualities that make accounting information useful for decision making. Predictive value is an ingredient of

| | *Relevance* | *Reliability* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | Yes |
| d. | Yes | No |

**N81#2.** The information provided by financial reporting pertains to

a. Individual business enterprises, rather than to industries or an economy as a whole or to members of society as consumers.
b. Individual business enterprises and industries, rather than to an economy as a whole or to members of society as consumers.
c. Individual business enterprises and an economy as a whole, rather than to industries or to members of society as consumers.
d. Individual business enterprises, industries, and an economy as a whole, rather than to members of society as consumers.

**M81#11.** Financial reporting provides information about an enterprise's performance during a period when it was under the direction of a particular management

a. But does **not** directly provide information about that management's performance.
b. And directly provides information about that management's performance.
c. And directly provides information about both management performance and enterprise performance.
d. And directly provides estimates of an enterprise's earning power.

**N79#18.** One of the basic features of financial accounting is the

a. Direct measurement of economic resources and obligations and changes in them in terms of money and sociological and psychological impact.
b. Direct measurement of economic resources and obligations and changes in them in terms of money.
c. Direct measurement of economic resources and obligations and changes in them in terms of money and sociological impact.
d. Direct measurement of economic resources and obligations and changes in them in terms of money and psychological impact.

## D. Basic Concepts and Accounting Principles

**N83#3.** Some costs cannot be directly related to particular revenues but are incurred to obtain benefits in the period in which the costs are incurred. An example of such a cost is

a. Electricity used to light offices.
b. Transportation to customers.
c. Cost of merchandise sold.
d. Sales commissions.

**M83#5.** Which of the following is expensed under the principle of systematic and rational allocation?

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

**M82#16.** Uncertainty and risks inherent in business situations should be adequately considered in financial reporting. This statement is an example of the concept of

a. Conservatism.
b. Completeness.
c. Neutrality.
d. Representational faithfulness.

**N81#1.** Imputing interest for certain assets and liabilities is primarily based on the concept of

a. Valuation.
b. Conservatism.
c. Consistency.
d. Stable monetary unit.

**N81#3.** Which of the following is an application of the principle of systematic and rational allocation?

a. Amortization of intangible assets.
b. Sales commissions.
c. Research and development costs.
d. Officers' salaries.

**N81#4.** A patent, purchased in 1978 and being amortized over a ten-year life, was determined to be worthless in 1981. The write-off of the asset in 1981 is an example of which of the following principles?
a. Associating cause and effect.
b. Immediate recognition.
c. Systematic and rational allocation.
d. Objectivity.

**N81#5.** The accrued balance in a revenue account represents an amount which is

| | *Earned* | *Collected* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |

**M81#2.** The valuation of a promise to receive cash in the future at present value on the financial statements of a business entity is valid because of the accounting concept of
a. Entity.
b. Materiality.
c. Going concern.
d. Neutrality.

**M81#3.** Which of the following is an example of the expense recognition principle of associating cause and effect?
a. Allocation of insurance cost.
b. Sales commissions.
c. Depreciation of fixed assets.
d. Officers' salaries.

**M81#4.** Accruing net losses on firm purchase commitments for inventory is an example of the accounting concept of
a. Conservatism.
b. Realization.
c. Consistency.
d. Materiality.

**M81#5.** Which of the following accounting concepts states that an accounting transaction should be supported by sufficient evidence to allow two or more qualified individuals to arrive at essentially similar measures and conclusions?
a. Matching.
b. Objectivity.
c. Periodicity.
d. Stable monetary unit.

**N80#5.** Objectivity is assumed to be achieved when an accounting transaction
a. Is recorded in a fixed amount of dollars.
b. Involves the payment or receipt of cash.
c. Involves an arm's-length transaction between two independent parties.
d. Allocates revenues or expenses in a rational and systematic manner.

**N80#6.** The concept of consistency is sacrificed in the accounting for which of the following income statement items?
a. Discontinued operations.
b. Loss on disposal of a segment of a business.
c. Extraordinary items.
d. Cumulative effect of change in accounting principle.

**N80#12.** When bad debt expense is estimated on the basis of the percentage of past actual losses from bad debts to past net credit sales, and this percentage is adjusted for anticipated conditions, the accounting concept of
a. Matching is being followed.
b. Matching is **not** being followed.
c. Substance over form is being followed.
d. Going concern is **not** being followed.

**M80#26.** The principle of objectivity includes the concept of
a. Summarization.
b. Classification.
c. Conservatism.
d. Verifiability.

**M80#29.** What is the underlying concept that supports the immediate recognition of a loss?
a. Conservatism.
b. Consistency.
c. Judgment.
d. Matching.

**N79#4.** An accrued expense is an expense
a. Incurred but **not** paid.
b. Incurred and paid.
c. Paid but **not** incurred.
d. **Not** reasonably estimable.

**N79#5.** Under what condition is it proper to recognize revenues prior to the sale of the merchandise?
a. When the ultimate sale of the goods is at an assured sales price.
b. When the revenue is to be reported as an installment sale.
c. When the concept of internal consistency (of amounts of revenue) must be complied with.
d. When management has a long-established policy to do so.

**N79#9.** Which of the following principles **best** describes the current method of accounting for research and development costs?
a. Associating cause and effect.
b. Systematic and rational allocation.
c. Income tax minimization.
d. Immediate recognition as an expense.

**N79#19.** Which of the following is an example of the concept of conservatism?
  a. Stating inventories at the lower of cost or market.
  b. Stating inventories using the FIFO method in periods of rising prices.
  c. Using the percentage-of-completion method in the first year of a long-term construction contract.
  d. Using the interest method instead of the straight-line method to record interest in the first year of a long-term receivable.

**N79#27.** Continuation of an accounting entity in the absence of evidence to the contrary is an example of the basic concept of
  a. Accounting entity.
  b. Consistency.
  c. Going concern.
  d. Substance over form.

### E. Nonmonetary Transactions Concepts

**M82#17.** In an arm's-length transaction, Company A and Company B exchanged nonmonetary assets with no monetary consideration involved. The exchange did culminate an earning process for both Company A and Company B, and the fair values of the nonmonetary assets were both clearly evident. The accounting for the exchange should be based on the
  a. Fair value of the asset surrendered.
  b. Fair value of the asset received.
  c. Recorded amount of the asset surrendered.
  d. Recorded amount of the asset received.

**N80#24.** When the fair value is determinable, a nonreciprocal transfer of a nonmonetary asset to another entity should be recorded at the
  a. Fair value of the asset received, but no gain or loss should be recognized on the disposition of the asset.
  b. Fair value of the asset transferred, and a gain or loss should be recognized on the disposition of the asset.
  c. Recorded amount of the asset transferred.
  d. Recorded amount of the asset received.

**M80#30.** Company A and Company B exchanged nonmonetary assets with **no** monetary consideration involved and **no** impairment of value. The exchange did **not** culminate an earning process for either Company A or Company B. The accounting for the exchange should be based on the
  a. Recorded amount of the asset received.
  b. Recorded amount of the asset relinquished.
  c. Fair value of the asset received.
  d. Fair value of the asset relinquished.

### H. Consolidated Financial Statements

**N82#2.** How would the retained earnings of a subsidiary acquired in a business combination usually be treated in a consolidated balance sheet prepared immediately after the acquisition?
  a. Excluded for both a purchase and a pooling of interests.
  b. Excluded for a pooling of interests but included for a purchase.
  c. Included for both a purchase and a pooling of interests.
  d. Included for a pooling of interests but excluded for a purchase.

**N82#4.** Consolidated financial statements are typically prepared when one company has
  a. Accounted for its investment in another company by the equity method.
  b. Accounted for its investment in another company by the cost method.
  c. Significant influence over the operating and financial policies of another company.
  d. The controlling financial interest in another company.

**M82#12.** A subsidiary may be acquired by issuing common stock in a pooling of interests transaction or by paying cash in a purchase transaction. Which of the following items would be reported in the consolidated financial statements at the same amount regardless of the accounting method used?
  a. Minority interest.
  b. Goodwill.
  c. Retained earnings.
  d. Capital stock.

**M82#18.** Ownership of 51 percent of the outstanding voting stock of a company would usually result in
  a. The use of the cost method.
  b. The use of the lower of cost or market method.
  c. A pooling of interests.
  d. A consolidation.

**M79#17.** Consolidated financial statements are prepared when a parent-subsidiary relationship exists in recognition of the accounting concept of
  a. Materiality.
  b. Entity.
  c. Objectivity.
  d. Going concern.

## I. Historical Cost, Constant Dollar, Current Cost, and Other Accounting Concepts

**N83#4.** When computing information on a historical cost/constant dollar basis, which of the following is classified as monetary?
  a. Equity investment in unconsolidated subsidiaries.
  b. Obligations under warranties.
  c. Unamortized discount on bonds payable.
  d. Deferred investment tax credits.

**M83#6.** When computing information on a historical cost/constant dollar basis, which of the following is classified as nonmónetary?
  a. Allowance for doubtful accounts.
  b. Accumulated depreciation of equipment.
  c. Unamortized premium on bonds payable.
  d. Advances to unconsolidated subsidiaries.

**M83#7.** A method of accounting based on measures of current cost or lower recoverable amount, without restatement into units having the same general purchasing power, is
  a. Historical cost/constant dollar accounting.
  b. Historical cost/nominal dollar accounting.
  c. Current cost/constant dollar accounting.
  d. Current cost/nominal dollar accounting.

**N82#3.** In accordance with FASB Statement No. 33, the Consumer Price Index for All Urban Consumers is used to compute information on a
  a. Historical cost basis.
  b. Current cost basis.
  c. Constant dollar basis.
  d. Nominal dollar basis.

**N82#33.** When computing information on a historical cost/constant dollar basis, which of the following is classified as monetary?
  a. Obligations under warranties.
  b. Inventories, other than inventories used on contracts.
  c. Trademarks.
  d. Accrued losses on firm purchase commitments.

**N82#34.** When measuring the current cost of inventories in accordance with FASB Statement No. 33, the "entry" date can mean which of the following?

| | *Beginning of year* | *Date of sale* |
|---|---|---|
| a. | Yes | No |
| b. | Yes | Yes |
| c. | No | Yes |
| d. | No | No |

**M82#26.** When computing information on a historical cost/constant dollar basis, which of the following is classified as nonmonetary?
  a. Obligations under warranties.
  b. Accrued expenses payable.
  c. Unamortized premium on bonds payable.
  d. Refundable deposits.

**M82#36.** A method of accounting based on measures of historical prices in dollars, each ȯf which has the same general purchasing power, is
  a. Current cost/constant dollar accounting.
  b. Current cost/nominal dollar accounting.
  c. Historical cost/constant dollar accounting.
  d. Historical cost/nominal dollar accounting.

**M82#39.** In accordance with FASB Statement No. 33, purchasing power gain or loss results from which of the following?

| | *Monetary assets and liabilities* | *Nonmonetary assets and liabilities* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |

**N81#6.** FASB Statement No. 33 requires that the current cost for inventories be measured as the
  a. Recoverable amount regardless of the current cost.
  b. Current cost regardless of the recoverable amount.
  c. Higher of current cost or recoverable amount.
  d. Lower of current cost or recoverable amount.

**N81#7.** When computing information on a historical cost/constant dollar basis, which of the following is classified as nonmonetary?
  a. Cash surrender value of life insurance.
  b. Long-term receivables.
  c. Allowance for doubtful accounts.
  d. Inventories, other than inventories used on contracts.

**M80#27.** Financial statements that are expressed assuming a stable monetary unit are
  a. General price-level financial statements.
  b. Historical-dollar financial statements.
  c. Current-value financial statements.
  d. Fair-value financial statements.

## II. Measurement, Valuation, Realization, and Presentation of Assets in Conformity With Generally Accepted Accounting Principles

### B. Marketable Securities and Investments

**N83#5.** A security in a current marketable equity securities portfolio is transferred to a noncurrent marketable equity securities portfolio. The security should be transferred between the corresponding portfolios at

a. The book value at date of transfer if higher than the market value at date of transfer.
b. The market value at date of transfer, regardless of its cost.
c. Its cost, regardless of the market value at date of transfer.
d. The lower of its cost or market value at date of transfer.

**N83#6.** Cash dividends declared out of current earnings are distributed to an investor. How will the investor's investment account be affected by those dividends under each of the following accounting methods?

| | *Cost method* | *Equity method* |
|---|---|---|
| a. | Decrease | No effect |
| b. | Decrease | Decrease |
| c. | No effect | Decrease |
| d. | No effect | No effect |

**M83#8.** Accumulated changes in the valuation allowance for a long-term marketable equity securities portfolio should be a component of

a. Current assets.
b. Noncurrent assets.
c. Noncurrent liabilities.
d. Net income.

**M83#9.** An investor purchased a bond as a long-term investment on January 1. Annual interest was received on December 31. The investor's interest income for the year would be lowest if the bond was purchased at

a. A discount.
b. A premium.
c. Par.
d. Face value.

**M83#13.** When an investor uses the equity method to account for investments in common stock, the investment account will be increased when the investor recognizes

a. A proportionate interest in the net income of the investee.
b. A cash dividend received from the investee.
c. Periodic amortization of the goodwill related to the purchase.
d. Depreciation related to the excess of market value over book value of the investee's depreciable assets at the date of purchase by the investor.

**N82#5.** When an investor uses the cost method to account for investments in common stock, cash dividends received by the investor from the investee should normally be recorded as

a. Dividend income.
b. An addition to the investor's share of the investee's profit.
c. A deduction from the investor's share of the investee's profit.
d. A deduction from the investment account.

**N81#16.** Which of the following conditions generally exists before market value can be used as the basis for valuation of a company's marketable equity securities?

a. Management's intention must be to dispose of the securities within one year.
b. Market value must be less than cost for each security held in the company's marketable equity security portfolio.
c. Market value must approximate historical cost.
d. The aggregate market value of a company's marketable equity security portfolio must be less than the aggregate cost of the portfolio.

**N80#19.** The equity method of accounting for an investment in the common stock of another company should be used when the investment

a. Is composed of common stock and it is the investor's intent to vote the common stock.
b. Ensures a source of supply such as raw materials.
c. Enables the investor to exercise significant influence over the investee.
d. Is obtained by an exchange of stock for stock.

**N80#20.** A parent corporation which uses the equity method of accounting for its investment in a 40 percent owned subsidiary, which earned $20,000 and paid $5,000 in dividends, made the following entries:

| | | |
|---|---|---|
| Investment in subsidiary | $8,000 | |
| Equity in earnings of subsidiary | | $8,000 |
| Cash | $2,000 | |
| Dividend revenue | | $2,000 |

What effect will these entries have on the parent's statement of financial position?

a. Investment in subsidiary understated, retained earnings understated.
b. Investment in subsidiary overstated, retained earnings overstated.
c. Investment in subsidiary overstated, retained earnings understated.
d. Financial position will be fairly stated.

**N80#23.** For a marketable equity securities portfolio included in noncurrent assets, which of the following should be included in net income of the period?

a. Realized gains during the period.
b. Unrealized losses during the period.
c. Accumulated changes in the valuation allowance.
d. Increases in the valuation allowance during the period.

**M80#2.** The carrying amount of a current marketable equity securities portfolio in the balance sheet of a company shall be the aggregate

a. Cost of the portfolio, whether it is higher than or lower than the aggregate market value of the portfolio.
b. Cost of the portfolio, when it is higher than the aggregate market value of the portfolio.
c. Market value of the portfolio, whether it is higher than or lower than the aggregate cost of the portfolio.
d. Market value of the portfolio, when it is lower than the aggregate cost of the portfolio.

**M80#5.** When an investor uses the equity method to account for investments in common stock, cash dividends received by the investor from the investee should be recorded as

a. Dividend income.
b. A deduction from the investor's share of the investee's profits.
c. A deduction from the investment account.
d. A deduction from the stockholders' equity account, dividends to stockholders.

**N79#30.** When the market value of a company's current marketable equity securities portfolio is lower than its cost, the difference should be

a. Accounted for as a liability.
b. Disclosed and described in a footnote to the financial statements but **not** accounted for.
c. Accounted for as a valuation allowance deducted from the asset to which it relates.
d. Accounted for separately in the shareholders' equity section of the balance sheet.

**M79#15.** A marketable equity security must have a ready market in order to be classified as current, and

a. Be available to management for use in short run operations.
b. Be traded on a recognized national exchange.
c. Have a current market value in excess of original cost.
d. Have been owned less than one year.

## C. Receivables and Accruals

**N83#7.** After being held for 30 days, a 90-day 15% interest-bearing note receivable was discounted at a bank at 18%. The proceeds received from the bank upon discounting would be the

a. Maturity value less the discount at 18%.
b. Maturity value plus the discount at 18%.
c. Face value less the discount at 18%.
d. Face value plus the discount at 18%.

**N83#8.** On July 1, 1983, a company received a one-year note receivable bearing interest at the market rate. The face amount of the note receivable and the entire amount of the interest are due on June 30, 1984. When the note receivable was recorded on July 1, 1983, which of the following were debited?

| | *Interest receivable* | *Unearned discount on note receivable* |
|---|---|---|
| a. | Yes | No |
| b. | Yes | Yes |
| c. | No | No |
| d. | No | Yes |

**M83#11.** On July 1 of this year, a company received a one-year note receivable bearing interest at the market rate. The face amount of the note receivable and the entire amount of the interest are due on June 30 of next year. At December 31 of this year, the company should report in its balance sheet

a. A deferred credit for interest applicable to next year.
b. No interest receivable.
c. Interest receivable for the entire amount of the interest due on June 30 of next year.
d. Interest receivable for the interest accruing this year.

**M83#12.** A method of estimating bad debts that focuses on the income statement rather than the balance sheet is the allowance method based on

a. Direct write off.
b. Aging the trade receivable accounts.
c. Credit sales.
d. The balance in the trade receivable accounts.

**N81#9.** When a note receivable of a company is sold with recourse before maturity, the note receivable has been

a. Pledged.
b. Assigned.
c. Factored.
d. Discounted.

**M80#22.** When the accounts receivable of a company are sold outright to a company which normally buys accounts receivable of other companies without recourse, the accounts receivable have been

a. Pledged.
b. Assigned.
c. Factored.
d. Collateralized.

## D. Inventories

**N83#9.** From a theoretical viewpoint, which of the following costs would be considered inventoriable?

| | *Freight* | *Warehousing* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | No |
| d. | Yes | Yes |

**N83#10.** The dollar value LIFO inventory cost flow method uses which of the following?

a. Specific goods (single item) pools.
b. Specific cost identification method.
c. Double-extension method.
d. Moving average method.

**N83#11.** The replacement cost of an inventory item is below the net realizable value and above the net realizable value less the normal profit margin. The original cost of the inventory item is above the replacement cost and below the net realizable value. As a result, under the lower of cost or market method, the inventory item should be valued at the

a. Replacement cost.
b. Original cost.
c. Net realizable value.
d. Net realizable value less the normal profit margin.

**N82#6.** The LIFO inventory cost flow method may be applied to which of the following inventory systems?

| | *Periodic* | *Perpetual* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | Yes |
| d. | Yes | No |

**N82#7.** Under the retail inventory method, freight-in would be included in the calculation of the goods available for sale for which of the following?

| | *Cost* | *Retail* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | No |
| d. | Yes | Yes |

**M82#7.** The double-extension method and the link-chain method are two variations of which of the following inventory cost flow methods?

a. Moving average.
b. FIFO.
c. Dollar value LIFO.
d. Conventional (lower of cost or market) retail.

**N81#10.** The moving average inventory cost flow method is applicable to which of the following inventory systems?

| | *Periodic* | *Perpetual* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | No |
| d. | No | Yes |

**N81#11.** The retail inventory method would include which of the following in the calculation of the goods available for sale at both cost and retail?

a. Freight-in.
b. Purchase returns.
c. Markups.
d. Markdowns.

**N80#17.** Goods on consignment should be included in the inventory of

a. The consignor but **not** the consignee.
b. Both the consignor and the consignee.
c. The consignee but **not** the consignor.
d. Neither the consignor **nor** the consignee.

**N80#18.** Which of the following inventory cost flow methods could use dollar-value pools?

a. Conventional (lower of cost or market) retail.
b. Weighted average.
c. FIFO.
d. LIFO.

**M80#3.** Estimates of price-level changes for specific inventories are required for which of the following inventory methods?

a. Dollar-value LIFO.
b. Weighted average cost.
c. FIFO.
d. Conventional retail.

**M80#4.** If the conventional (lower of cost or market) retail inventory method is used, which of the following calculations would include (exclude) net markdowns?

| | *Cost ratio (percentage)* | *Ending inventory at retail* |
|---|---|---|
| a. | Include | Include |
| b. | Include | Exclude |
| c. | Exclude | Include |
| d. | Exclude | Exclude |

**M79#11.** Assuming **no** beginning inventory, what can be said about the trend of inventory prices if cost of goods sold computed when inventory is valued using the FIFO method exceeds cost of goods sold when inventory is valued using the LIFO method?

a. Prices decreased.
b. Prices remained unchanged.
c. Prices increased.
d. Price trend **cannot** be determined from information given.

## E. Property, Plant, and Equipment

**M83#10.** Lyle, Inc., purchased certain plant assets under a deferred payment contract on December 31, 1982. The agreement was to pay $20,000 at the time of purchase and $20,000 at the end of each of the next five years. The plant assets should be valued at

a. The present value of a $20,000 ordinary annuity for five years.
b. $120,000.
c. $120,000 less imputed interest.
d. $120,000 plus imputed interest.

**M83#14.** When one machine is retired, the accumulated depreciation account is debited for the original cost of that machine less any residual recovery under which of the following depreciation methods?

| | *Composite* | *Group* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | No |
| d. | Yes | Yes |

**M83#15.** At the end of the expected useful life of a depreciable asset with an estimated 15% salvage value, the accumulated depreciation would equal the original cost of the asset under which of the following depreciation methods?

| | *Straight-line* | *Sum-of-the-years-digits* |
|---|---|---|
| a. | Yes | Yes |
| b. | No | No |
| c. | Yes | No |
| d. | No | Yes |

**N82#8.** When a company replaces an old asphalt roof on its plant with a new fiberglass insulated roof, which of the following types of expenditure occurs?

a. Ordinary repair and maintenance.
b. Addition.
c. Rearrangement.
d. Betterment.

**N82#12.** A fixed asset with a five-year estimated useful life is sold during the second year. How would the use of the straight-line method of depreciation instead of the double-declining-balance method of depreciation affect the amount of gain or loss on the sale of the fixed asset?

| | *Gain* | *Loss* |
|---|---|---|
| a. | No effect | No effect |
| b. | No effect | Increase |
| c. | Decrease | Increase |
| d. | Increase | Decrease |

**M82#1.** A machine with a four-year estimated useful life and an estimated fifteen-percent salvage value was acquired on January 1. Would depreciation expense using the sum-of-the-years-digits method of depreciation be higher or lower than depreciation expense using the double-declining-balance method of depreciation in the first and second years?

| | *First year* | *Second year* |
|---|---|---|
| a. | Higher | Higher |
| b. | Higher | Lower |
| c. | Lower | Higher |
| d. | Lower | Lower |

**N81#12.** The composite depreciation method

a. Is applied to a group of homogeneous assets.
b. Is an accelerated method of depreciation.
c. Does **not** recognize gain or loss on the retirement of single assets in the group.
d. Excludes salvage value from the base of the depreciation calculation.

**N81#13.** A donated fixed asset for which the fair value has been determined should be recorded as a debit to fixed assets and a credit to

a. Additional paid-in capital.
b. Retained earnings.
c. Deferred income.
d. Other income.

**M80#35.** A method which excludes salvage value from the base for the depreciation calculation is

a. Straight-line.
b. Sum-of-the-years-digits.
c. Double-declining-balance.
d. Productive-output.

**M80#36.** When a company purchases land with a building on it and immediately tears down the building so that the land can be used for the construction of a plant, the costs incurred to tear down the building should be

a. Expensed as incurred.
b. Added to the cost of the plant.
c. Added to the cost of the land.
d. Amortized over the estimated time period between the tearing down of the building and the completion of the plant.

**M79#13.** The sale of a depreciable asset resulting in a loss indicates that the proceeds from the sale were

a. Less than current market value.
b. Greater than cost.
c. Greater than book value.
d. Less than book value.

## F. Capitalized Leased Assets

**M83#16.** For a capital lease, an amount equal to the present value at the beginning of the lease term of minimum lease payments during the lease term, excluding that portion of the payments representing executory costs such as insurance, maintenance, and property taxes to be paid by the lessor, together with any profit thereon, should be recorded by the lessee as a (an)

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

**N82#10.** In a lease that is recorded as a sales-type lease by the lessor, the difference between the gross investment in the lease and the sum of the present values of the components of the gross investment should be recognized as income

a. In full at the lease's expiration.
b. In full at the lease's inception.
c. Over the period of the lease using the interest method of amortization.
d. Over the period of the lease using the straight-line method of amortization.

## G. Intangibles

**N83#12.** A purchased patent has a remaining legal life of 15 years. It should be

a. Expensed in the year of acquisition.
b. Amortized over 15 years regardless of its useful life.
c. Amortized over its useful life if less than 15 years.
d. Amortized over 40 years.

**M83#17.** Should the following fees associated with the registration of an internally developed patent be capitalized?

| | *Legal fees* | *Registration fees* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |

**M83#18.** Which of the following assets acquired in 1983 are amortizable?

| | *Goodwill* | *Trademarks* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | Yes |
| d. | Yes | No |

**M82#3.** On January 1, 1975, an intangible asset with a thirty-five year estimated useful life was acquired. On January 1, 1980, a review was made of the estimated useful life, and it was determined that the intangible asset had an estimated useful life of forty-five more years. As a result of the review

a. The original cost at January 1, 1975, should be amortized over a fifty-year life.
b. The original cost at January 1, 1975, should be amortized over the remaining thirty-year life.
c. The unamortized cost at January 1, 1980, should be amortized over a forty-year life.
d. The unamortized cost at January 1, 1980, should be amortized over a thirty-five year life.

**N81#17.** Goodwill represents the excess of the cost of an acquired company over the

a. Sum of the fair values assigned to identifiable assets acquired less liabilities assumed.
b. Sum of the fair values assigned to tangible assets acquired less liabilities assumed.
c. Sum of the fair values assigned to intangible assets acquired less liabilities assumed.
d. Book value of an acquired company.

**M81#7.** Which of the following should be expensed as incurred by the franchisee for a franchise with an estimated useful life of ten years?

a. Amount paid to the franchisor for the franchise.
b. Periodic payments to a company, other than the franchisor, for that company's franchise.
c. Legal fees paid to the franchisee's lawyers to obtain the franchise.
d. Periodic payments to the franchisor based on the franchisee's revenues.

**N80#15.** A consideration in determining the useful life of an intangible asset is **not** the

a. Legal, regulatory, or contractual provisions.
b. Provisions for renewal or extension.
c. Expected actions of competitors.
d. Initial cost.

**M80#37.** Goodwill from a business combination

a. Should be expensed in the year of acquisition.
b. Is an asset that is **not** subject to amortization.
c. Is an intangible asset.
d. Occurs in a pooling of interests.

**M79#12.** What is the proper time or time period over which to match the cost of an intangible asset with revenues if it is likely that the benefit of the asset will last for an indeterminate but very long period of time?

a. Forty years.
b. Fifty years.
c. Immediately.
d. At such time as diminution in value can be quantitatively determined.

### H. Prepaid Expenses and Deferred Charges

**M83#19.** The premium on a three-year insurance policy expiring on December 31, 1982 was paid in total on January 1, 1980. Assuming that the original payment was recorded as a prepaid asset, how would each of the following be affected in 1982?

| | *Prepaid assets* | *Expenses* |
|---|---|---|
| a. | No change | Increase |
| b. | No change | No change |
| c. | Decrease | No change |
| d. | Decrease | Increase |

**N81#15.** The premium on a three-year insurance policy which expires in 1984 was paid in advance in 1980. What is the effect of this transaction on the 1980 financial statements for each of the following?

| | *Prepaid assets* | *Expenses* |
|---|---|---|
| a. | Increase | No effect |
| b. | Increase | Increase |
| c. | No effect | Increase |
| d. | No effect | No effect |

**M80#8.** Which of the following is a deferred cost that should be amortized over the periods estimated to be benefitted?

a. Prepayment of three-year insurance premiums on machinery.
b. Security deposit representing two-months' rent on leased office space.
c. Advance from customer to be returned when sale completed.
d. Property tax for this year payable next year.

## III. Valuation, Recognition, and Presentation of Liabilities in Conformity With Generally Accepted Accounting Principles

### A. Payables and Accruals

**N83#13.** The issuer of a 10-year term bond sold at par three years ago with interest payable May 1 and November 1 each year, should report on its December 31 balance sheet a (an)

a. Liability for accrued interest.
b. Addition to bonds payable.
c. Increase in deferred charges.
d. Contingent liability.

**M83#21.** When a company receives a deposit from a customer to protect itself against nonpayment for future services, the deposit should be classified by the company as

a. Revenue.
b. A liability.
c. Part of the allowance for doubtful accounts.
d. A deferred credit deducted from accounts receivable.

**N81#8.** On September 1, 1981, a company borrowed cash and signed a one-year interest-bearing note on which both the principal and interest are payable on September 1, 1982. How will the note payable and the related interest be classified in the December 31, 1981, balance sheet?

| | *Note payable* | *Accrued interest* |
|---|---|---|
| a. | Current liability | Noncurrent liability |
| b. | Noncurrent liability | Current liability |
| c. | Current liability | Current liability |
| d. | Noncurrent liability | No entry |

**N80#3.** Which of the following is an accrued liability?

a. Cash dividends payable.
b. Wages payable.
c. Rent revenue collected one month in advance.
d. Portion of long-term debt payable in current year.

**M80#7.** Rent collected in advance by the lessor for an operating lease is a (an)

a. Accrued liability.
b. Deferred asset.
c. Accrued revenue.
d. Deferred revenue.

**N79#14.** Rent revenue collected one month in advance should be accounted for as

a. Revenue in the month collected.
b. A current liability.
c. A separate item in stockholders' equity.
d. An accrued liability.

### C. Deferred Income Tax Liabilities

**M83#20.** A machine with a ten-year useful life is being depreciated on a straight-line basis for financial statement purposes, and over five years for income tax purposes under the accelerated cost recovery system. Assuming that the company is profitable and that there are and have been **no** other timing differences, the related deferred income taxes would be reported in the

balance sheet at the end of the first year of the estimated useful life as a
  a. Current liability.
  b. Current asset.
  c. Noncurrent liability.
  d. Noncurrent asset.

**D. Capitalized Lease Liability**

**M83#22.** For a six-year capital lease, the portion of the minimum lease payment in the third year applicable to the reduction of the obligation should be
  a. Less than in the second year.
  b. More than in the second year.
  c. The same as in the fourth year.
  d. More than in the fourth year.

**M82#4.** For which of the following transactions would the use of the present value of an annuity due concept be appropriate in calculating the present value of the asset obtained or liability owed at the date of incurrence?
  a. A capital lease is entered into with the initial lease payment due one month subsequent to the signing of the lease agreement.
  b. A capital lease is entered into with the initial lease payment due upon the signing of the lease agreement.
  c. A ten-year 8% bond is issued on January 2 with interest payable semi-annually on July 1 and January 1 yielding 7%.
  d. A ten-year 8% bond is issued on January 2 with interest payable semi-annually on July 1 and January 1 yielding 9%.

**N80#21.** Lease Y contains a bargain purchase option and the lease term is equal to 75 percent of the estimated economic life of the leased property. Lease Z contains a bargain purchase option and the lease term is equal to less than 75 percent of the estimated economic life of the leased property. How should the lessee classify these leases?

| | *Lease Y* | *Lease Z* |
|---|---|---|
| a. | Operating lease | Operating lease |
| b. | Operating lease | Capital lease |
| c. | Capital lease | Capital lease |
| d. | Capital lease | Operating lease |

**E. Bonds Payable**

**N83#14.** The market rate of interest for a bond issue which sells for more than its par value is
  a. Independent of rate stated on the bond.
  b. Higher than rate stated on the bond.
  c. Equal to rate stated on the bond.
  d. Less than rate stated on the bond.

**N83#15.** How would the amortization of premium on bonds payable affect each of the following?

| | *Carrying value of bond* | *Net income* |
|---|---|---|
| a. | Increase | Decrease |
| b. | Increase | Increase |
| c. | Decrease | Decrease |
| d. | Decrease | Increase |

**N83#16.** A gain on the conversion of outstanding bonds into common stock would be recognized when using the

| | *Book value method* | *Market value method* |
|---|---|---|
| a. | Yes | No |
| b. | Yes | Yes |
| c. | No | No |
| d. | No | Yes |

**N83#17.** Which of the following material gains on refunding of bonds payable should be recognized separately as an extraordinary gain?

| | *Direct exchange of old bonds for new bonds* | *Issuance of new bonds; proceeds used to retire old bonds* |
|---|---|---|
| a. | Yes | No |
| b. | Yes | Yes |
| c. | No | Yes |
| d. | No | No |

**M83#23.** Should the following bond issue costs be expensed as incurred?

| | *Legal fees* | *Underwriting costs* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | No |
| d. | Yes | Yes |

**M83#24.** For the issuer of a ten-year term bond, the amount of amortization using the interest method would increase each year if the bond was sold at a

| | *Discount* | *Premium* |
|---|---|---|
| a. | No | No |
| b. | Yes | Yes |
| c. | No | Yes |
| d. | Yes | No |

**M83#25.** A portion of the proceeds should be allocated to paid-in capital for bonds issued with

| | *Detachable stock purchase warrants* | *Nondetachable stock purchase warrants* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | No |
| d. | Yes | Yes |

**M83#30.** When the issuer of bonds exercises the call provision to retire the bonds, the excess of the cash paid over the carrying amount of the bonds should be recognized separately as a (an)

a. Extraordinary loss.
b. Extraordinary gain.
c. Loss from continuing operations.
d. Loss from discontinued operations.

**M82#6.** When the interest payment dates of a bond are May 1 and November 1, and a bond issue is sold on June 1, the amount of cash received by the issuer will be

a. Increased by accrued interest from June 1 to November 1.
b. Increased by accrued interest from May 1 to June 1.
c. Decreased by accrued interest from June 1 to November 1.
d. Decreased by accrued interest from May 1 to June 1.

**M82#8.** When the cash proceeds from a bond issued with detachable stock purchase warrants exceeds the sum of the par value of the bonds and the fair value of the warrants, the excess should be credited to

a. Additional paid-in capital.
b. Retained earnings.
c. Premium on bonds payable.
d. Detachable stock warrants outstanding.

**M81#15.** How should the cash proceeds from convertible bonds sold at issue date at par be recorded?

a. As additional paid-in capital for the portion of the proceeds attributable to the conversion feature and as a liability for the portion of the proceeds attributable to the debt.
b. As retained earnings for the portion of the proceeds attributable to the conversion feature and as a liability for the portion of the proceeds attributable to the debt.
c. As a liability for the entire proceeds.
d. As additional paid-in capital for the portion of the proceeds attributable to the conversion feature and as retained earnings for the portion of the proceeds attributable to the debt.

## G. Contingent Liabilities and Commitments

**N83#18.** On December 20, 1982, an uninsured property damage loss was caused by a company car being driven on company business by a company salesman. The company did not become aware of the loss until January 25, 1983. The amount of the loss was reasonably estimable before the company's 1982 financial statements were issued. The company's December 31, 1982, financial statements should report an estimated loss as

a. A disclosure, but **not** an accrual.
b. An accrual.
c. Neither an accrual nor a disclosure.
d. An appropriation of retained earnings.

**N82#11.** An estimated loss from a loss contingency that is probable and for which the amount of the loss can be reasonably estimated should

a. Not be accrued but should be disclosed in the notes to the financial statements.
b. Be accrued by debiting an appropriated retained earnings account and crediting a liability account or an asset account.
c. Be accrued by debiting an expense account and crediting an appropriated retained earnings account.
d. Be accrued by debiting an expense account and crediting a liability account or an asset account.

**M82#5.** A particular warranty obligation is probable and the amount of the loss can be reasonably estimated. The particular parties that will make claims under the warranty are not identifiable. An estimated loss contingency should then be

a. Classified as an appropriation of retained earnings.
b. Neither accrued nor disclosed.
c. Disclosed but **not** accrued.
d. Accrued.

**N81#14.** A threat of expropriation of assets which is reasonably possible, and for which the amount of loss can be reasonably estimated, is an example of a (an)

a. Loss contingency that should be disclosed, but **not** accrued.
b. Loss contingency that should be accrued and disclosed.
c. Appropriation of retained earnings against which losses should be charged.
d. General business risk which should **not** be accrued, and need **not** be disclosed.

**M81#10.** How should a loss contingency that is reasonably possible and for which the amount can be reasonably estimated be reported?

| | *Accrued* | *Disclosed* |
|---|---|---|
| a. | Yes | No |
| b. | No | Yes |
| c. | Yes | Yes |
| d. | No | No |

**M80#25.** Reserves for contingencies for general or unspecified business risks should

a. Be accrued in the financial statements and disclosed in the notes thereto.
b. **Not** be accrued in the financial statements but should be disclosed in the notes thereto.
c. **Not** be accrued in the financial statements and need **not** be disclosed in the notes thereto.
d. Be accrued in the financial statements but need **not** be disclosed in the notes thereto.

## IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With Generally Accepted Accounting Principles

### A. Preferred and Common Stock

**N81#19.** For a company that has only common stock outstanding, total shareholders' equity divided by the number of shares outstanding represents the
- a. Return on equity.
- b. Stated value per share.
- c. Book value per share.
- d. Price-earnings ratio.

**M81#1.** What is the most likely effect of a stock split on the par value per share and the number of shares outstanding?

| | *Par value per share* | *Number of shares outstanding* |
|---|---|---|
| a. | Decrease | Increase |
| b. | Decrease | No effect |
| c. | Increase | Increase |
| d. | No effect | No effect |

**N79#7.** At the date of the financial statements, common stock shares issued would exceed common stock shares outstanding as a result of the
- a. Declaration of a stock split.
- b. Declaration of a stock dividend.
- c. Purchase of treasury stock.
- d. Payment in full of subscribed stock.

### B. Additional Paid-in Capital

**N83#19.** The excess of the subscription price over the par value should be recorded as additional paid-in capital for

| | *Common stock* | *Preferred stock* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | No |
| d. | Yes | Yes |

**N82#9.** The excess of the subscription price over the par value of nonredeemable preferred stock subscribed should be recorded as
- a. A liability.
- b. Additional paid-in capital.
- c. Retained earnings.
- d. Revenue.

**N81#20.** Authorized common stock is sold on a subscription basis at a price in excess of par value. Additional paid-in capital should be recorded when the subscribed stock is
- a. Contracted for.
- b. Paid for.
- c. Issued.
- d. Authorized.

**M81#12.** How should the excess of the subscription price over the par value of common stock subscribed be recorded?
- a. As additional paid-in capital when the subscription is received.
- b. As additional paid-in capital when the subscription is collected.
- c. As retained earnings when the subscription is received.
- d. As additional paid-in capital when the capital stock is issued.

### C. Retained Earnings and Dividends

**N83#20.** A property dividend should be debited to retained earnings at the property's
- a. Market value at date of declaration.
- b. Market value at date of issuance (payment).
- c. Book value at date of declaration.
- d. Book value at date of issuance (payment).

**N83#21.** The issuer should charge retained earnings for the market value of the shares issued in a (an)
- a. 10 percent stock dividend.
- b. 2 for 1 stock split.
- c. Employee stock bonus.
- d. Pooling of interests.

**N82#13.** The correction of an error in the financial statements of a prior period should be reflected, net of applicable income taxes, in the current
- a. Income statement after income from continuing operations and before extraordinary items.
- b. Income statement after income from continuing operations and after extraordinary items.
- c. Retained earnings statement as an adjustment of the opening balance.
- d. Retained earnings statement after net income but before dividends.

**M82#10.** The dollar amount of total stockholders' equity remains the same when there is a (an)
- a. Issuance of preferred stock in exchange for convertible debentures.
- b. Issuance of nonconvertible bonds with detachable stock purchase warrants.
- c. Declaration of a stock dividend.
- d. Declaration of a cash dividend.

**N81#24.** A prior period adjustment should be reflected, net of applicable income taxes, in the financial statements of a business entity in the
- a. Retained earnings statement after net income but before dividends.
- b. Retained earnings statement as an adjustment of the opening balance.

c. Income statement after income from continuing operations.
d. Income statement as part of income from continuing operations.

**M81#13.** An example of an item which should be reported as a prior period adjustment is the
a. Collection of previously written-off accounts receivable.
b. Payment of taxes resulting from examination of prior year income tax returns.
c. Correction of error in financial statements of a prior year.
d. Receipt of insurance proceeds for damage to building sustained in a prior year.

## D. Treasury Stock and Other Contra Accounts

**N83#22.** When treasury stock is purchased for cash at more than its par value, what is the effect on total stockholders' equity under each of the following methods?

| | *Cost method* | *Par value method* |
|---|---|---|
| a. | Increase | Increase |
| b. | Decrease | Decrease |
| c. | No effect | Decrease |
| d. | No effect | No effect |

**M83#27.** When treasury stock accounted for by the cost method is subsequently sold for more than its purchase price, the excess of the cash proceeds over the carrying value of the treasury stock should be recognized as
a. Extraordinary gain.
b. Income from continuing operations.
c. Increase in additional paid-in capital.
d. Increase in retained earnings.

**N82#19.** Ten thousand (10,000) shares of common stock with a par value of $20 per share were initially issued at $25 per share. Subsequently, two thousand (2,000) of these shares were purchased as treasury stock at $30 per share. Assuming that the par value method of accounting for treasury stock transactions is used, what is the effect of the purchase of the treasury stock on each of the following?

| | *Additional paid-in capital* | *Retained earnings* |
|---|---|---|
| a. | Decrease | Increase |
| b. | Decrease | Decrease |
| c. | Increase | Decrease |
| d. | Increase | No effect |

**M82#11.** When treasury stock is purchased for more than its par value, treasury stock is debited for the purchase price under which of the following methods?

| | *Cost method* | *Par value method* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | No |
| d. | Yes | Yes |

**N81#22.** When treasury stock which was purchased for more than the par value of the stock is subsequently sold for more than its purchase price, additional paid-in capital from the sale of the treasury stock is credited under which of the following methods?

| | *Cost method* | *Par value method* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | Yes |
| d. | Yes | No |

**N79#6.** When treasury stock is purchased for more than the par value of the stock and the cost method is used to account for treasury stock, what account(s) should be debited?
a. Treasury stock for the par value and additional paid-in capital for the excess of the purchase price over the par value.
b. Additional paid-in capital for the purchase price.
c. Treasury stock for the purchase price.
d. Treasury stock for the par value and retained earnings for the excess of the purchase price over the par value.

## E. Stock Options, Warrants, and Rights

**N83#23.** A company issued rights to its existing shareholders to purchase, for $30 per share, 10,000 unissued shares of $15 par value common stock. When the rights are exercised
a. Additional paid-in capital will be debited.
b. Additional paid-in capital will be credited.
c. Stock rights outstanding will be debited.
d. Retained earnings will be debited.

**M82#13.** Which of the following is issued to shareholders by a corporation as evidence of the ownership of rights to acquire its unissued or treasury stock?
a. Stock options.
b. Stock warrants.
c. Stock dividends.
d. Stock subscriptions.

**N81#23.** The granting by a company to its shareholders of the opportunity to buy additional shares of stock within a specified future time at a specified price is an example of a

a. Dividend reinvestment plan.
b. Stock right.
c. Stock dividend.
d. Stock option.

**M81#9.** How should the value of warrants attached to a debt security be accounted for?

a. No value assigned.
b. A separate portion of paid-in capital.
c. An appropriation of retained earnings.
d. A liability.

### F. Reorganization and Change in Entity

**N82#16.** A company with a substantial deficit undertakes a quasi-reorganization. Certain assets will be written down to their present fair market value. Liabilities will remain the same. How would the entries to record the quasi-reorganization affect each of the following?

| | *Contributed capital* | *Retained earnings* |
|---|---|---|
| a. | Increase | Decrease |
| b. | Decrease | No effect |
| c. | Decrease | Increase |
| d. | No effect | Increase |

**N79#23.** Conditions warranted that a company have a quasi-reorganization. Immediately after the quasi-reorganization, the retained earnings account

a. Has a zero balance.
b. Remains the same as it was before the quasi-reorganization.
c. Is frozen and dated, and subsequent transactions will be shown separately.
d. Has a debit balance equal to the write-down of the assets which were overstated.

## V. Measurement and Presentation of Income and Expense Items, Their Relationship to Matching and Periodicity, and Their Relationship to Generally Accepted Accounting Principles

### A. Sales or Revenues

**N83#24.** When an investor uses the equity method to account for investments in common stock, the equity in the earnings of the investee reported in the investor's income statement will be affected by which of the following?

| | *Cash dividends from investee* | *Goodwill amortization related to purchase* |
|---|---|---|
| a. | No | Yes |
| b. | No | No |
| c. | Yes | No |
| d. | Yes | Yes |

**N83#25.** A sale of goods, denominated in a currency other than the entity's functional currency, resulted in a receivable that was fixed in terms of the amount of foreign currency that would be received. Exchange rates between the functional currency and the currency in which the transaction was denominated changed. The resulting gain should be included as a (an)

a. Separate component of stockholders' equity.
b. Deferred credit.
c. Component of income from continuing operations.
d. Extraordinary item.

**M83#26.** When should an indicated loss on a long-term contract be recognized under the completed-contract method and the percentage-of-completion method, respectively?

| | *Completed-contract* | *Percentage-of-completion* |
|---|---|---|
| a. | Immediately | Over life of project |
| b. | Immediately | Immediately |
| c. | Contract complete | Over life of project |
| d. | Contract complete | Immediately |

**M83#28.** In a lease that is recorded as a sales-type lease by the lessor, unearned interest

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

**M83#29.** Rent received in advance by the lessor for an operating lease should be recognized as revenue

a. When received.
b. At the lease's inception.
c. In the period specified by the lease.
d. At the lease's expiration.

**N82#17.** The excess of the fair value of leased property at the inception of the lease over its cost or carrying amount should be classified by the lessor as

a. Unearned income from a sales-type lease.
b. Unearned income from a direct-financing lease.
c. Manufacturer's or dealer's profit from a sales-type lease.
d. Manufacturer's or dealer's profit from a direct-financing lease.

**M81#14.** When a fixed asset with a five-year estimated useful life is sold during the second year, how would the use of the sum-of-the-years-digits method of depreciation instead of the straight-line method of depreciation affect the gain or loss on the sale of the fixed asset?

| | *Gain* | *Loss* |
|---|---|---|
| a. | Decrease | Increase |
| b. | Increase | Decrease |
| c. | No effect | No effect |
| d. | No effect | Decrease |

**N80#22.** In a lease that is recorded as a sales-type lease by the lessor, the difference between the gross investment in the lease and the sum of the present values of the two components of the gross investment should be recorded as

a. Unearned income.
b. Manufacturer's or dealer's profit.
c. Rental income.
d. Deferred charge.

**N79#12.** In a lease that is appropriately recorded as a direct financing lease by the lessor, unearned income

a. Should be amortized over the period of the lease using the interest method.
b. Should be amortized over the period of the lease using the straight-line method.
c. Does **not** arise.
d. Should be recognized at the lease's expiration.

**M79#2.** The year-end balance of accounts receivable on the books of a foreign subsidiary should be translated by the parent company for consolidation purposes at the

a. Historical rate.
b. Current rate.
c. Negotiated rate.
d. Spot rate.

**M79#6.** Based **solely** upon the following sets of circumstances indicated below, which set gives rise to a sales type or direct financing lease of a lessor?

| | *Transfers ownership by end of lease?* | *Contains bargain purchase provision?* | *Collectibility of lease payments assured?* | *Any important uncertainties?* |
|---|---|---|---|---|
| a. | No | Yes | Yes | No |
| b. | Yes | No | No | No |
| c. | Yes | No | No | Yes |
| d. | No | Yes | Yes | Yes |

## B. Cost of Goods Sold

**N82#21.** In a periodic inventory system which uses the weighted average cost flow method, the beginning inventory is the

a. Net purchases minus the cost of goods sold.
b. Net purchases minus the ending inventory.
c. Total goods available for sale minus the net purchases.
d. Total goods available for sale minus the cost of goods sold.

**M82#21.** In a period of rising prices, the use of which of the following inventory cost flow methods would result in the highest cost of goods sold?

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

**M82#22.** In a periodic inventory system which uses the FIFO cost flow method, the cost of goods available for sale is net purchases

a. Plus the ending inventory.
b. Plus the beginning inventory.
c. Minus the ending inventory.
d. Minus the beginning inventory.

**N81#21.** In a periodic inventory system which uses the LIFO inventory cost flow method, the cost of goods sold is the total cost of goods available for sale

a. Plus the ending inventory.
b. Minus the ending inventory.
c. Plus the beginning inventory.
d. Minus the beginning inventory.

## C. Expenses

**N83#26.** In determining whether to accrue employees' compensation for future absences, one of the conditions that must be met is that the employer has an obligation to make payment even if an employee terminates. This is an example of a (an)

a. Vested right.
b. Accumulated right.
c. Contingent right.
d. Estimable right.

**N83#27.** In the calculation of the annual provision for pension cost, 10 percent of past service cost (until fully amortized) would be included in the

| | *Minimum limit* | *Maximum limit* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | No |
| d. | No | Yes |

**M83#31.** The sum-of-the-years-digits method of depreciation is being used for a machine with a five-year estimated useful life. What would be the fraction applied to the cost to be depreciated in the second year?
a. 2/3.
b. 2/15.
c. 4/15.
d. 4/5.

**M83#32.** Compensation cost should be recognized in the income statement of each period in which services are rendered for a compensatory stock option plan for which the date of grant and the measurement date are

| | *Different* | *Identical* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | Yes |
| d. | Yes | No |

**M83#33.** The maximum annual provision for pension cost permitted is normal cost, plus
a. 10 percent of past service cost (until fully amortized).
b. 10 percent of past service cost (until fully amortized), plus 10 percent of any increases or decreases in prior service cost arising on amendments of the plan, plus interest equivalents on the difference between provisions and amounts funded.
c. Interest equivalents on any unfunded prior service cost, plus a provision for the excess of the actuarially computed value of vested benefits over the total of the pension fund if such excess is **not** at least 5 percent less than the comparable excess at the beginning of the year.
d. A provision for vested benefits.

**M83#34.** When equipment held under an operating lease is subleased by the original lessee, the original lessee would account for the sublease as a (an)
a. Operating lease.
b. Sales-type lease.
c. Direct financing lease.
d. Capital lease.

**N82#18.** The pension expense accrued by a company will be increased by interest equivalents when
a. The plan is fully vested.
b. The plan is fully funded.
c. Amounts funded are less than pension cost accrued.
d. Amounts funded are greater than pension cost accrued.

**N82#20.** Equal monthly rental payments for a particular lease should be charged to rental expense by the lessee for which of the following?

| | *Capital lease* | *Operating lease* |
|---|---|---|
| a. | Yes | No |
| b. | Yes | Yes |
| c. | No | No |
| d. | No | Yes |

**N82#22.** For a compensatory stock option plan for which the date of grant and the measurement date are different, compensation cost should be recognized in the income statement
a. At the later of grant or measurement date.
b. At the exercise date.
c. Of each period in which the services are rendered.
d. At the adoption date of the plan.

**N82#23.** A loss should be presented separately as a component of income from continuing operations when it is unusual in nature and which of the following?

| | *Material in amount* | *Infrequent in occurrence* |
|---|---|---|
| a. | No | Yes |
| b. | No | No |
| c. | Yes | No |
| d. | Yes | Yes |

**N82#25.** An activity that would be expensed currently as research and development costs is the
a. Testing in search for or evaluation of product or process alternatives.
b. Adaptation of an existing capability to a particular requirement or customer's need as a part of continuing commercial activity.
c. Legal work in connection with patent applications or litigation, and the sale or licensing of patents.
d. Engineering follow-through in an early phase of commercial production.

**M82#23.** In the calculation of the maximum limit for the annual provision for pension cost, the past service cost portion of the calculation should **not** be greater than
a. Ten percent of the past service cost (until fully amortized).
b. Ten percent of the actuarially computed value of the vested benefits.
c. Seventy-five percent of the normal cost.
d. An amount equivalent to amortization of the past service cost on a forty-year basis.

**M82#31.** When the allowance method of recognizing bad debt expense is used, the typical write off of a specific customer's account
a. Has **no** effect on net income.
b. Decreases net income.
c. Decreases current assets.
d. Decreases working capital.

**M82#34.** Which of the following utilizes the straight-line depreciation method?

| | *Composite depreciation* | *Group depreciation* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | No |
| d. | Yes | Yes |

**N81#25.** Actuarial gains or losses directly related to the operation of a pension plan should be
a. Allocated to current and future periods.
b. Deferred until pension plan investments give rise to actuarial gains or losses.
c. Offset against pension expense in year of occurrence.
d. Disclosed in a note to the financial statements only.

**N81#26.** In a lease that is recorded as an operating lease by the lessee, the equal monthly rental payments should be
a. Allocated between interest expense and depreciation expense.
b. Allocated between a reduction in the liability for leased assets and interest expense.
c. Recorded as a reduction in the liability for leased assets.
d. Recorded as rental expense.

**N81#29.** For a troubled debt restructuring involving only modification of terms, it is appropriate for a debtor to recognize a gain when the carrying amount of the debt
a. Exceeds the total future cash payments specified by the new terms.
b. Is less than the total future cash payments specified by the new terms.
c. Exceeds the present value specified by the new terms.
d. Is less than the present value specified by the new terms.

**M81#17.** Which of the following depreciation methods is computed in the same way as depletion is computed?
a. Straight-line.
b. Sum-of-the-years-digits.
c. Double-declining-balance.
d. Productive-output.

**M81#19.** For a compensatory stock option plan for which the date of grant and the measurement date are the same, compensation cost should be recognized in the income statement
a. At the date of retirement.
b. Of each period in which services are rendered.
c. At the exercise date.
d. At the adoption date of the plan.

**M81#20.** In which of the following methods is salvage value **not** considered in the calculation of the first year's depreciation on fixed assets?
a. Straight-line.
b. Double-declining-balance.
c. Sum-of-the-years-digits.
d. Productive-output.

**M81#21.** A transaction that is material in amount, unusual in nature, but **not** infrequent in occurrence, should be presented separately as a (an)
a. Component of income from continuing operations, but **not** net of applicable income taxes.
b. Component of income from continuing operations, net of applicable income taxes.
c. Extraordinary item, net of applicable income taxes.
d. Prior period adjustment, but **not** net of applicable income taxes.

**N80#1.** When a specific customer's account receivable is written off as uncollectible, what will be the effect on net income under each of the following methods of recognizing bad debt expense?

| | *Allowance* | *Direct write off* |
|---|---|---|
| a. | None | Decreased |
| b. | Decreased | None |
| c. | Decreased | Decreased |
| d. | None | None |

**D. Provision for Income Tax**

**M83#35.** Assuming **no** prior period adjustments, would the following affect net income?

| | *Interperiod income tax allocation* | *Intraperiod income tax allocation* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |

**N82#14.** Which of the following could require interperiod tax allocation?
a. Premiums paid on officers' life insurance.
b. Unearned service contract revenue.
c. Interest received on municipal obligations.
d. Dividends received exclusion.

**N81#28.** Intraperiod income tax allocation arises because
a. Items included in the determination of taxable income may be presented in different sections of the financial statements.
b. Income taxes must be allocated between current and future periods.
c. Certain revenues and expenses appear in the financial statements either before or after they are included in taxable income.
d. Certain revenues and expenses appear in the financial statements but are excluded from taxable income.

**N81#35.** Interperiod income tax allocation is justified by the basic theory that income taxes should be treated as which of the following?
a. An expense for the current portion and a distribution of earnings for the deferred portion.
b. An expense.
c. A distribution of earnings for the current portion and an expense for the deferred portion.
d. A distribution of earnings.

**N80#8.** In accounting for income taxes, interest received on municipal obligations is an example of
a. Intraperiod tax allocation.
b. Interperiod tax allocation.
c. A permanent difference.
d. A timing difference.

**M80#12.** Which of the following interperiod tax allocation methods uses the tax rates in effect at the origination of the timing differences and does **not** adjust for subsequent changes in tax rates?
a. Deferred method.
b. Liability method.
c. Net of tax method.
d. Net present value method.

**M80#13.** An example of intraperiod income tax allocation is
a. Interest income on municipal obligations.
b. Estimated expenses for major repairs accrued for financial statement purposes in one year, but deducted for income tax purposes when paid in a subsequent year.
c. Rental income included in income for income tax purposes when collected, but deferred for financial statement purposes until earned in a subsequent year.
d. Reporting the cumulative effect on prior years of changing to a different depreciation method in the income statement, net of direct tax effects.

**N79#17.** Which of the following requires intraperiod tax allocation?
a. Extraordinary gains or losses as defined by the Accounting Principles Board.
b. That portion of dividends reduced by the dividends received deduction by corporations under existing federal income tax law.
c. The excess of accelerated depreciation used for tax purposes over straight-line depreciation used for financial reporting purposes.
d. All differences between taxable income and financial statement earnings.

**M79#9.** The amount of income tax applicable to transactions that must be reported using intraperiod income tax allocation is computed
a. By multiplying the item by the effective income tax rate.
b. As the difference between the tax computed based on taxable income without including the item and the tax computed based on taxable income including the item.
c. As the difference between the tax computed on the item based on the amount used for financial reporting and the amount used in computing taxable income.
d. By multiplying the item by the difference between the effective income tax rate and the statutory income tax rate.

## E. Recurring Versus Nonrecurring Transactions and Events

**N83#28.** When a segment of a business has been discontinued during the year, the loss on disposal should
a. Be an extraordinary item.
b. Be an operating item.
c. Exclude operating losses of the current period up to the measurement date.
d. Exclude operating losses during the phase-out period.

**N83#29.** A loss from early extinguishment of debt, if material, should be reported as a component of income
a. After cumulative effect of accounting changes and after discontinued operations of a segment of a business.
b. After cumulative effect of accounting changes and before discontinued operations of a segment of a business.
c. Before cumulative effect of accounting changes and after discontinued operations of a segment of a business.
d. Before cumulative effect of accounting changes and before discontinued operations of a segment of a business.

**M82#29.** Which of the following items, if material, should be presented in the income statement separately as a component of income, net of applicable income taxes?
a. Write off of goodwill.
b. Losses due to a strike.

c. Losses from translation of foreign currencies.
d. Gain from early extinguishment of long-term debt.

**N81#30.** A loss from the disposal of a segment of a business enterprise should be reported separately as a component of income

a. After cumulative effect of accounting changes and before extraordinary items.
b. Before cumulative effect of accounting changes and after extraordinary items.
c. After extraordinary items and cumulative effect of accounting changes.
d. Before extraordinary items and cumulative effect of accounting changes.

**M81#22.** An extraordinary item should be reported separately as a component of income

a. Before cumulative effect of accounting changes and after discontinued operations of a segment of a business.
b. Before cumulative effect of accounting changes and before discontinued operations of a segment of a business.
c. After cumulative effect of accounting changes and after discontinued operations of a segment of a business.
d. After cumulative effect of accounting changes and before discontinued operations of a segment of a business.

**N80#13.** An extraordinary item is one which

a. Occurs infrequently and is uncontrollable in nature.
b. Occurs infrequently and is unusual in nature.
c. Is material and is unusual in nature.
d. Is material and is uncontrollable in nature.

**M80#10.** Gains or losses from the early extinguishment of debt, if material, should be

a. Amortized over the remaining original life of the extinguished issue.
b. Amortized over the life of the new issue.
c. Recognized as an extraordinary item in the period of extinguishment.
d. Recognized in income before taxes in the period of extinguishment.

**M80#11.** When a segment of a business has been discontinued during the year, the gain or loss on disposal should

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

**M80#15.** A transaction that is material in amount, unusual in nature, and infrequent in occurrence, should be presented in the income statement separately as a component of income

a. Net of applicable income taxes.
b. As a prior period adjustment.
c. From continuing operations.
d. From discontinued operations.

**N79#16.** In order to be classified as an extraordinary item in the income statement, an event or transaction should be

a. Infrequent and material; but it need **not** be unusual in nature.
b. Unusual in nature and material; but it need **not** be infrequent.
c. Unusual in nature, infrequent, and material.
d. Unusual in nature and infrequent; but it need **not** be material.

## F. Accounting Changes

**M83#36.** When a cumulative effect type change in accounting principle is made during the year, the cumulative effect on retained earnings is determined

a. During the year using the weighted-average method.
b. As of the date of the change.
c. As of the beginning of the year in which the change is made.
d. As of the end of the year in which the change is made.

**M82#25.** A company changes from the double-declining-balance method of depreciation for previously recorded assets to the straight-line method. The cumulative effect of the change on the amount of retained earnings at the beginning of the period in which the change is made, should be reported separately as a (an)

a. Extraordinary item.
b. Component of income after extraordinary items.
c. Component of income from continuing operations.
d. Prior period adjustment.

**M81#23.** An example of a special change in accounting principle that should be reported by restating the financial statements of prior periods is the change from the

a. Straight-line method of depreciating plant equipment to the sum-of-the-years-digits method.
b. Sum-of-the-years-digits method of depreciating plant equipment to the straight-line method.
c. LIFO method of inventory pricing to the FIFO method.
d. FIFO method of inventory pricing to the LIFO method.

## G. Earnings Per Share

**M83#37.** Antidilutive common stock equivalents would generally be used in the calculation of

| | *Primary earnings per share* | *Fully diluted earnings per share* |
|---|---|---|
| a. | Yes | Yes |
| b. | No | Yes |
| c. | No | No |
| d. | Yes | No |

**N82#24.** In determining earnings per share, interest expense, net of applicable income taxes, on convertible debt which is both a common stock equivalent and dilutive should be

a. Added back to net income for primary earnings per share, and ignored for fully diluted earnings per share.
b. Added back to net income for both primary earnings per share and fully diluted earnings per share.
c. Deducted from net income for primary earnings per share, and ignored for fully diluted earnings per share.
d. Deducted from net income for both primary earnings per share and fully diluted earnings per share.

**M82#20.** In determining primary earnings per share, dividends on nonconvertible cumulative preferred stock should be

a. Deducted from net income whether declared or not.
b. Deducted from net income only if declared.
c. Added back to net income whether declared or not.
d. Disregarded.

**N81#31.** When computing primary earnings per share, common stock equivalents are

a. Recognized only if they are dilutive.
b. Recognized only if they are anti-dilutive.
c. Recognized whether they are dilutive or anti-dilutive.
d. Ignored.

**N81#32.** A company with a simple capital structure for purposes of computing earnings per share would include which of the following in the computation of earnings per share?

a. Dividends on nonconvertible cumulative preferred stock.
b. Dividends on common stock.
c. Common stock equivalents.
d. Number of shares of nonconvertible cumulative preferred stock.

**M81#24.** When computing fully diluted earnings per share, convertible securities that are **not** common stock equivalents are

a. Ignored.
b. Recognized whether they are dilutive or anti-dilutive.
c. Recognized only if they are dilutive.
d. Recognized only if they are anti-dilutive.

**M81#25.** For purposes of computing the weighted-average number of shares outstanding during the year, a midyear event that must be treated as occurring at the beginning of the year is the

a. Declaration and payment of stock dividend.
b. Purchase of treasury stock.
c. Sale of additional common stock.
d. Issuance of stock warrants.

**N80#11.** In applying the treasury stock method of computing the dilutive effect of outstanding options or warrants, for quarterly fully diluted earnings per share, when is it appropriate to use the ending market price of common stock as the assumed repurchase price?

a. Always.
b. Never.
c. When the ending market price is higher than the average market price and the exercise price.
d. When the ending market price is lower than the average market price and higher than the exercise price.

**M79#18.** Dilutive common stock equivalents must be used in the computation of

a. Fully diluted earnings per share only.
b. Primary earnings per share only.
c. Fully diluted and primary earnings per share.
d. Other potentially dilutive securities only.

## VI. Other Financial Topics

### A. Statement of Changes in Financial Position

**N83#30.** The conversion of nonparticipating preferred stock into common stock should be presented in a statement of changes in financial position as a

| | *Source of funds* | *Use of funds* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | No |
| d. | No | Yes |

**N83#31.** In a statement of changes in financial position, the amortization of goodwill of a company with substantial operating profits should be presented as a (an)
a. Source and use of funds.
b. Use of funds.
c. Deduction from income from continuing operations.
d. Addition to income from continuing operations.

**M83#38.** A gain on the sale of a long-term investment should be presented in a statement of changes in financial position of a company with substantial operating profits as a (an)
a. Deduction from income from continuing operations.
b. Addition to income from continuing operations.
c. Source and use of funds.
d. Use of funds.

**M83#39.** The retirement of long-term debt by the issuance of common stock should be presented in a statement of changes in financial position as a

| | *Source of funds* | *Use of funds* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | No |
| d. | Yes | Yes |

**N82#26.** Bad debt expense on long-term receivables should be presented in a statement of changes in financial position as a (an)
a. Use of funds.
b. Source and a use of funds.
c. Deduction from income from continuing operations.
d. Addition to income from continuing operations.

**N82#27.** Which of the following should be presented in a statement of changes in financial position only because of the all-financial-resources concept?
a. Conversion of preferred stock to common stock.
b. Purchase of treasury stock.
c. Sale of common stock.
d. Declaration of cash dividend.

**M82#27.** The amortization of bond discount on long-term debt should be presented in a statement of changes in financial position as a (an)
a. Use of funds.
b. Source and a use of funds.
c. Addition to income.
d. Deduction from income.

**M82#28.** A loss on the sale of machinery in the ordinary course of business should be presented in a statement of changes in financial position as a (an)
a. Deduction from income.
b. Addition to income.
c. Source and a use of funds.
d. Use of funds.

**N81#33.** The amortization of patents should be presented in a statement of changes in financial position as a (an)
a. Source and use of funds.
b. Use of funds.
c. Addition to net income.
d. Deduction from net income.

**M81#26.** When preparing a statement of changes in financial position (defining funds as cash), an increase in ending inventory over beginning inventory will result in an adjustment to reported net earnings because
a. Funds were increased since inventory is a current asset.
b. Inventory is an expense deducted in computing net earnings, but is **not** a use of funds.
c. The net increase in inventory reduces cost of goods sold and represents an assumed use of cash.
d. All changes in non-cash accounts must be disclosed under the all-financial-resources concept.

**M81#27.** In a statement of changes in financial position (defining funds as working capital), bad debt expense should be added back to net income when it relates to

| | *Current receivables* | *Long-term receivables* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | No |
| d. | No | Yes |

**N80#29.** Which of the following need **not** be disclosed in a statement of changes in financial position as a source and use of funds?
a. Acquisition of fixed assets in exchange for capital stock.
b. Dividend paid in capital stock of the company (stock dividend).
c. Retirement of a bond issue through the issuance of another bond issue.
d. Conversion of convertible debt to capital stock.

**N80#30.** How should the amortization of bond discount for a bond issuer be shown on the statement of changes in financial position (defining funds as working capital)?
a. Need **not** be shown.
b. Use of funds.
c. Expense **not** requiring the use of funds.
d. Contra-expense item **not** providing funds.

**M80#16.** If a company issues both a balance sheet and an income statement with comparative figures from last year, a statement of changes in financial position
a. Is no longer necessary; but may be issued at the company's option.
b. Should **not** be issued.
c. Should be issued for each period for which an income statement is presented.
d. Should be issued for the current year only.

**M80#17.** Which of the following items is included on a statement of changes in financial position only because of the all-financial-resources concept?
a. Depreciation.
b. Issuance (sale) of common stock.
c. Purchase of treasury stock.
d. Retirement of long-term debt by issuance of preferred stock.

**M80#18.** The working capital format is an acceptable format for presenting a statement of changes in financial position. Which of the following formats is (are) also acceptable?

| | *Cash* | *Quick assets* |
|---|---|---|
| a. | Acceptable | Not acceptable |
| b. | Not acceptable | Not acceptable |
| c. | Not acceptable | Acceptable |
| d. | Acceptable | Acceptable |

**M80#20.** Which of the following must be disclosed in a statement of changes in financial position or in a related tabulation for at least the current period?
a. Net change in each balance sheet account.
b. Net change in each element of working capital.
c. Gross changes in depreciable assets.
d. Earnings per share.

**M79#16.** An increase in inventory balance would be reported in a statement of changes in financial position as a
a. Use of working capital.
b. Source of working capital.
c. Source of cash.
d. Use of cash.

## B. Accounting Policies

**N82#36.** Which of the following should be disclosed in the Summary of Significant Accounting Policies?
a. Composition of plant assets.
b. Pro forma effect of retroactive application of an accounting change.
c. Basis of consolidation.
d. Maturity dates of long-term debt.

**M82#37.** Which of the following facts concerning plant assets should be disclosed in the Summary of Significant Accounting Policies?

| | *Composition* | *Depreciation expense amount* |
|---|---|---|
| a. | No | Yes |
| b. | No | No |
| c. | Yes | No |
| d. | Yes | Yes |

**M81#28.** Which of the following should be disclosed in the Summary of Significant Accounting Policies?
a. Rent expense amount.
b. Maturity dates of long-term debt.
c. Methods of amortizing intangibles.
d. Composition of plant assets.

**N80#9.** Which of the following should be disclosed in the Summary of Significant Accounting Policies?
a. Composition of inventory (raw materials, work-in-process, and finished goods).
b. Basis of consolidation.
c. Depreciation expense amount.
d. Adequacy of pension plan assets in relationship to vested benefits.

**M80#23.** APB Opinion No. 22, "Disclosure of Accounting Policies,"
a. Requires description of every accounting policy followed by a reporting entity.
b. Provides a specific listing of all types of accounting policies which must be disclosed.
c. Requires disclosure of the format for the statement of changes in financial position.
d. Requires description of all significant accounting policies to be included as an integral part of the financial statements.

**M80#24.** An example of an inventory accounting policy that should be disclosed is the
a. Effect of inventory profits caused by inflation.
b. Composition of inventory into raw materials, work-in-process, and finished goods.
c. Identification of major suppliers.
d. Method used for inventory pricing.

## C. Accounting Changes

**N83#32.** A company has included in its consolidated financial statements this year a subsidiary acquired several years ago that was appropriately excluded from consolidation last year. This results in
a. An accounting change that should be reported prospectively.
b. An accounting change that should be reported by restating the financial statements of all prior periods presented.
c. A correction of an error.
d. Neither an accounting change nor a correction of an error.

**M83#40.** Pro forma effects of retroactive application would usually be reported on the face of the income statement for a
a. Correction of error.
b. Change in entity.
c. Change in accounting estimate.
d. Change in accounting principle.

**N82#28.** A change in the salvage value of an asset depreciated on a straight-line basis and arising because additional information has been obtained is
a. An accounting change that should be reported in the period of change and future periods if the change affects both.
b. An accounting change that should be reported by restating the financial statements of all prior periods presented.
c. A correction of an error.
d. Not an accounting change.

**M82#24.** Pro forma effects of retroactive application would usually be reported on the face of the income statement for a change
a. In the service lives of depreciable assets.
b. In the salvage value of a depreciable asset.
c. From the straight-line method of depreciation to the double-declining-balance method.
d. From presenting statements for individual companies to presenting consolidated statements.

**M81#29.** How should a change in accounting estimate that is recognized by a change in accounting principle be reported?

| | *Change in accounting estimate* | *Change in accounting principle* |
|---|---|---|
| a. | No | No |
| b. | Yes | Yes |
| c. | No | Yes |
| d. | Yes | No |

**N79#28.** Presenting consolidated financial statements this year when statements of individual companies were presented last year is
a. A correction of an error.
b. An accounting change that should be reported prospectively.
c. An accounting change that should be reported by restating the financial statements of all prior periods presented.
d. Not an accounting change.

**M79#7.** A change in accounting entity is actually a change in accounting
a. Principle.
b. Estimate.
c. Method.
d. Concept.

## D. Business Combinations

**N83#33.** On November 1, 1982, Company X acquired all of the outstanding common stock of Company Y in a business combination accounted for as a pooling of interests. Both companies have a December 31 year end and have been in business for many years. Consolidated net income for the year ended December 31, 1982, should include net income for 12 months of

| | *Company X* | *Company Y* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | No |
| d. | No | Yes |

**N83#34.** In order to report a business combination as a pooling of interests, the minimum amount of an investee's common stock which must be acquired during the combination period in exchange for the investor's common stock is
a. 100 percent.
b. 51 percent.
c. 80 percent.
d. 90 percent.

**M83#41.** In a business combination how should plant and equipment of the acquired corporation generally be reported under each of the following methods?

| | *Pooling of interests* | *Purchase* |
|---|---|---|
| a. | Fair value | Recorded value |
| b. | Fair value | Fair value |
| c. | Recorded value | Recorded value |
| d. | Recorded value | Fair value |

**N82#31.** Company X acquired for cash all of the outstanding common stock of Company Y. How should Company X determine in general the amounts to be reported for the inventories and long-term debt acquired from Company Y?

| | *Inventories* | *Long-term debt* |
|---|---|---|
| a. | Fair value | Fair value |
| b. | Fair value | Recorded value |
| c. | Recorded value | Fair value |
| d. | Recorded value | Recorded value |

**N82#35.** Costs incurred in effecting a business combination accounted for as a pooling of interests should be

a. Added to the cost of the investment account of the parent corporation.
b. Deducted from additional paid-in capital of the combined corporation.
c. Deducted in determining net income of the combined corporation for the period in which the costs were incurred.
d. Capitalized and subsequently amortized over a period not exceeding forty years.

**M82#30.** Which of the following is the appropriate basis for valuing fixed assets acquired in a business combination accounted for as a purchase carried out by exchanging cash for common stock?

a. Historic cost.
b. Book value.
c. Cost plus any excess of purchase price over book value of asset acquired.
d. Fair value.

**M82#32.** A supportive argument for the pooling of interests method of accounting for a business combination is that

a. One company is clearly the dominant and continuing entity.
b. Goodwill is generally a part of any acquisition.
c. It was developed within the boundaries of the historical-cost system and is compatible with it.
d. A portion of the total cost is assigned to individual assets acquired on the basis of their fair value.

**M81#31.** How should long-term debt assumed in a business combination be shown under each of the following methods?

| | *Purchase* | *Pooling of interests* |
|---|---|---|
| a. | Recorded value | Recorded value |
| b. | Recorded value | Fair value |
| c. | Fair value | Fair value |
| d. | Fair value | Recorded value |

**M80#14.** Which of the following is a potential abuse that can arise when a business combination is accounted for as a pooling of interests?

a. Assets of the investee may be overvalued when the price paid by the investor is allocated among specific assets.
b. Liabilities may be undervalued when the price paid by the investor is allocated to the specific liabilities.
c. An undue amount of cost may be assigned to goodwill, thus potentially allowing for an overstatement of pooled earnings.
d. Earnings of the pooled entity may be increased because of the combination only and **not** as a result of efficient operations.

**M80#40.** On October 1, Company X acquired for cash all of the outstanding common stock of Company Y. Both companies have a December 31 year end and have been in business for many years. Consolidated net income for the year ended December 31 should include net income of

a. Company X for 3 months and Company Y for 3 months.
b. Company X for 12 months and Company Y for 3 months.
c. Company X for 12 months and Company Y for 12 months.
d. Company X for 12 months; but no income from Company Y until Company Y distributes a dividend.

**N79#26.** If all other conditions for consolidation are met, how should subsidiaries acquired in a business combination be shown under each of the following methods?

| | *Purchase* | *Pooling of interests* |
|---|---|---|
| a. | Consolidated | **Not** consolidated |
| b. | Consolidated | Consolidated |
| c. | **Not** consolidated | Consolidated |
| d. | **Not** consolidated | **Not** consolidated |

**M79#1.** In a business combination, what is the appropriate method of accounting for an excess of fair value assigned to net assets over the cost paid for them?

a. Record as negative goodwill.
b. Record as additional paid-in capital from combination on the books of the combined company.
c. Proportionately reduce values assigned to nonmonetary assets and record any remaining excess as a deferred credit.
d. Proportionately reduce values assigned to noncurrent assets and record any remaining excess as a deferred credit.

**M79#4.** Which of the following transactions related to a business combination would require that the combination be accounted for as a purchase?

a. The combination is to be completed within twelve months from the date the plan was initiated.
b. Ninety-two percent of one company's common stock is exchanged for only common stock in the other company.
c. The combined company is to retire a portion of the common stock exchanged to effect the combination within twelve months of the combination.
d. The combined company will dispose of numerous fixed assets representing duplicate facilities subsequent to the combination.

## E. Interim Financial Statements

**N83#35.** For external reporting purposes, it is appropriate to use estimated gross profit rates to determine the cost of goods sold for

| | *Interim financial reporting* | *Year-end financial reporting* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |

**N82#32.** An inventory loss from a market decline occurred in the first quarter that was not expected to be restored in the fiscal year. For interim financial reporting purposes, how would the dollar amount of inventory in the balance sheet be affected in the first and fourth quarters?

| | *First quarter* | *Fourth quarter* |
|---|---|---|
| a. | Decrease | No effect |
| b. | Decrease | Increase |
| c. | No effect | Decrease |
| d. | No effect | No effect |

**M82#38.** For interim financial reporting, an inventory loss from a market decline in the second quarter that is **not** expected to be restored in the fiscal year should be recognized as a loss

a. In the fourth quarter.
b. Proportionately in each of the second, third, and fourth quarters.
c. Proportionately in each of the first, second, third, and fourth quarters.
d. In the second quarter.

**N81#36.** If annual major repairs made in the first quarter and paid for in the second quarter clearly benefit the entire year, when should they be expensed?

a. An allocated portion in each of the last three quarters.
b. An allocated portion in each quarter of the year.
c. In full in the first quarter.
d. In full in the second quarter.

**M81#32.** For interim financial reporting, an inventory loss from a temporary market decline in the first quarter which can reasonably be expected to be restored in the fourth quarter

a. Should be recognized as a loss proportionately in each of the first, second, third, and fourth quarters.
b. Should be recognized as a loss proportionately in each of the first, second, and third quarters.
c. Need **not** be recognized as a loss in the first quarter.
d. Should be recognized as a loss in the first quarter.

**N80#16.** The computation of a company's third quarter provision for income taxes should be based upon earnings

a. For the quarter at an expected annual effective income tax rate.
b. For the quarter at the statutory rate.
c. To date at an expected annual effective income tax rate less prior quarters' provisions.
d. To date at the statutory rate less prior quarters' provisions.

**M79#3.** Which of the following methods of inventory valuation is allowable at interim dates but **not** at year end?

a. Weighted average.
b. Estimated gross profit rates.
c. Retail method.
d. Specific identification.

**F. Loss or Gain Contingencies**

**N82#37.** A clearly identified appropriation of retained earnings for reasonably possible loss contingencies should be

a. Charged with all losses related to that contingency.
b. Transferred to income as losses are realized.
c. Classified in the liability section of the balance sheet.
d. Shown within the stockholders' equity section of the balance sheet.

**M82#40.** A loss contingency for which the amount of loss can be reasonably estimated should be accrued when the occurrence of the loss is

| | *Reasonably possible* | *Remote* |
|---|---|---|
| a. | Yes | No |
| b. | Yes | Yes |
| c. | No | No |
| d. | No | Yes |

**N81#37.** An estimated loss from a loss contingency should be accrued when

a. It is probable at the date of the financial statements that a loss has been incurred and the amount of the loss can be reasonably estimated.
b. The loss has been incurred by the date of the financial statements and the amount of the loss may be material.
c. It is probable at the date of the financial statements that a loss has been incurred and the amount of the loss may be material.
d. It is probable that a loss will be incurred in a future period and the amount of the loss can be reasonably estimated.

**M81#36.** Gain contingencies are usually recognized in the income statement when

a. Realized.
b. Occurrence is reasonably possible and the amount can be reasonably estimated.
c. Occurrence is probable and the amount can be reasonably estimated.
d. The amount can be reasonably estimated.

**N79#2.** Abbot Co. is being sued for illness caused to local residents as a result of negligence on the company's part in permitting the local residents to be exposed to highly toxic chemicals from its plant. Abbot's lawyer states that it is probable that Abbot will lose the suit and be found liable for a judgment costing Abbot anywhere from $500,000 to $2,500,000. However, the lawyer states that the most probable cost is $1,000,000. As a result of the above facts, Abbot should accrue

a. A loss contingency of $500,000 and disclose an additional contingency of up to $2,000,000.
b. A loss contingency of $1,000,000 and disclose an additional contingency of up to $1,500,000.
c. A loss contingency of $1,000,000 but **not** disclose any additional contingency.
d. No loss contingency but disclose a contingency of $500,000 to $2,500,000.

**N79#3.** Information prior to the issuance of the financial statements indicates that it is probable that, at the date of the financial statements, a liability has been incurred for obligations related to product warranties. The amount of the loss involved can be reasonably estimated. Based on the above facts, an estimated loss contingency should be

a. Accrued.
b. Disclosed but **not** accrued.
c. **Neither** accrued **nor** disclosed.
d. Classified as an appropriation of retained earnings.

**M79#5.** Which of the following sets of conditions would give rise to the accrual of a contingency under current generally accepted accounting principles?

a. Amount of loss is reasonably estimable and event occurs infrequently.
b. Amount of loss is reasonably estimable and occurrence of event is probable.
c. Event is unusual in nature and occurrence of event is probable.
d. Event is unusual in nature and event occurs infrequently.

**G. Segments and Lines of Business**

**M83#44.** In financial reporting for segments of a business enterprise, the operating profit or loss of a segment should include

| | *Reasonably allocated common operating costs* | *Traceable operating costs* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | No |
| d. | Yes | Yes |

**M82#2.** When reporting the loss on disposal of a segment of a business which is to be abandoned, an estimated amount for operating losses during the phase-out period should

a. Be included in the income statement as part of the loss on disposal of the discontinued segment.
b. Be included in the income statement as part of the income (loss) from operations of the discontinued segment.
c. Be included in the income statement as part of the income (loss) from continuing operations.
d. Not be included in the income statement.

**N81#40.** In financial reporting for segments of a business enterprise, which of the following assets should be included as an identifiable asset of industry segment A?

a. An intangible asset used by industry segment A.
b. An advance from nonfinancial industry segment A to another industry segment.
c. An allocation of a tangible asset used for general corporate purposes, and **not** used in the operations of any particular industry segment.
d. An allocation of a tangible asset used by another industry segment which transfers products to industry segment A.

**M81#39.** In financial reporting for segments of a business enterprise, the operating profit or loss of a segment should include among other items

a. Traceable costs.
b. Foreign income taxes.
c. Extraordinary items.
d. Loss on discontinued operations.

**N80#10.** How should the gain or loss from the disposal of a segment of a business enterprise be shown in the financial statements?

a. An extraordinary item.
b. A separate item after continuing operations.
c. A separate item before income taxes.
d. A retained earnings adjustment.

**N80#28.** Selected data for a segment of a business enterprise are to be separately reported in accordance with FASB Statement No. 14 when the revenues of the segment exceed 10 percent of the

a. Combined net income of all segments reporting profits.
b. Total revenues obtained in transactions with outsiders.
c. Total revenues of all the enterprise's industry segments.
d. Total combined revenues of all segments reporting profits.

**M80#38.** In financial reporting for segments of a business enterprise, the operating profit or loss of a segment should include

a. Federal income taxes.
b. Interest expense even though segment's operations are **not** principally of a financial nature.
c. Revenue earned at the corporate level.
d. Common costs allocated on a reasonable basis.

**N79#25.** The profitability information that should be reported for each reportable segment of a business enterprise consists of

a. An operating profit or loss figure consisting of segment revenues less traceable costs and allocated common costs.
b. An operating profit or loss figure consisting of segment revenues less traceable costs but **not** allocated common costs.
c. An operating profit or loss figure consisting of segment revenues less allocated common costs but **not** traceable costs.
d. Segment revenues only.

## H. Long-Term Contracts

**M83#43.** In accounting for a long-term construction contract for which there is a projected profit, the balance in the appropriate asset accounts at the end of the first year of work using the completed-contract method would be

a. Zero.
b. The same as the percentage-of-completion method.
c. Higher than the percentage-of-completion method.
d. Lower than the percentage-of-completion method.

**N82#38.** The calculation of the income recognized in the second year of a four-year construction contract which is accounted for using the percentage-of-completion method is based on the

a. Latest available estimated costs.
b. Cumulative actual costs incurred only.
c. Incremental cost for the second year only.
d. Estimated costs at the inception of the contract.

**M82#19.** The completed-contract method of accounting for long-term construction-type contracts is preferable when

a. A contractor is involved in numerous projects.
b. The contracts are of a relatively long duration.
c. Estimates of costs to complete and extent of progress toward completion are reasonably dependable.
d. Lack of dependable estimates or inherent hazards cause forecasts to be doubtful.

**N81#34.** Which of the following would be used in the calculation of the income recognized in the third and final year of a construction contract which is accounted for using the percentage-of-completion method?

| | *Contract price* | *Actual total costs* | *Income previously recognized* |
|---|---|---|---|
| a. | Yes | Yes | No |
| b. | Yes | Yes | Yes |
| c. | Yes | No | Yes |
| d. | No | No | Yes |

**M81#35.** When progress billings are sent on a long-term contract, what type of account should be credited under the completed-contract method and percentage-of-completion method?

| | Completed-contract | Percentage-of-completion |
|---|---|---|
| a. | Revenue | Revenue |
| b. | Revenue | Contra asset |
| c. | Contra asset | Revenue |
| d. | Contra asset | Contra asset |

**N79#11.** In accounting for a long-term construction-type contract using the percentage-of-completion method, the gross profit recognized during the first year would be the estimated total gross profit from the contract multiplied by the percentage of the costs incurred during the year to the

a. Total costs incurred to date.
b. Total estimated cost.
c. Unbilled portion of the contract price.
d. Total contract price.

**N79#15.** The percentage-of-completion method of accounting for long-term construction-type contracts is preferable when

a. Estimates of costs to complete and extent of progress toward completion are reasonably dependable.
b. The collectibility of progress billings from the customer is reasonably assured.
c. A contractor is involved in numerous projects.
d. The contracts are of a relatively short duration.

## I. Employee Benefits

**M83#42.** In accounting for the cost of pension plans, an acceptable actuarial cost method for financial reporting purposes is

a. Pay-as-you-go.
b. Unit credit.
c. Turnover.
d. Terminal funding.

**N82#39.** For its defined benefit pension plans, an employer should disclose for each complete set of financial statements, as of the most recent benefit information date for which the data are available, the actuarial present value of accumulated plan benefits that are

| | Vested | Nonvested |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |

**M82#35.** If the stock for a compensatory stock option plan is issued before some or all of the services are performed, a part of the consideration recorded for the stock issued is unearned compensation and should be shown in the balance sheet as a line item in

a. Noncurrent liabilities.
b. Stockholders' equity.
c. Current assets.
d. Noncurrent assets.

**N81#38.** Compensatory stock options were granted to executives on January 1, 1979, with a measurement date of June 30, 1980, for services to be rendered during 1979, 1980, and 1981. The excess of the market value of the stock over the option price at the measurement date was reasonably estimable at the date of grant. The stock option was exercised on October 31, 1981. Compensation expense should be recognized in the income statement in which of the following years?

| | 1979 | 1980 | 1981 |
|---|---|---|---|
| a. | No | No | Yes |
| b. | No | Yes | Yes |
| c. | Yes | No | No |
| d. | Yes | Yes | Yes |

**M81#37.** APB Opinion No. 8 sets minimum and maximum limits on the annual provision for pension cost. An amount that is always included in the calculation of both the minimum and maximum limit is

a. Normal cost.
b. Amortization of past service cost.
c. Interest on unfunded past and prior service costs.
d. Retirement benefits paid.

**M81#38.** For a compensatory stock option plan for which the date of the grant and the measurement date are the same, what account is credited at the date of the grant?

a. Retained earnings.
b. Stock options outstanding.
c. Deferred compensation cost.
d. Compensation expense.

**M80#21.** Which of the following disclosures concerning pension plans should be made in a company's financial statements or their notes?

a. A statement of a company's accounting and funding policies.
b. The amount of retirement benefits paid during the year.
c. A description of the actuarial assumptions made.
d. The amount of unfunded past service costs.

**M80#33.** In accounting for the cost of pension plans, an acceptable actuarial cost method for financial purposes is

a. Pay-as-you-go.
b. Terminal funding.
c. Entry age normal.
d. Turnover.

**N79#8.** The vested benefits of an employee in a pension plan represent

a. Benefits to be paid to the retired employee in the current year.
b. Benefits to be paid to the retired employee in the subsequent year.
c. Benefits accumulated in the hands of an independent trustee.
d. Benefits that are **not** contingent on the employee's continuing in the service of the employer.

**N79#20.** The past service costs in a pension plan

a. Should be charged to income in the year of the inception of the pension plan.
b. Should be funded in the year of the inception of the pension plan.
c. Represent pension cost assigned to years prior to the current balance sheet date.
d. Represent pension cost assigned to years prior to the inception of the pension plan.

**M79#8.** In which of the following pension instances would the accrual of past service costs have to be reduced for interest presumed earned?

a. When past service costs have been fully accrued prior to funding.
b. When pension expense exceeds the maximum allowable accrual.
c. When past service costs have been fully funded prior to accrual.
d. When interest presumed earned on previously accrued past service cost exceeds interest presumed earned on unaccrued past service cost.

## J. Analysis of Financial Statements

**M83#45.** Inventories would be included in the calculation of which of the following?

| | *Acid test (quick) ratio* | *Working capital (current) ratio* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |

**N82#40.** How are the following used in the calculation of the dividend payout ratio for a company with only common stock outstanding?

| | *Dividends per share* | *Earnings per share* | *Book value per share* |
|---|---|---|---|
| a. | Denominator | Numerator | Not used |
| b. | Denominator | Not used | Numerator |
| c. | Numerator | Denominator | Not used |
| d. | Numerator | Not used | Denominator |

**N81#39.** What is the effect of the collection of accounts receivable on the current ratio and net working capital, respectively?

| | *Current ratio* | *Net working capital* |
|---|---|---|
| a. | No effect | No effect |
| b. | Increase | Increase |
| c. | Increase | No effect |
| d. | No effect | Increase |

**M81#30.** Which of the following is an appropriate computation for return on investment?

a. Income divided by total assets.
b. Income divided by sales.
c. Sales divided by total assets.
d. Sales divided by stockholders' equity.

**M81#40.** Which of the following accounts would be included in the calculation of the acid test (quick) ratio?

| | *Accounts receivable* | *Inventories* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | No |
| d. | Yes | Yes |

**N80#4.** A characteristic of all assets and liabilities comprising working capital is that they are

a. Cash equivalents.
b. Current.
c. Monetary.
d. Marketable.

**M80#1.** If current assets exceed current liabilities, payments to creditors made on the last day of the month will

a. Decrease current ratio.
b. Increase current ratio.
c. Decrease net working capital.
d. Increase net working capital.

**M80#50.** Which of the following ratios measures short-term solvency?

a. Current ratio.
b. Age of receivables.
c. Creditors' equity to total assets.
d. Return on investment.

## VII. Cost Accumulation, Planning, and Control

### A. Nature of Cost Elements

**N83#36.** Wages paid to factory machine operators of a manufacturing plant are an element of

| | *Prime cost* | *Conversion cost* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | No |
| d. | Yes | Yes |

**N83#37.** Property taxes on a manufacturing plant are an element of

| | *Conversion cost* | *Period cost* |
|---|---|---|
| a. | Yes | No |
| b. | Yes | Yes |
| c. | No | Yes |
| d. | No | No |

**N83#38.** Factory supplies for a manufacturing plant are generally

a. Prime costs.
b. Period costs.
c. Variable costs.
d. Excluded from product costs.

**M83#46.** Supervisory salaries for a manufacturing plant would be an example of which of the following?

| | *Prime cost* | *Conversion cost* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |

**N82#42.** Wages of the security guard for a small plant would be an example of

| | *Indirect labor* | *Fixed factory overhead* |
|---|---|---|
| a. | No | No |
| b. | Yes | Yes |
| c. | Yes | No |
| d. | No | Yes |

**N81#41.** Indirect materials are a (an)

a. Prime cost.
b. Fixed cost.
c. Irrelevant cost.
d. Factory overhead cost.

**N81#42.** Factory overhead

a. Is a prime cost.
b. Can be a variable cost or a fixed cost.
c. Can only be a fixed cost.
d. Includes all factory labor.

**N81#46.** Direct materials are a

| | *Conversion cost* | *Manufacturing cost* | *Prime cost* |
|---|---|---|---|
| a. | Yes | Yes | No |
| b. | Yes | Yes | Yes |
| c. | No | Yes | Yes |
| d. | No | No | No |

**M81#41.** For a manufacturing company, which of the following is an example of a period rather than a product cost?

a. Depreciation on factory equipment.
b. Wages of salespersons.
c. Wages of machine operators.
d. Insurance on factory equipment.

**M81#42.** Prime cost and conversion cost share what common element of total cost?

a. Variable overhead.
b. Fixed overhead.
c. Direct materials.
d. Direct labor.

**M81#43.** In order to identify costs that relate to a specific product, an allocation base should be chosen that

a. Does **not** have a cause and effect relationship.
b. Has a cause and effect relationship.
c. Considers variable costs but **not** fixed costs.
d. Considers direct materials and direct labor but **not** factory overhead.

**N79#35.** Factory overhead includes

a. All manufacturing costs.
b. All manufacturing costs, except direct materials and direct labor.
c. Indirect materials but **not** indirect labor.
d. Indirect labor but **not** indirect materials.

**M79#34.** Which of the following items of cost would be **least** likely to appear in a performance report based on responsibility accounting techniques for the supervisor of an assembly line in a large manufacturing situation?

a. Supervisor's salary.
b. Materials.
c. Repairs and maintenance.
d. Direct labor.

## B. Job Order Costing

**N83#39.** Accounting for factory overhead costs involves averaging in

| | Job order costing | Process costing |
|---|---|---|
| a. | Yes | No |
| b. | Yes | Yes |
| c. | No | Yes |
| d. | No | No |

**N82#41.** An actual cost system may be used in
- a. Neither process costing nor job order costing.
- b. Process costing but **not** job order costing.
- c. Job order costing but **not** process costing.
- d. Both job order costing and process costing.

**M82#41.** In job order costing, what journal entry should be made for the return to the storekeeper of direct materials previously issued to the factory for use on a particular job?
- a. Debit materials and credit factory overhead.
- b. Debit materials and credit work in process.
- c. Debit purchase returns and credit work in process.
- d. Debit work in process and credit materials.

**N81#44.** A nonmanufacturing organization may use
- a. Job order costing but **not** process costing.
- b. Process costing but **not** job order costing.
- c. Either job order costing or process costing.
- d. Neither job order costing nor process costing.

**M81#44.** What is the best cost accumulation procedure to use when many batches, each differing as to product specifications, are produced?
- a. Job order.
- b. Process.
- c. Actual.
- d. Standard.

**M80#42.** In job order costing, the basic document to accumulate the cost of each order is the
- a. Invoice.
- b. Purchase order.
- c. Requisition sheet.
- d. Job cost sheet.

**M79#22.** In job order costing, payroll taxes paid by the employer for factory employees are preferably accounted for as
- a. Direct labor.
- b. Factory overhead.
- c. Indirect labor.
- d. Administrative costs.

## C. Process Costing

**N83#40.** Assuming that there was no beginning work in process inventory, and the ending work in process inventory is 50% complete as to conversion costs, the number of equivalent units as to conversion costs would be
- a. The same as the units placed in process.
- b. The same as the units completed.
- c. Less than the units placed in process.
- d. Less than the units completed.

**N83#41.** In the computation of manufacturing cost per equivalent unit, the weighted-average method of process costing considers
- a. Current costs only.
- b. Current costs plus cost of ending work in process inventory.
- c. Current costs less cost of beginning work in process inventory.
- d. Current costs plus cost of beginning work in process inventory.

**N82#43.** The percentage of completion of the beginning work-in-process inventory should be included in the computation of the equivalent units of production for which of the following methods of process costing?

| | First-in, first-out | Weighted-average |
|---|---|---|
| a. | Yes | No |
| b. | Yes | Yes |
| c. | No | Yes |
| d. | No | No |

**M82#42.** The beginning work in process inventory was 60 percent complete as to conversion costs, and the ending work in process inventory was 45 percent complete as to conversion costs. The dollar amount of the conversion cost included in the ending work in process inventory (using the weighted-average method) is determined by multiplying the average unit conversion costs by what percentage of the total units in the ending work in process inventory?
- a. 100 percent.
- b. 60 percent.
- c. 55 percent.
- d. 45 percent.

**N81#43.** Purchased materials are added in the second department of a three-department process; this increases the number of units produced in the second department and would always
- a. Change the direct labor cost percentage in the ending work-in-process inventory.
- b. Cause **no** adjustment to the unit cost transferred in from the first department.
- c. Increase total unit costs.
- d. Decrease total ending work-in-process inventory.

**N81#45.** Purchased materials are added in the second department of a three-department process; this does **not** increase the number of units produced in the second department and would

a. Not change the dollar amount transferred to the next department.
b. Decrease total work-in-process inventory.
c. Increase the factory overhead portion of the ending work-in-process inventory.
d. Increase total unit cost.

**M81#46.** The units transferred in from the first department to the second department should be included in the computation of the equivalent units for the second department for which of the following methods of process costing?

| | *First-in, first-out* | *Weighted-average* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |

**N80#43.** The weighted-average method of process costing differs from the first-in, first-out method of process costing in that the weighted-average method

a. Requires that ending work-in-process inventory be stated in terms of equivalent units of production.
b. Considers the ending work-in-process inventory only partially complete.
c. Does **not** consider the degree of completion of beginning work-in-process inventory when computing equivalent units of production.
d. Can be used under any cost-flow assumption.

**N80#44.** When using the first-in, first-out method of process costing, total equivalent units of production for a given period of time is equal to the number of units

a. Started into process during the period, plus the number of units in work-in-process at the beginning of the period.
b. In work-in-process at the beginning of the period, plus the number of units started during the period, plus the number of units remaining in work-in-process at the end of the period times the percent of work necessary to complete the items.
c. In work-in-process at the beginning of the period times the percent of work necessary to complete the items, plus the number of units started during the period, less the number of units remaining in work-in-process at the end of the period times the percent of work necessary to complete the items.
d. Transferred out during the period, plus the number of units remaining in work-in-process at the end of the period times the percent of work necessary to complete the items.

**M80#41.** Which is the best cost accumulation procedure to use when there is a continuous mass production of like units?

a. Actual.
b. Standard.
c. Job order.
d. Process.

**M79#29.** A true process costing system could make use of each of the following **except**

a. Standards.
b. Individual lots.
c. Variable costing.
d. Responsibility accounting.

**M79#39.** In order to compute equivalent units of production using the FIFO method of process costing, work for the period must be broken down to units

a. Completed during the period and units in ending inventory.
b. Completed from beginning inventory, started and completed during the month, and units in ending inventory.
c. Started during the period and units transferred out during the period.
d. Processed during the period and units completed during the period.

## D. Standard Costing and Variance Analysis

**N83#42.** Under the two-variance method for analyzing factory overhead, the volume variance is the difference between the

a. Budget allowance based on standard hours allowed and the budget allowance based on actual hours worked.
b. Budget allowance based on standard hours allowed and the factory overhead applied to production.
c. Actual factory overhead and the budget allowance based on standard hours allowed.
d. Actual factory overhead and the factory overhead applied to production.

**N83#43.** Under the three-variance method for analyzing factory overhead, which of the following is used in the computation of the spending variance?

| | *Actual factory overhead* | *Factory overhead applied to production* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |

**M83#48.** Under the two-variance method for analyzing factory overhead, the controllable (budget) variance is the difference between the

a. Budget allowance based on standard hours allowed and the factory overhead applied to production.
b. Budget allowance based on standard hours allowed and the budget allowance based on actual hours worked.
c. Actual factory overhead and the factory overhead applied to production.
d. Actual factory overhead and the budget allowance based on standard hours allowed.

**N82#48.** The difference between the actual labor rate multiplied by the actual labor hours worked and the standard labor rate multiplied by the standard labor hours is the

a. Total labor variance.
b. Labor rate variance.
c. Labor usage variance.
d. Labor efficiency variance.

**N82#50.** The standard unit cost is used in the calculation of which of the following variances?

| | *Materials price variance* | *Materials usage variance* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | No |
| d. | Yes | Yes |

**N81#52.** An unfavorable labor efficiency variance connotes that

a. The actual labor rate was higher than the standard labor rate.
b. The total labor variance must also be unfavorable.
c. Actual labor hours worked exceeded standard labor hours for the production level achieved.
d. Overtime labor was used during the period.

**N81#53.** Which of the following unfavorable variances would be directly affected by the relative position of a production process on a learning curve?

a. Materials mix.
b. Materials price.
c. Labor rate.
d. Labor efficiency.

**M81#50.** Which department is customarily held responsible for an unfavorable materials usage variance?

a. Quality control.
b. Purchasing.
c. Engineering.
d. Production.

**N80#38.** A standard cost system may be used in

a. Either job order costing or process costing.
b. Job order costing but **not** process costing.
c. Process costing but **not** job order costing.
d. Neither process costing nor job order costing.

**N80#48.** The absolute minimum cost that would be possible under the best conceivable operating conditions is a description of which type of standard cost?

a. Currently attainable (expected).
b. Theoretical.
c. Normal.
d. Practical.

**N80#49.** If the actual hours worked exceed the standard hours allowed, what type of variance will occur?

a. Favorable labor usage (efficiency) variance.
b. Favorable labor rate variance.
c. Unfavorable labor usage (efficiency) variance.
d. Unfavorable labor rate variance.

**N80#50.** An unfavorable price variance occurs because of

a. Price increases on raw materials.
b. Price decreases on raw materials.
c. Less than anticipated levels of waste in the manufacturing process.
d. More than anticipated levels of waste in the manufacturing process.

**M80#45.** How is a labor rate variance computed?

a. The difference between standard and actual rate multiplied by actual hours.
b. The difference between standard and actual rate multiplied by standard hours.
c. The difference between standard and actual hours multiplied by actual rate.
d. The difference between standard and actual hours multiplied by the difference between standard and actual rate.

**M79#20.** What type of direct material variances for price and usage will arise if the actual number of pounds of materials used exceeds standard pounds allowed but actual cost was less than standard cost?

| | *Usage* | *Price* |
|---|---|---|
| a. | Unfavorable | Favorable |
| b. | Favorable | Favorable |
| c. | Favorable | Unfavorable |
| d. | Unfavorable | Unfavorable |

**M79#23.** If a company follows a practice of isolating variances at the earliest point in time, what would be the appropriate time to isolate and recognize a direct material price variance?

a. When material is issued.
b. When material is purchased.
c. When material is used in production.
d. When purchase order is originated.

**M79#25.** How should a usage variance that is significant in amount be treated at the end of an accounting period?

a. Reported as a deferred charge or credit.
b. Allocated among work-in-process inventory, finished goods inventory, and cost of goods sold.
c. Charged or credited to cost of goods manufactured.
d. Allocated among cost of goods manufactured, finished goods inventory, and cost of goods sold.

**M79#33.** What is the normal year-end treatment of immaterial variances recognized in a cost accounting system utilizing standards?

a. Reclassified to deferred charges until all related production is sold.
b. Allocated among cost of goods manufactured and ending work-in-process inventory.
c. Closed to cost of goods sold in the period in which they arose.
d. Capitalized as a cost of ending finished goods inventory.

## E. Joint Costing

**N82#44.** Relative sales value at split-off is used to allocate

| | *Costs beyond split-off* | *Joint costs* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |

**M82#44.** For purposes of allocating joint costs to joint products, the relative sales value at split-off method could be used in which of the following situations?

| | *No costs beyond split-off* | *Costs beyond split-off* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |

**N81#48.** For purposes of allocating joint costs to joint products, the relative sales value at split-off is equal to

a. Sales price less a normal profit margin at point of sale.
b. Sales price at point of sale reduced by cost to complete after split-off.
c. Total sales value less joint costs at point of split-off.
d. Separable product cost plus a normal profit margin.

**M81#48.** Joint costs are most frequently allocated based upon relative

a. Profitability.
b. Conversion costs.
c. Prime costs.
d. Sales value.

**N80#39.** Relative sales value at split-off is used to

a. Allocate separable costs.
b. Determine relevant costs.
c. Determine the breakeven point in sales dollars.
d. Allocate joint costs.

**M80#43.** Joint product costs generally are allocated using the

a. Relative sales value at split-off.
b. Additional costs after split-off.
c. Relative profitability.
d. Direct labor hours.

**M79#31.** Which of the following components of production are allocable as joint costs when a single manufacturing process produces several salable products?

a. Materials, labor, overhead.
b. Materials and labor only.
c. Labor and overhead only.
d. Overhead and materials only.

## F. By-Product Costing

**N82#45.** Which of the following is (are) acceptable regarding the allocation of joint product cost to a by-product?

| | *None allocated* | *Some portion allocated* |
|---|---|---|
| a. | Acceptable | Not acceptable |
| b. | Acceptable | Acceptable |
| c. | Not acceptable | Acceptable |
| d. | Not acceptable | Not acceptable |

**N81#49.** At the split-off point, products may be salable or may require further processing in order to be salable. Which of the following have both of these characteristics?

| | *By-products* | *Joint products* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | No |
| d. | Yes | Yes |

**M81#49.** Under an acceptable method of costing by-products, inventory costs of the by-product are based on the portion of the joint production cost allocated to the by-product

a. But any subsequent processing cost is debited to the cost of the main product.

b. But any subsequent processing cost is debited to revenue of the main product.
c. Plus any subsequent processing cost.
d. Less any subsequent processing cost.

**N80#40.** Which of the following products are difficult to cost because of indivisibility?

| | *By-products* | *Joint products* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |

**N79#33.** One of the accepted methods of accounting for a by-product is to recognize the value of the by-product as it is produced. Under this method, inventory costs for the by-product would be based on

a. An allocation of some portion of joint costs but **not** any subsequent processing costs.
b. **Neither** an allocation of some portion of joint costs **nor** any subsequent processing costs.
c. Subsequent processing costs less an allocation of some portion of joint costs.
d. An allocation of some portion of joint costs plus any subsequent processing costs.

## G. Spoilage, Waste, and Scrap

**N81#57.** Which of the following is an inventoriable cost?

| | *Abnormal spoilage* | *Normal spoilage* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | No |
| d. | Yes | Yes |

**N80#46.** Normal spoilage and abnormal spoilage should be classified as

| | *Normal* | *Abnormal* |
|---|---|---|
| a. | Period cost | Period cost |
| b. | Product cost | Period cost |
| c. | Period cost | Product cost |
| d. | Product cost | Product cost |

**N79#34.** If the amount of spoilage in a manufacturing process is abnormal, it should be classified as a

a. Deferred charge.
b. Joint cost.
c. Period cost.
d. Product cost.

## H. Absorption and Direct Costing

**N83#44.** The direct (variable) costing method includes in inventory

a. Direct materials cost, direct labor cost, but **no** factory overhead cost.
b. Direct materials cost, direct labor cost, and variable factory overhead cost.
c. Prime cost but **not** conversion cost.
d. Prime cost and all conversion cost.

**M83#47.** Operating income using direct costing as compared to absorption costing would be higher

a. When the quantity of beginning inventory equals the quantity of ending inventory.
b. When the quantity of beginning inventory is more than the quantity of ending inventory.
c. When the quantity of beginning inventory is less than the quantity of ending inventory.
d. Under **no** circumstances.

**M82#43.** When using full absorption costing, what costs attendant to an element of production (material, labor, or overhead) are used in order to compute variances from standard amounts?

a. Controllable costs.
b. Total costs.
c. Variable costs.
d. Fixed costs.

**M82#45.** An income statement is prepared as an internal report. Under which of the following methods would the term contribution margin appear?

| | *Absorption costing* | *Direct costing* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | No |
| d. | Yes | Yes |

**M81#47.** What factor, related to manufacturing costs, causes the difference in net earnings computed using absorption costing and net earnings computed using direct costing?

a. Absorption costing considers all costs in the determination of net earnings, whereas direct costing considers only direct costs.
b. Absorption costing allocates fixed costs between cost of goods sold and inventories, and direct costing considers all fixed costs to be period costs.
c. Absorption costing "inventories" all direct costs, but direct costing considers direct costs to be period costs.
d. Absorption costing "inventories" all fixed costs for the period in ending finished goods inventory, but direct costing expenses all fixed costs.

**N80#31.** Which of the following must be known about a production process in order to institute a direct costing system?

a. The variable and fixed components of all costs related to production.
b. The controllable and noncontrollable components of all costs related to production.
c. Standard production rates and times for all elements of production.
d. Contribution margin and breakeven point for all goods in production.

**K. Budgeting and Flexible Budgeting**

**M83#49.** A flexible budget is

a. Not appropriate when costs and expenses are affected by fluctuations in volume limits.
b. Appropriate for any relevant level of activity.
c. Appropriate for control of factory overhead but **not** for control of direct materials and direct labor.
d. Appropriate for control of direct materials and direct labor but **not** for control of factory overhead.

**N82#46.** When using a flexible budget, what will occur to fixed costs (on a per unit basis) as production increases within the relevant range?

a. Fixed costs are **not** considered in flexible budgeting.
b. Fixed costs per unit will decrease.
c. Fixed costs per unit will increase.
d. Fixed costs per unit will remain unchanged.

**N81#51.** Controllable costs for responsibility accounting purposes are those costs that are directly influenced by

a. A given manager within a given period of time.
b. A change in activity.
c. Production volume.
d. Sales volume.

**M79#38.** The basic difference between a master budget and a flexible budget is that a

a. Flexible budget considers only variable costs but a master budget considers all costs.
b. Flexible budget allows management latitude in meeting goals whereas a master budget is based on a fixed standard.
c. Master budget is for an entire production facility but a flexible budget is applicable to single departments only.
d. Master budget is based on one specific level of production and a flexible budget can be prepared for any production level within a relevant range.

**L. Breakeven and Cost-Volume-Profit Analysis**

**N83#45.** How would the following be used in calculating sales necessary to realize a projected profit?

| | *Projected profit* | *Contribution margin ratio* |
|---|---|---|
| a. | Denominator | Numerator |
| b. | Denominator | Not used |
| c. | Numerator | Numerator |
| d. | Numerator | Denominator |

**N83#46.** The contribution margin decreases when sales volume remains the same and

a. Fixed costs increase.
b. Fixed costs decrease.
c. Variable cost per unit increases.
d. Variable cost per unit decreases.

**M82#47.** How may the following be used in calculating the breakeven point in units?

| | *Fixed costs* | *Contribution margin per unit* |
|---|---|---|
| a. | Denominator | Numerator |
| b. | Denominator | Not used |
| c. | Numerator | Not used |
| d. | Numerator | Denominator |

**M82#50.** The contribution margin increases when sales volume remains the same and

a. Variable cost per unit decreases.
b. Variable cost per unit increases.
c. Fixed costs decrease.
d. Fixed costs increase.

**N81#50.** At the breakeven point, fixed cost is always

a. Less than the contribution margin.
b. Equal to the contribution margin.
c. More than the contribution margin.
d. More than the variable cost.

**N81#56.** The dollar amount of sales needed to attain a desired profit is calculated by dividing the contribution margin ratio into

a. Fixed cost.
b. Desired profit.
c. Desired profit plus fixed cost.
d. Desired profit less fixed cost.

**N80#34.** Within a relevant range, the amount of variable cost per unit

a. Differs at each production level.
b. Remains constant at each production level.
c. Increases as production increases.
d. Decreases as production increases.

**N80#35.** The contribution margin ratio always increases when the
a. Breakeven point increases.
b. Breakeven point decreases.
c. Variable costs as a percentage of net sales decrease.
d. Variable costs as a percentage of net sales increase.

**M80#47.** If the fixed costs attendant to a product increase while variable costs and sales price remain constant, what will happen to (1) contribution margin and (2) breakeven point?

| | *Contribution margin* | *Breakeven point* |
|---|---|---|
| a. | Increase | Decrease |
| b. | Decrease | Increase |
| c. | Unchanged | Increase |
| d. | Unchanged | Unchanged |

**N79#31.** If the fixed costs for a product decrease and the variable costs (as a percentage of sales dollars) decrease, what will be the effect on the contribution margin ratio and the breakeven point, respectively?

| | *Contribution margin ratio* | *Breakeven point* |
|---|---|---|
| a. | Decreased | Increased |
| b. | Increased | Decreased |
| c. | Decreased | Decreased |
| d. | Increased | Increased |

**M79#28.** Which of the following would cause the breakeven point to change?
a. Sales increased.
b. Total production decreased.
c. Total variable costs increased as a function of higher production.
d. Fixed costs increased due to addition to physical plant.

**M79#32.** Each of the following would affect the breakeven point **except** a change in the
a. Number of units sold.
b. Variable cost per unit.
c. Total fixed costs.
d. Sales price per unit.

**M79#37.** The method of cost accounting that lends itself to breakeven analysis is
a. Variable.
b. Standard.
c. Absolute.
d. Absorption.

## N. Differential Cost Analysis

**N80#45.** The type of costs presented to management for an equipment replacement decision should be limited to
a. Relevant costs.
b. Standard costs.
c. Controllable costs.
d. Conversion costs.

**M80#44.** In a make-or-buy decision,
a. Only variable costs are relevant.
b. Fixed costs that can be avoided in the future are relevant.
c. Fixed costs that will continue regardless of the decision are relevant.
d. Only conversion costs are relevant.

**N79#32.** In deciding whether to manufacture a part or buy it from an outside vendor, a cost that is irrelevant to the short-run decision is
a. Direct labor.
b. Variable overhead.
c. Fixed overhead that will be avoided if the part is bought from an outside vendor.
d. Fixed overhead that will continue even if the part is bought from an outside vendor.

**M79#21.** In considering a special order situation that will enable a company to make use of presently idle capacity, which of the following costs would be irrelevant?
a. Materials.
b. Depreciation.
c. Direct labor.
d. Variable overhead.

**M79#24.** Which of the following cost allocation methods would be used to determine the lowest price that could be quoted for a special order that would utilize idle capacity within a production area?
a. Job order.
b. Process.
c. Variable.
d. Standard.

## O. Capital Budgeting Techniques

**N83#47.** The discount rate (hurdle rate of return) must be determined in advance for the
a. Payback period method.
b. Time adjusted rate of return method.
c. Internal rate of return method.
d. Net present value method.

**N83#48.** Which of the following capital budgeting techniques consider(s) cash flow over the entire life of the project?

| | *Internal rate of return* | *Payback* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |

**M82#46.** Which of the following capital budgeting techniques require(s) the use of cash flows from period to period?

| | *Internal rate of return* | *Net present value* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |

**M82#49.** How are the following used in the calculation of the net present value of a proposed project? Ignore income tax considerations.

| | *Depreciation expense* | *Salvage value* |
|---|---|---|
| a. | Include | Include |
| b. | Include | Exclude |
| c. | Exclude | Include |
| d. | Exclude | Exclude |

**N81#60.** The minimum return that a project must earn for a company in order to leave the value of the company unchanged is the

a. Current borrowing rate.
b. Discount rate.
c. Capitalization rate.
d. Cost of capital.

**N80#32.** The net present value of a proposed project represents the

a. Cash flows less the present value of the cash flows.
b. Cash flows less the original investment.
c. Present value of the cash flows plus the present value of the original investment less the original investment.
d. Present value of the cash flows less the original investment.

**N80#33.** Which of the following is necessary in order to calculate the pay-back period for a project?

a. Useful life.
b. Minimum desired rate of return.
c. Net present value.
d. Annual cash flow.

**M80#48.** On May 1, 1980, a company purchased a new machine which it does not have to pay for until May 1, 1982. The total payment on May 1, 1982, will include both principal and interest. Assuming interest at a 10% rate, the cost of the machine would be the total payment multiplied by what time value of money concept?

a. Future amount of annuity of 1.
b. Future amount of 1.
c. Present value of annuity of 1.
d. Present value of 1.

**M80#49.** On what basis is the cost of capital derived from bonds and preferred stock measured, respectively?

a. Pretax rate of interest for bonds and stated annual dividend rate less the expected earnings per share for preferred stock.
b. Pretax rate of interest for bonds and stated annual dividend rate for preferred stock.
c. Aftertax rate of interest for bonds and stated annual dividend rate less the expected earnings per share for preferred stock.
d. Aftertax rate of interest for bonds and stated annual dividend rate for preferred stock.

**N79#39.** On May 1, 1979, a company sold some machinery to another company. The two companies entered into an installment sales contract at a predetermined interest rate. The contract required five equal annual payments with the first payment due on May 1, 1979. What present value concept is appropriate for this situation?

a. Present value of an annuity due of $1 for five periods.
b. Present value of an ordinary annuity of $1 for five periods.
c. Future amount of an annuity of $1 for five periods.
d. Future amount of $1 for five periods.

## P. Performance Analysis

**N83#49.** A company's return on investment (ROI) would generally increase when

a. Assets increase.
b. Selling prices decrease.
c. Costs decrease.
d. Costs increase.

## Q. Quantitative Techniques for Planning and Control

**N83#50.** Simple regression analysis

a. Establishes a cause and effect relationship.
b. Produces measures of probable error.
c. Involves the use of independent variables only.
d. Involves the use of more than two variables.

**M83#50.** The economic order quantity formula can be used to determine the optimum size of a

| | *Production run* | *Purchase order* |
|---|---|---|
| a. | Yes | No |
| b. | Yes | Yes |
| c. | No | Yes |
| d. | No | No |

**N82#47.** Multiple regression analysis
a. Establishes a cause and effect relationship.
b. Does **not** produce measures of probable error.
c. Measures the change in one variable associated with the change in one other variable.
d. Measures the change in one variable associated with the change in more than one other variable.

**N82#49.** The order size determined by the economic order quantity formula minimizes the annual inventory cost which is comprised of ordering cost and
a. Safety-stock cost.
b. Stock-out cost.
c. Set-up cost.
d. Carrying cost.

**M82#48.** When using the graphic method of solving a linear-programming problem, which of the following would be depicted on the graph?
a. Coefficient of correlation.
b. Line of best fit.
c. Critical path.
d. Constraint.

**N81#54.** Which of the following could be determined by using the economic order quantity formula?
a. Optimum size of a production run.
b. Safety stock.
c. Stock-out cost.
d. Order point.

**N81#55.** In a program evaluation review technique system (PERT), reducing total time can be accomplished only by
a. Shortening a slack path.
b. Shortening the critical path.
c. Working overtime.
d. Using sensitivity analysis.

**N81#58.** Probability (risk) analysis
a. Ignores probability weights under fifty percent.
b. Is only for situations in which there are three or fewer possible outcomes.
c. Does **not** enhance the usefulness of sensitivity analysis data.
d. Is an extension of sensitivity analysis.

**N81#59.** When using the graphic method of solving a linear programming problem, the optimal solution will always be at
a. Minimum value of X.
b. X and Y intercept.
c. A corner point described by the feasible area.
d. Point of inception.

**N80#36.** The estimates necessary to compute the economic order quantity are
a. Annual usage in units, cost per order, and annual cost of carrying one unit in stock.
b. Annual usage in units, cost per unit of inventory, and annual cost of carrying one unit in stock.
c. Annual cost of placing orders, and annual cost of carrying one unit in stock.
d. Cost per unit of inventory, annual cost of placing orders, and annual carrying cost.

**N80#41.** The use of the graphic method as a means for solving linear programming problems
a. Can be used when there are more than two restrictions (constraints).
b. Is limited to situations where there are two restrictions (constraints).
c. Is limited to situations where there is one restriction (constraint).
d. **Cannot** be used if there are any restrictions (constraints).

**N80#42.** What is the appropriate technique for defining the critical path when the completion of a total project is dependent upon the completion of various subunits at specific times to enable the work to progress?
a. Linear programming.
b. Multiple regression analysis.
c. Program evaluation review technique.
d. Queuing theory.

**N80#47.** Which of the following methods can be used to determine the fixed and variable elements of a semivariable expense?
a. Statistical scattergraph method.
b. Linear programming.
c. Input-output analysis.
d. Program evaluation review technique.

**M80#46.** Regression analysis is superior to other cost behavior analysis techniques because it
a. Produces measures of probable error.
b. Examines only one variable.
c. Proves a cause and effect relationship.
d. Is **not** a sampling technique.

**N79#36.** A company buys a certain part for its manufacturing process. In order to determine the optimum size of a normal purchase order, the formula for the economic order quantity (EOQ) is used. In addition to the annual demand, what other information is necessary to complete the formula?

a. Cost of placing an order, and annual cost of carrying a unit in stock.
b. Cost of the part, and annual cost of carrying a unit in stock.
c. Cost of placing an order.
d. Cost of the part.

**N79#37.** Simple regression analysis involves the use of

a. One variable.
b. Two variables.
c. Three variables.
d. More than three variables.

**N79#38.** Program evaluation review technique (PERT) is a system which uses

a. Least squares method.
b. Linear programming.
c. Economic order quantity formula.
d. Network analysis and critical path methods.

**N79#40.** A company manufactures two models, X and Y. Model X is processed 4 hours in the machining department and 2 hours in the polishing department. Model Y is processed 9 hours in the machining department and 6 hours in the polishing department. The available time for processing the two models is 200 hours a week in the machining department and 180 hours a week in the polishing department. The contribution margins expected are $10 for Model X and $14 for Model Y. How would the restriction (constraint) for the polishing department be expressed?

a. $2X + 6Y \leq 180$.
b. $6X + 15Y \leq 180$.
c. $2(10X) + 6(14Y) \leq 180$.
d. $10X + 14Y \leq 180$.

**M79#26.** Which of the following quantitative methods will separate a semi-variable cost into its fixed and variable components with the highest degree of precision under all circumstances?

a. High-low method.
b. Simplex method.
c. Least squares method.
d. Scattergraph method.

**M79#27.** A measure of the extent to which two variables are related linearly is referred to as

a. Cause-effect ratio.
b. Coefficient of correlation.
c. Sensitivity analysis.
d. Input-output analysis.

**M79#36.** The quantitative analysis tool whose primary objective is to define a critical path is

a. Linear programming.
b. Queuing theory.
c. Program evaluation and review technique.
d. Multiple regression analysis.

## VIII. Not-for-Profit and Governmental Accounting

### A. Conceptual Framework

**N80#51.** One of the differences between accounting for a governmental (not-for-profit) unit and a commercial (for-profit) enterprise is that a governmental (not-for-profit) unit should

a. **Not** record depreciation expense in any of its funds.
b. Always establish and maintain complete self-balancing accounts for each fund.
c. Use only the cash basis of accounting.
d. Use only the modified accrual basis of accounting.

**M80#58.** What is **not** a major concern of governmental units?

a. Budgets.
b. Funds.
c. Legal requirements.
d. Consolidated statements.

**M79#50.** What is the underlying reason a governmental unit uses separate funds to account for its transactions?

a. Governmental units are so large that it would be unduly cumbersome to account for all transactions as a single unit.
b. Because of the diverse nature of the services offered and legal provisions regarding activities of a governmental unit, it is necessary to segregate activities by functional nature.
c. Generally accepted accounting principles require that not-for-profit entities report on a funds basis.
d. Many activities carried on by governmental units are short-lived and their inclusion in a general set of accounts could cause undue probability of error and omission.

### B. Fund Accounting

**N83#51.** Which of the following accounts of a governmental unit is credited when the budget is recorded?

a. Encumbrances.
b. Reserve for encumbrances.
c. Estimated revenues.
d. Appropriations.

**N83#52.** Which of the following accounts of a governmental unit is debited when supplies previously ordered are received?
a. Encumbrances.
b. Reserve for encumbrances.
c. Vouchers payable.
d. Appropriations.

**N83#53.** When fixed assets purchased from general fund revenues were received, the appropriate journal entry was made in the general fixed asset account group. What account, if any, should have been debited in the general fund?
a. No journal entry should have been made in the general fund.
b. Fixed assets.
c. Expenditures.
d. Due from general fixed asset account group.

**M83#51.** Which of the following will increase the fund balance of a governmental unit at the end of the fiscal year?
a. Appropriations are less than expenditures and reserve for encumbrances.
b. Appropriations are less than expenditures and encumbrances.
c. Appropriations are more than expenditures and encumbrances.
d. Appropriations are more than estimated revenues.

**M83#52.** Which of the following accounts of a governmental unit is credited to close it out at the end of the fiscal year?
a. Appropriations.
b. Revenues.
c. Reserve for encumbrances.
d. Encumbrances.

**M83#53.** Which of the following accounts of a governmental unit is credited when taxpayers are billed for property taxes?
a. Estimated revenues.
b. Revenues.
c. Appropriations.
d. Reserve for encumbrances.

**N82#51.** Which of the following accounts of a governmental unit is (are) closed out at the end of the fiscal year?

| | *Estimated revenues* | *Fund balance* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | Yes |
| d. | Yes | No |

**N82#52.** Which of the following accounts of a governmental unit is credited when a purchase order is approved?
a. Reserve for encumbrances.
b. Encumbrances.
c. Vouchers payable.
d. Appropriations.

**N82#53.** Repairs that have been made for a governmental unit, and for which a bill has been received, should be recorded in the general fund as a debit to an
a. Expenditure.
b. Encumbrance.
c. Expense.
d. Appropriation.

**M82#53.** At the end of the fiscal year of a governmental unit, the excess of expenditures and encumbrances over appropriations
a. Increases the fund balance.
b. Decreases the fund balance.
c. Increases the reserve for encumbrances.
d. Decreases the reserve for encumbrances.

**M82#54.** Which of the following accounts of a governmental unit is closed out at the end of the fiscal year?
a. Fund balance.
b. Reserve for encumbrances.
c. Appropriations.
d. Vouchers payable.

**M82#55.** The encumbrance account of a governmental unit is debited when
a. A purchase order is approved.
b. Goods are received.
c. A voucher payable is recorded.
d. The budget is recorded.

**M81#51.** When the estimated revenue account of a governmental unit is closed out at the end of the fiscal year, the excess of revenues over estimated revenues is
a. Debited to fund balance.
b. Debited to reserve for encumbrances.
c. Credited to fund balance.
d. Credited to reserve for encumbrances.

**M81#52.** Encumbrances would **not** appear in which fund?
a. General.
b. Enterprise.
c. Capital projects.
d. Special revenue.

**M81#53.** When goods which have been previously approved for purchase are received by a governmental unit but **not** yet paid for, what account is credited?
a. Reserve for encumbrances.
b. Vouchers payable.
c. Expenditures.
d. Appropriations.

**N80#52.** If a credit was made to the fund balance in the process of recording a budget for a governmental unit, it can be assumed that
a. Estimated revenues exceed appropriations.
b. Estimated expenses exceed actual revenues.
c. Actual expenses exceed estimated expenses.
d. Appropriations exceed estimated revenues.

**N80#53.** Which of the following accounts is closed out at the end of the fiscal year?
a. Fund balance.
b. Expenditures.
c. Vouchers payable.
d. Reserve for encumbrances.

**M80#55.** When the budget of a governmental unit is adopted and the estimated revenues exceed the appropriations, the excess is
a. Debited to reserve for encumbrances.
b. Credited to reserve for encumbrances.
c. Debited to fund balance.
d. Credited to fund balance.

**N79#42.** Under the modified accrual basis of accounting, which of the following taxes is usually recorded before it is received in cash?
a. Property.
b. Income.
c. Gross receipts.
d. Gift.

**N79#48.** Which of the following terms refers to an actual cost rather than an estimate?
a. Expenditure.
b. Appropriation.
c. Budget.
d. Encumbrance.

**N79#49.** When a truck is received by a governmental unit, it should be recorded in the General Fund as a (an)
a. Appropriation.
b. Encumbrance.
c. Expenditure.
d. Fixed asset.

**N79#50.** How should wages that have been earned by the employees of a governmental unit, but **not** paid, be recorded in the General Fund?
a. Appropriation.
b. Encumbrance.
c. Expenditure.
d. Expense.

**M79#47.** A city's general fund budget for the forthcoming fiscal year shows estimated revenues in excess of appropriations. The initial effect of recording this will result in an increase in
a. Taxes receivable.
b. Fund balance.
c. Reserve for encumbrances.
d. Encumbrances.

**M79#48.** Under the modified accrual method of accounting used by a local governmental unit, which of the following would be a revenue susceptible to accrual?
a. Income taxes.
b. Business licenses.
c. Property taxes.
d. Sales taxes.

**M79#49.** Which of the following accounts is a budgetary account in governmental accounting?
a. Reserve for inventory of supplies.
b. Fund balance.
c. Appropriations.
d. Estimated uncollectible property taxes.

### C. Types of Funds and Fund Accounts

**N83#54.** Which of the following funds of a governmental unit integrates budgetary accounts into the accounting system?
a. Enterprise.
b. Special revenue.
c. Internal service.
d. Nonexpendable trust.

**N83#55.** Which of the following funds of a governmental unit uses the modified accrual basis of accounting?
a. Debt service.
b. Internal service.
c. Enterprise.
d. Nonexpendable trust.

**N83#56.** Long-term liabilities of an enterprise fund should be accounted for in the

| | *Enterprise fund* | *Long-term debt account group* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | Yes |
| d. | Yes | No |

**N83#57.** Fixed assets should be accounted for in the general fixed assets account group for

| | *Governmental funds* | *Proprietary funds* |
|---|---|---|
| a. | No | Yes |
| b. | No | No |
| c. | Yes | No |
| d. | Yes | Yes |

**M83#54.** Which of the following funds of a governmental unit uses the modified accrual basis of accounting?
a. General.
b. Enterprise.
c. Internal service.
d. Nonexpendable trust.

**M83#55.** Which of the following funds of a governmental unit would account for depreciation in the accounts of the fund?
a. General.
b. Internal service.
c. Capital projects.
d. Special assessment.

**M83#56.** Which of the following funds of a governmental unit uses the same basis of accounting as the special revenue fund?
a. Internal service.
b. Expendable trust.
c. Nonexpendable trust.
d. Enterprise.

**M83#57.** Which of the following funds of a governmental unit would account for long-term liabilities in the accounts of the fund?
a. Special assessment.
b. Special revenue.
c. Capital projects.
d. Debt service.

**M83#58.** Which of the following accounts would be included in the asset section of the combined balance sheet of a governmental unit for the general long-term debt account group?

| | *Amount available in debt service funds* | *Amount to be provided for retirement of general long-term debt* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |

**N82#54.** A debt service fund of a municipality is an example of which of the following types of fund?
a. Fiduciary.
b. Governmental.
c. Proprietary.
d. Internal service.

**N82#55.** Revenues of a special revenue fund of a governmental unit should be recognized in the period in which the
a. Revenues become available and measurable.
b. Revenues become available for appropriation.
c. Revenues are billable.
d. Cash is received.

**N82#56.** Which of the following funds of a governmental unit would use the general long-term debt account group to account for unmatured general long-term liabilities?
a. Special assessment.
b. Capital projects.
c. Trust.
d. Internal service.

**N82#57.** Which of the following funds of a governmental unit uses the same basis of accounting as an enterprise fund?
a. Special revenue.
b. Internal service.
c. Expendable trust.
d. Capital projects.

**N82#58.** Which of the following funds of a governmental unit could use the general fixed assets account group to account for fixed assets?
a. Internal service.
b. Enterprise.
c. Trust.
d. Special assessment.

**M82#51.** Fixed assets utilized in a city-owned utility are accounted for in which of the following?

| | *Enterprise fund* | *General fixed assets group of accounts* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | No |
| d. | Yes | Yes |

**M82#52.** Which of the following funds of a governmental unit would use the general long-term debt account group to account for unmatured general long-term liabilities?
a. Special assessment.
b. Trust.
c. Internal service (intragovernmental service).
d. Debt service.

**M82#56.** Which of the following funds of a governmental unit recognizes revenues and expenditures under the same basis of accounting as the general fund?
a. Debt service.
b. Enterprise.
c. Internal service (intragovernmental service).
d. Nonexpendable pension trust.

**M82#57.** Which of the following funds of a governmental unit would include retained earnings in its balance sheet?
a. Expendable pension trust.
b. Internal service (intragovernmental service).
c. Special revenue.
d. Capital projects.

**M82#58.** Which of the following requires the use of the encumbrance system?
a. Special assessment fund.
b. Debt service fund.
c. General fixed assets group of accounts.
d. Enterprise fund.

**M81#54.** Which of the following types of revenue would generally be recorded directly in the general fund of a governmental unit?

a. Receipts from a city-owned parking structure.
b. Interest earned on investments held for retirement of employees.
c. Revenues from intragovernmental service funds.
d. Property taxes.

**M81#55.** A capital projects fund of a municipality is an example of what type of fund?

a. Internal service (intragovernmental service).
b. Proprietary.
c. Fiduciary.
d. Governmental.

**M81#56.** Which of the following accounts could be included in the balance sheet of an enterprise fund?

| | *Reserve for encumbrances* | *Revenue bonds payable* | *Retained earnings* |
|---|---|---|---|
| a. | No | No | Yes |
| b. | No | Yes | Yes |
| c. | Yes | Yes | No |
| d. | No | No | No |

**M81#57.** Which of the following accounts would be included in the combined balance sheet for the long-term debt account group?

a. Amount to be provided for retirement of general long-term debt.
b. Unreserved fund balance.
c. Reserve for encumbrances.
d. Cash.

**M81#58.** Customers' meter deposits which cannot be spent for normal operating purposes would be classified as restricted cash in the balance sheet of which fund?

a. Internal service (intragovernmental service).
b. Trust.
c. Agency.
d. Enterprise.

**N80#55.** Within a governmental unit, three funds that are accounted for in a manner similar to a for-profit entity are

a. General, Debt Service, Special Assessment.
b. Intragovernmental Service, Enterprise, General.
c. Enterprise, General, Debt Service.
d. Special Assessment, Enterprise, Intragovernmental Service.

**N80#56.** When a capital project is financed entirely from a single bond issue, and the proceeds of the bond issue equal the par value of the bonds, the capital projects fund would record this transaction by debiting cash and crediting

a. Bond issue proceeds.
b. Fund balance.
c. Appropriations.
d. Bonds payable.

**N80#58.** Which of the following funds should account for the payment of interest and principal on revenue bond debt?

a. Capital projects.
b. Enterprise.
c. Trust.
d. Debt service.

**M80#51.** The accounting for special revenue funds is most similar to which type of fund?

a. Capital projects.
b. Enterprise.
c. General.
d. Special assessment.

**M80#53.** Taxes collected and held by a municipality for a school district would be accounted for in a (an)

a. Enterprise fund.
b. Intragovernmental service fund.
c. Agency fund.
d. Special revenue fund.

**N79#43.** Which fund is **not** an expendable fund?

a. Capital projects.
b. General.
c. Special revenue.
d. Intragovernmental service.

**N79#45.** Interest expense on bonds payable should be recorded in a Debt Service Fund

a. At the end of the fiscal period if the interest due date does **not** coincide with the end of the fiscal period.
b. When bonds are issued.
c. When legally payable.
d. When paid.

**N79#46.** An expenditures account appears in

a. The general fixed-assets group of accounts.
b. The general long-term debt group of accounts.
c. A special revenue fund.
d. An intragovernmental service fund.

## D. Presentation of Financial Statements for Various Not-for-Profit and Governmental Organizations

**N83#58.** The comprehensive annual financial report (CAFR) of a governmental unit should contain a combined statement of changes in financial position for

| | *Governmental funds* | *Proprietary funds* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | No |
| d. | Yes | Yes |

## E. Various Types of Not-for-Profit and Governmental Organizations

**N83#59.** The current funds group of a not-for-profit private university includes which of the following subgroups?

| | *Term endowment funds* | *Life income funds* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | Yes |
| d. | Yes | No |

**N83#60.** Which of the following would normally be included in Other Operating Revenues of a voluntary not-for-profit hospital?

a. Unrestricted interest income from an endowment fund.
b. An unrestricted gift.
c. Donated services.
d. Tuition received from an educational program.

**M83#59.** Revenues of a municipality should be recognized in the accounting period in which they become available and measurable for a

| | *Governmental fund* | *Proprietary fund* |
|---|---|---|
| a. | Yes | No |
| b. | Yes | Yes |
| c. | No | Yes |
| d. | No | No |

**M83#60.** Tuition waivers for which there is **no** intention of collection from the student should be classified by a not-for-profit university as

| | *Revenue* | *Expenditures* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | Yes |
| d. | Yes | No |

**N82#59.** A state governmental unit should use which basis of accounting for each of the following types of funds?

| | *Governmental* | *Proprietary* |
|---|---|---|
| a. | Cash | Modified accrual |
| b. | Modified accrual | Modified accrual |
| c. | Modified accrual | Accrual |
| d. | Accrual | Accrual |

**N82#60.** An unrestricted pledge from an annual contributor to a voluntary not-for-profit hospital made in December 1981 and paid in cash in March 1982 would generally be credited to

a. Nonoperating revenue in 1981.
b. Nonoperating revenue in 1982.
c. Operating revenue in 1981.
d. Operating revenue in 1982.

**M82#59.** Which of the following is utilized for current expenditures by a not-for-profit university?

| | *Unrestricted current funds* | *Restricted current funds* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | No |
| d. | Yes | Yes |

**M82#60.** Donated medicines which normally would be purchased by a hospital should be recorded at fair market value and should be credited directly to

a. Other operating revenue.
b. Other nonoperating revenue.
c. Fund balance.
d. Deferred revenue.

**M81#59.** For state and local governmental units, the full accrual basis of accounting should be used for what type of fund?

a. Special revenue.
b. General.
c. Debt service.
d. Internal service (intragovernmental service).

**M81#60.** A gift to a voluntary not-for-profit hospital that is not restricted by the donor should be credited directly to
- a. Fund balance.
- b. Deferred revenue.
- c. Operating revenue.
- d. Nonoperating revenue.

**N80#59.** Which of the following should be used in accounting for not-for-profit colleges and universities?
- a. Fund accounting and accrual accounting.
- b. Fund accounting but **not** accrual accounting.
- c. Accrual accounting but **not** fund accounting.
- d. Neither accrual accounting nor fund accounting.

**N80#60.** A voluntary health and welfare organization received a pledge in 1979 from a donor specifying that the amount pledged be used in 1981. The donor paid the pledge in cash in 1980. The pledge should be accounted for as
- a. A deferred credit in the balance sheet at the end of 1979, and as support in 1980.
- b. A deferred credit in the balance sheet at the end of 1979 and 1980, and as support in 1981.
- c. Support in 1979.
- d. Support in 1980, and **no** deferred credit in the balance sheet at the end of 1979.

**M80#59.** A reason for a voluntary health and welfare organization to adopt fund accounting is that
- a. Restrictions have been placed on certain of its assets by donors.
- b. It provides more than one type of program service.
- c. Fixed assets are significant.
- d. Donated services are significant.

**M80#60.** Depreciation should be recognized in the financial statements of
- a. Proprietary (for-profit) hospitals only.
- b. Both proprietary (for-profit) and not-for-profit hospitals.
- c. Both proprietary (for-profit) and not-for-profit hospitals, only when they are affiliated with a college or university.
- d. All hospitals, as a memorandum entry not affecting the statement of revenues and expenses.

**M79#42.** In the loan fund of a college or university, each of the following types of loans would be found **except**
- a. Student.
- b. Staff.
- c. Building.
- d. Faculty.

**M79#43.** What is the recommended method of accounting to be used by colleges and universities?
- a. Cash.
- b. Modified cash.
- c. Restricted accrual.
- d. Accrual.

**M79#44.** Why do voluntary health and welfare organizations, unlike some not-for-profit organizations, record and recognize depreciation of fixed assets?
- a. Fixed assets are more likely to be material in amount in a voluntary health and welfare organization than in other not-for-profit organizations.
- b. Voluntary health and welfare organizations purchase their fixed assets, and therefore have a historical cost basis from which to determine amounts to be depreciated.
- c. A fixed asset used by a voluntary health and welfare organization has alternative uses in private industry and this opportunity cost should be reflected in the organization's financial statements.
- d. Contributors look for the most efficient use of funds, and since depreciation represents a cost of employing fixed assets, it is appropriate that a voluntary health and welfare organization reflect it as a cost of providing services.

**M79#45.** Which of the following receipts is properly recorded as restricted current funds on the books of a university?
- a. Tuition.
- b. Student laboratory fees.
- c. Housing fees.
- d. Research grants.

**M79#46.** Which of the following funds of a voluntary health and welfare organization does **not** have a counterpart **fund** in governmental accounting?
- a. Current unrestricted.
- b. Land, building, and equipment.
- c. Custodian.
- d. Endowment.

## SELECTED MULTIPLE CHOICE ITEMS — UNOFFICIAL ANSWERS

### I. General Concepts, Principles, Terminology, Environment, and Other Professional Standards

**C. Conceptual Framework**

N83# 1 c
N83# 2 a
M83# 1 d
M83# 2 a
M83# 3 b
M83# 4 b
N82# 1 b
N82#29 a
N82#30 b
M82#14 a
M82#15 b
M82#33 d
N81# 2 a
M81#11 a
N79#18 b

**D. Basic Concepts and Accounting Principles**

N83# 3 a
M83# 5 b
M82#16 a
N81# 1 a
N81# 3 a
N81# 4 b
N81# 5 b
M81# 2 c
M81# 3 b
M81# 4 a
M81# 5 b
N80# 5 c
N80# 6 d
N80#12 a
M80#26 d
M80#29 a
N79# 4 a
N79# 5 a
N79# 9 d
N79#19 a
N79#27 c

**E. Nonmonetary Transactions Concepts**

M82#17 a
N80#24 b
M80#30 b

**H. Consolidated Financial Statements**

N82# 2 d
N82# 4 d
M82#12 a
M82#18 d
M79#17 b

**I. Historical Cost, Constant Dollar, Current Cost, and Other Accounting Concepts**

N83# 4 c
M83# 6 b
M83# 7 d
N82# 3 c
N82#33 d
N82#34 a
M82#26 a
M82#36 c
M82#39 b
N81# 6 d
N81# 7 d
M80#27 b

### II. Measurement, Valuation, Realization, and Presentation of Assets in Conformity with Generally Accepted Accounting Principles

**B. Marketable Securities and Investments**

N83# 5 d
N83# 6 c
M83# 8 b
M83# 9 b
M83#13 a
N82# 5 a
N81#16 d
N80#19 c
N80#20 b
N80#23 a
M80# 2 d
M80# 5 c
N79#30 c
M79#15 a

**C. Receivables and Accruals**

N83# 7 a
N83# 8 c
M83#11 d
M83#12 c
N81# 9 d
M80#22 c

**D. Inventories**

N83# 9 d
N83#10 c
N83#11 a
N82# 6 c
N82# 7 c
M82# 7 c
N81#10 d
N81#11 b
N80#17 a
N80#18 d
M80# 3 a
M80# 4 c
M79#11 a

**E. Property, Plant, and Equipment**

M83#10 c
M83#14 d
M83#15 b
N82# 8 d
N82#12 c
M82# 1 c
N81#12 c
N81#13 a
M80#35 c
M80#36 c
M79#13 d

**F. Capitalized Leased Assets**

M83#16 d
N82#10 c

**G. Intangibles**

N83#12 c
M83#17 a
M83#18 c
M82# 3 d
N81#17 a
M81# 7 d
N80#15 d
M80#37 c
M79#12 a

**H. Prepaid Expenses and Deferred Charges**

M83#19 d
N81#15 a
M80# 8 a

## III. Valuation, Recognition, and Presentation of Liabilities in Conformity with Generally Accepted Accounting Principles

**A. Payables and Accruals**

N83#13 a
M83#21 b
N81# 8 c
N80# 3 b
M80# 7 d
N79#14 b

**C. Deferred Income Tax Liabilities**

M83#20 c

**D. Capitalized Lease Liability**

M83#22 b
M82# 4 b
N80#21 c

**E. Bonds Payable**

N83#14 d
N83#15 d
N83#16 d
N83#17 b
M83#23 a
M83#24 b
M83#25 c
M83#30 a
M82# 6 b
M82# 8 c
M81#15 c

**G. Contingent Liabilities and Commitments**

N83#18 b
N82#11 d
M82# 5 d
N81#14 a
M81#10 b
M80#25 c

## IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity with Generally Accepted Accounting Principles

**A. Preferred and Common Stock**

N81#19 c
M81# 1 a
N79# 7 c

**B. Additional Paid-in Capital**

N83#19 d
N82# 9 b
N81#20 a
M81#12 a

**C. Retained Earnings and Dividends**

N83#20 a
N83#21 a
N82#13 c
M82#10 c
N81#24 b
M81#13 c

**D. Treasury Stock and Other Contra Accounts**

N83#22 b
M83#27 c
N82#19 b
M82#11 c
N81#22 c
N79# 6 c

**E. Stock Options, Warrants, and Rights**

N83#23 b
M82#13 b
N81#23 b
M81# 9 b

**F. Reorganization and Change in Entity**

N82#16 c
N79#23 a

## V. Measurement and Presentation of Income and Expense Items, Their Relationship to Matching and Periodicity, and Their Relationship to Generally Accepted Accounting Principles

**A. Sales or Revenues**

N83#24 a
N83#25 c
M83#26 b
M83#28 d
M83#29 c
N82#17 c
M81#14 b
N80#22 a
N79#12 a
M79# 2 b
M79# 6 a

**B. Cost of Goods Sold**

N82#21 c
M82#21 b
M82#22 b
N81#21 b

**C. Expenses**

N83#26 a
N83#27 d
M83#31 c
M83#32 c
M83#33 b
M83#34 a
N82#18 c
N82#20 d
N82#22 c
N82#23 c
N82#25 a
M82#23 a
M82#31 a
M82#34 d
N81#25 a
N81#26 d
N81#29 a
M81#17 d
M81#19 b
M81#20 b
M81#21 a
N80# 1 a

**D. Provision for Income Tax**

M83#35 b
N82#14 b
N81#28 a
N81#35 b
N80# 8 c
M80#12 a
M80#13 d
N79#17 a
M79# 9 b
M80#11 d
M80#15 a
N79#16 c

**E. Recurring Versus Nonrecurring Transactions and Events**

N83#28 c
N83#29 c
M82#29 d
N81#30 d
M81#22 a
N80#13 b
M80#10 c

**F. Accounting Changes**

M83#36 c
M82#25 b
M81#23 c

**G. Earnings Per Share**

M83#37 c
N82#24 b
M82#20 a
N81#31 a
N81#32 a
M81#24 c
M81#25 a
N80#11 c
M79#18 c

## VI. Other Financial Topics

### A. Statement of Changes in Financial Position

N83#30 a
N83#31 d
M83#38 a
M83#39 d
N82#26 d
N82#27 a
M82#27 c
M82#28 b
N81#33 c
M81#26 c
M81#27 d
N80#29 b
N80#30 c
M80#16 c
M80#17 d
M80#18 d
M80#20 b
M79#16 d

### B. Accounting Policies

N82#36 c
M82#37 b
M81#28 c
N80# 9 b
M80#23 d
M80#24 d

### C. Accounting Changes

N83#32 b
M83#40 d
N82#28 a
M82#24 c
M81#29 d
N79#28 c
M79# 7 a

### D. Business Combinations

N83#33 a
N83#34 d
M83#41 d
N82#31 a
N82#35 c
M82#30 d
M82#32 c
M81#31 d
M80#14 d
M80#40 b
N79#26 b
M79# 1 d
M79# 4 c

### E. Interim Financial Statements

N83#35 b
N82#32 a
M82#38 d
N81#36 b
M81#32 c
N80#16 c
M79# 3 b

### F. Loss or Gain Contingencies

N82#37 d
M82#40 c
N81#37 a
M81#36 a
N79# 2 b
N79# 3 a
M79# 5 b

### G. Segments and Lines of Business

M83#44 d
M82# 2 a
N81#40 a
M81#39 a
N80#10 b
N80#28 c
M80#38 d
N79#25 a

### H. Long-Term Contracts

M83#43 d
N82#38 a
M82#19 d
N81#34 b
M81#35 d
N79#11 b
N79#15 a

### I. Employee Benefits

M83#42 b
N82#39 a
M82#35 b
N81#38 d
M81#37 a
M81#38 b
M80#21 a
M80#33 c
N79# 8 d
N79#20 d
M79# 8 c

### J. Analysis of Financial Statements

M83#45 c
N82#40 c
N81#39 a
M81#30 a
M81#40 c
N80# 4 b
M80# 1 b
M80#50 a

## VII. Cost Accumulation, Planning, and Control

### A. Nature of Cost Elements

N83#36 d
N83#37 a
N83#38 c
M83#46 c
N82#42 b
N81#41 d
N81#42 b
N81#46 c
M81#41 b
M81#42 d
M81#43 b
N79#35 b
M79#34 a

### B. Job Order Costing

N83#39 b
N82#41 d
M82#41 b
N81#44 c
M81#44 a
M80#42 d
M79#22 b

### C. Process Costing

N83#40 c
N83#41 d
N82#43 a
M82#42 d
N81#43 a
N81#45 d
M81#46 a
N80#43 c
N80#44 c
M80#41 d
M79#29 b
M79#39 b

### D. Standard Costing and Variance Analysis

N83#42 b
N83#43 b
M83#48 d
N82#48 a
N82#50 d
N81#52 c
N81#53 d
M81#50 d
N80#38 a
N80#48 b
N80#49 c
N80#50 a
M80#45 a
M79#20 a
M79#23 b
M79#25 b
M79#33 c

### E. Joint Costing

N82#44 c
M82#44 a
N81#48 b
M81#48 d
N80#39 d
M80#43 a
M79#31 a

### F. By-Product Costing

N82#45 b
N81#49 d
M81#49 c
N80#40 a
N79#33 d

**G. Spoilage, Waste, and Scrap**

N81#57 b
N80#46 b
N79#34 c

**H. Absorption and Direct Costing**

N83#44 b
M83#47 b
M82#43 b
M82#45 b
M81#47 b
N80#31 a

**K. Budgeting and Flexible Budgeting**

M83#49 b
N82#46 b
N81#51 a
M79#38 d

**L. Breakeven and Cost-Volume-Profit Analysis**

N83#45 d
N83#46 c
M82#47 d
M82#50 a
N81#50 b
N81#56 c
N80#34 b
N80#35 c
M80#47 c
N79#31 b
M79#28 d
M79#32 a
M79#37 a

**N. Differential Cost Analysis**

N80#45 a
M80#44 b
N79#32 d
M79#21 b
M79#24 c

**O. Capital Budgeting Techniques**

N83#47 d
N83#48 b
M82#46 a
M82#49 c
N81#60 d
N80#32 d
N80#33 d
M80#48 d
M80#49 d
N79#39 a

**P. Performance Analysis**

N83#49 c

**Q. Quantitative Techniques for Planning and Control**

N83#50 b
M83#50 b
N82#47 d
N82#49 d
M82#48 d
N81#54 a
N81#55 b
N81#58 d
N81#59 c
N80#36 a
N80#41 a
N80#42 c
N80#47 a
M80#46 a
N79#36 a
N79#37 b
N79#38 d
N79#40 a
M79#26 c
M79#27 b
M79#36 c

## VIII. Not-for-Profit and Governmental Accounting

**A. Conceptual Framework**

N80#51 b
M80#58 d
M79#50 b

**B. Fund Accounting**

N83#51 d
N83#52 b
N83#53 c
M83#51 c
M83#52 d
M83#53 b
N82#51 d
N82#52 a
N82#53 a
M82#53 b
M82#54 c
M82#55 a
M81#51 c
M81#52 b
M81#53 b
N80#52 a
N80#53 b
M80#55 d
N79#42 a
N79#48 a
N79#49 c
N79#50 c
M79#47 b
M79#48 c
M79#49 c

**C. Types of Funds and Fund Accounts**

N83#54 b
N83#55 a
N83#56 d
N83#57 c
M83#54 a
M83#55 b
M83#56 b
M83#57 a
M83#58 a
N82#54 b
N82#55 a
N82#56 b
N82#57 b
N82#58 d
M82#51 c
M82#52 d
M82#56 a
M82#57 b
M82#58 a
M81#54 d
M81#55 d
M81#56 b
M81#57 a
M81#58 d
N80#55 d
N80#56 a
N80#58 b
M80#51 c
M80#53 c
N79#43 d
N79#45 c
N79#46 c

**D. Presentation of Financial Statements for Various Not-for-Profit and Governmental Organizations**

N83#58 b

**E. Various Types of Not-for-Profit and Governmental Organizations**

N83#59 a
N83#60 d
M83#59 a
M83#60 c
N82#59 c
N82#60 a
M82#59 d
M82#60 a
M81#59 d
M81#60 d
N80#59 a
N80#60 b
M80#59 a
M80#60 b
M79#42 c
M79#43 d
M79#44 d
M79#45 d
M79#46 b

## I. General Concepts, Principles, Terminology, Environment, and Other Professional Standards

**N83**
**Number 4 (Estimated time —— 15 to 25 minutes)**

Selected information from the financial statements of the Pace Company follows:

*Pace Company*
**CURRENT ASSETS SECTION OF BALANCE SHEETS**

| | December 31, 1982 | December 31, 1981 |
|---|---|---|
| | (000 omitted) | |
| Cash | $ 7,000 | $ 7,200 |
| Marketable securities, at cost which approximates market | 26,000 | 22,000 |
| Accounts receivable, net of allowance for doubtful accounts | 210,000 | 190,000 |
| Inventories | 252,000 | 308,000 |
| Prepaid expenses | 5,000 | 4,800 |
| Total current assets | $500,000 | $532,000 |

*Pace Company*
**STATEMENTS OF INCOME**

| | Year ended December 31, 1982 | Year ended December 31, 1981 |
|---|---|---|
| | (000 omitted) | |
| Net sales | $1,200,000 | $1,000,000 |
| Costs and expenses: | | |
| Cost of goods sold | 960,000 | 800,000 |
| Selling, general and administrative expenses | 147,000 | 120,000 |
| Other, net | 24,000 | 18,300 |
| Total costs and expenses | 1,131,000 | 938,300 |
| Income from continuing operations before income taxes | 69,000 | 61,700 |
| Income taxes | 26,900 | 25,300 |
| Income from continuing operations | 42,100 | 36,400 |
| Cumulative effect of change in estimates of salvage values of property, plant, and equipment, less applicable income taxes of $1,500,000 | — | 3,000 |
| Net income | $ 42,100 | $ 33,400 |
| Earnings per share of common stock: | | |
| Income from continuing operations | $ 4.21 | $ 3.64 |
| Cumulative effect of change in estimates of salvage values of property, plant, and equipment, less applicable income taxes | — | .30 |
| Net income | $ 4.21 | $ 3.34 |

Selected information from the notes to the financial statements of the Pace Company is as follows:

*[From Summary of Significant Accounting Policies]*

*Inventories* — Inventories are stated at the lower of cost (first-in, first-out) or market.

*Deferred Income Taxes* — Deferred income taxes arise from timing differences when profits or expenses are included in taxable income on the income tax return later or earlier than they are included in the statement of income. Such timing differences principally relate to depreciation.

A provision for deferred income taxes of $6,700,000 in 1982 and $6,300,000 in 1981 is included in the statements of income in "other, net."

*[From Notes to Financial Statements]*

*Inventories* — Inventories are comprised of the following:

| | *December 31,* | |
|---|---|---|
| | *1982* | *1981* |
| | *(000 omitted)* | |
| Finished goods | $176,000 | $215,000 |
| Goods in process | 13,000 | 14,000 |
| Raw materials | 63,000 | 79,000 |
| | $252,000 | $308,000 |

Inventories at December 31, 1982, were reduced from a cost of $292,000,000 to a market value of $252,000,000 using the direct inventory reduction method. The cost of inventories at December 31, 1981, approximated their market value.

*Accounting Change* — During the third quarter of 1981, Pace Company revised earlier estimates of salvage values for its property, plant, and equipment. This change in accounting reduced the 1981 net income by $3,000,000 ($0.30 per share).

**Required:**

**a.** Are inventories and the related cost of goods sold presented appropriately? Explain why or why not. If the presentation is not appropriate, specify the appropriate presentation and explain why.

**b.** 1. What are the components of the quick (acid-test) ratio?

2. How should the quick (acid-test) ratio be used?

**c.** Is the provision for deferred income taxes presented appropriately? Explain why or why not. If the presentation is not appropriate, specify the appropriate presentation and explain why.

**d.** Is the accounting change presented appropriately? Explain why or why not. If the presentation is not appropriate, specify the appropriate presentation and explain why. Assume that the accounting change did not involve deferred income taxes.

**N81**
**Number 4**

**Part a.** The Whit Company and the Berry Company, a manufacturer and retailer, respectively, entered into a business combination whereby the Whit Company acquired for cash all of the outstanding voting common stock of the Berry Company.

**Required:**

1. The Whit Company is preparing consolidated financial statements immediately after the consummation of the above-stated business combination. How should the Whit Company determine in general the amounts to be reported for the assets and liabilities of Berry Company? Assuming that the business combination resulted in goodwill, indicate how the amount of goodwill is determined.

2. Why and under what circumstances should Berry Company be included in the entity's consolidated financial statements?

**M81**
**Number 3 (Estimated time —— 15 to 25 minutes)**

Financial reporting should provide information to help investors, creditors, and other users of financial statements. Statement of Financial Accounting Standards No. 33 requires large public enterprises to disclose certain supplementary information.

**Required:**

**a.** Describe the historical cost/constant dollar method of accounting. Include in your discussion how historical cost amounts are used to make historical cost/constant dollar measurements.

**b.** Describe the principal advantage of the historical cost/constant dollar method of accounting over the historical cost method of accounting.

**c.** Describe the current cost method of accounting.

**d.** Why would depreciation expense for a given year differ using the current cost method of accounting instead of the historical cost method of accounting? Include in your discussion whether depreciation expense is likely to be higher or lower using the current cost method of accounting instead of the historical cost method of accounting in a period of rising prices, and why.

**N79**
**Number 3 (Estimated time —— 15 to 20 minutes)**

Generally accepted accounting principles require the use of accruals and deferrals in the determination of income.

**Required:**

**a.** How does accrual accounting affect the determination of income? Include in your discussion what constitutes an accrual and a deferral, and give appropriate examples of each.

**b.** Contrast accrual accounting with cash accounting.

**M79**

**Number 2 (Estimated time — — 20 to 25 minutes)**

Shown below are the financial statements issued by Allen Corporation for its fiscal year ended October 31, 1978:

*Allen Corporation*

**Statement of Financial Position**

*October 31, 1978*

| | | |
|---|---|---|
| *Assets* | | |
| Cash | | $ 15,000 |
| Accounts receivable, net | | 150,000 |
| Inventory | | 120,000 |
| Total current assets | | 285,000 |
| Trademark (Note 3) | | 250,000 |
| Land | | 125,000 |
| Total assets | | $660,000 |
| *Liabilities* | | |
| Accounts payable | | $ 80,000 |
| Accrued expenses | | 20,000 |
| Total current liabilities | | 100,000 |
| Deferred income tax payable (Note 4) | | 80,000 |
| Total liabilities | | $180,000 |
| *Stockholders' Equity* | | |
| Common stock, par $1 (Note 5) | $100,000 | |
| Additional paid-in capital | 180,000 | |
| Retained earnings | 200,000 | 480,000 |
| Total liabilities and stockholders' equity | | $660,000 |

*Allen Corporation*

**Earnings Statement**

*For the fiscal year ended October 31, 1978*

| | | |
|---|---|---|
| Sales | | $1,000,000 |
| Cost of goods sold | | 750,000 |
| Gross margin | | 250,000 |
| Expenses: | | |
| Bad debt expense | $ 7,000 | |
| Insurance | 13,000 | |
| Lease expenses (Note 1) | 40,000 | |
| Repairs and maintenance | 30,000 | |
| Pensions (Note 2) | 12,000 | |
| Salaries | 60,000 | 162,000 |
| Earnings before provision for income tax | | 88,000 |
| Provision for income tax | | 28,740 |
| Net earnings | | $ 59,260 |
| Earnings per common share outstanding | | $ 0.5926 |

*Allen Corporation*

**Statement of Retained Earnings**

*For the fiscal year ended October 31, 1978*

| | |
|---|---|
| Retained earnings, November 1, 1977 | $150,000 |
| Extraordinary gain, net of income tax | 25,000 |
| Net earnings for the fiscal year ended October 31, 1978 | 59,260 |
| | 234,260 |
| Dividends ($0.3426 per share) | 34,260 |
| Retained earnings, October 31, 1978 | $200,000 |

**Footnotes**

Note 1 — Long-Term Lease

Under the terms of a 5-year noncancelable lease for buildings and equipment, the Company is obligated to make annual rental payments of $40,000 in each of the next four fiscal years. At the conclusion of the lease period, the Company has the option of purchasing the leased assets for $20,000 (a bargain purchase option) or entering into another 5-year lease of the same property at an annual rental of $5,000.

Note 2 — Pension Plan

Substantially all employees are covered by the Company's pension plan. Pension expense is equal to the total of pension benefits paid to retired employees during the year.

Note 3 — Trademark

The Company's trademark was purchased from Apex Corporation on January 1, 1976, for $250,000.

Note 4 — Deferred Income Tax Payable

The entire balance in the deferred income tax payable account arose from tax-exempt municipal bonds that were held during the previous fiscal year giving rise to a difference between taxable income and reported net earnings for the fiscal year ended October 31, 1977. The deferred liability amount was calculated on the basis of expected tax rates in future years.

Note 5 — Warrants

On January 1, 1977, one common stock warrant was issued to stockholders of record for each common share owned. An additional share of common stock is to be issued upon exercise of ten stock warrants and receipt of an amount equal to par value. For the six months ended October 31, 1978, the average market value for the Company's common stock was $5 per share and no warrants had yet been exercised.

Note 6 — Contingent Liability

On October 31, 1978, the Company was contingently liable for product warranties in an amount estimated to aggregate $75,000.

**Required:**

Review the preceding financial statements and related footnotes. Identify any inclusions or exclusions from them that would be in violation of generally accepted accounting principles, and indicate corrective action to be taken. Do **not** comment as to format or style. Respond in the following order:

- Statement of Financial Position.
- Footnotes.
- Earnings Statement.
- Statement of Retained Earnings.
- General.

## II. Measurement, Valuation, Realization, and Presentation of Assets in Conformity With Generally Accepted Accounting Principles

**N83**

**Number 2 (Estimated time —— 15 to 25 minutes)**

George Company purchased land for use as its corporate headquarters. A small factory that was on the land when it was purchased was torn down before construction of the office building began. Furthermore, a substantial amount of rock blasting and removal had to be done to the site before construction of the building foundation began. Because the office building was set back on the land far from the public road, George Company had the contractor construct a paved road which led from the public road to the parking lot of the office building.

Three years after the office building was occupied, George Company added four stories to the office building. The four stories had an estimated useful life of five years more than the remaining estimated useful life of the original office building.

Ten years later the land and building were sold at an amount more than their net book value and George Company had a new office building constructed in another state for use as its new corporate headquarters.

**Required:**

**a.** Which of the above expenditures should be capitalized? How should each be depreciated or amortized? Discuss the rationale for your answers.

**b.** How would the sale of the land and building be accounted for? Include in your answer how to determine the net book value at the date of sale. Discuss the rationale for your answer.

**M83**

**Number 2 (Estimated time —— 15 to 25 minutes)**

Taylor Company, a household appliances dealer, purchases its inventories from various suppliers. Taylor has consistently stated its inventories at the lower of cost (FIFO) or market.

**Required:**

**a.** Taylor is considering alternate methods of accounting for the cash discounts it takes when paying its suppliers promptly. From a theoretical standpoint, discuss the acceptability of each of the following methods:

1. Financial income when payments are made.
2. Reduction of cost of goods sold for period when payments are made.
3. Direct reduction of purchase cost.

**b.** Identify the effects on both the balance sheet and the income statement of using the LIFO inventory method instead of the FIFO method over a substantial time period when purchase prices of household appliances are rising. State why these effects take place.

**c.** Why is the lower of cost-or-market rule used for valuing inventories when the FIFO method is used?

**N82**
**Number 2 (Estimated time — — 15 to 25 minutes)**

**Part a.** On July 1, 1981, Carme Company, a calendar-year company, sold special-order merchandise on credit and received in return an interest-bearing note receivable from the customer. Carme Company will receive interest at the prevailing rate for a note of this type. Both the principal and interest are due in one lump sum on June 30, 1982.

**Required:**
1. When should Carme Company report interest income from the note receivable? Discuss the rationale for your answer.
2. Assume that the note receivable was discounted without recourse at a bank on December 31, 1981. How would Carme Company determine the amount of the discount and what is the appropriate accounting for the discounting transaction?

**Part b.** On December 31, 1981, Carme Company had significant amounts of accounts receivable as a result of credit sales to its customers. Carme Company uses the allowance method based on credit sales to estimate bad debts. Based on past experience, 1% of credit sales normally will not be collected. This pattern is expected to continue.

**Required:**
1. Discuss the rationale for using the allowance method based on credit sales to estimate bad debts. Contrast this method with the allowance method based on the balance in the trade receivables accounts.
2. How should Carme Company report the allowance for bad debts account on its balance sheet at December 31, 1981? Also, describe the alternatives, if any, for presentation of bad debt expense in Carme Company's 1981 income statement.

**M82**
**Number 2 (Estimated time — — 15 to 25 minutes)**

**Part a.** At the end of its first year of operations, Key Company had a current marketable equity securities portfolio with a cost of $500,000 and a market value of $550,000. At the end of its second year of operations, Key Company had a current marketable equity securities portfolio with a cost of $525,000 and a market value of $475,000. No securities were sold during the first year. One security with a cost of $80,000 and a market value of $70,000 at the end of the first year was sold for $100,000 during the second year.

**Required:**
How should Key Company report the above facts in its balance sheets and income statements for both years? Discuss the rationale for your answer.

**Part b.** On July 1, 1981, Dynamic Company purchased for cash 40 percent of the outstanding capital stock of Cart Company. Both Dynamic Company and Cart Company have a December 31 year end. Cart Company, whose common stock is actively traded in the over-the-counter market, reported its total net income for the year to Dynamic Company, and also paid cash dividends on November 15, 1981, to Dynamic Company and its other stockholders.

**Required:**
How should Dynamic Company report the above facts in its December 31, 1981, balance sheet and its income statement for the year then ended? Discuss the rationale for your answer.

**N81**
**Number 5 (Estimated time — — 15 to 25 minutes)**

Doherty Company leased equipment from Lambert Company. The classification of the lease makes a difference in the amounts reflected on the balance sheet and income statement of both Doherty Company and Lambert Company.

**Required:**
**a.** What criteria must be met by the lease in order that Doherty Company classify it as a capital lease?
**b.** What criteria must be met by the lease in order that Lambert Company classify it as a sales-type or direct financing lease?
**c.** Contrast a sales-type lease with a direct financing lease.

**M81**
**Number 4 (Estimated time — — 15 to 25 minutes)**

Retail, Inc., sells normal brand name household products both from its own store and on consignment through The Mall Space Company.

**Required:**
**a.** Should Retail, Inc., include in its inventory normal brand name goods purchased from its suppliers but not yet received if the terms of purchase are FOB shipping point (manufacturer's plant)? Why?
**b.** Should Retail, Inc., include freight-in expenditures as an inventoriable cost? Why?
**c.** Retail, Inc., purchased cooking utensils for sale in the ordinary course of business three times during the current year, each time at a higher price than the previous purchase. What would have been the effect on ending inventory and cost of goods sold had Retail, Inc., used the weighted-average cost method instead of the FIFO method?

**d.** How and why will Retail, Inc., treat net markdowns when it calculates the estimated cost of ending inventory using the conventional (lower of cost or market) retail inventory method?

**e.** What are products on consignment and how should they be presented on the balance sheets of Retail, Inc., and The Mall Space Company?

**N80**
**Number 2 (Estimated time —— 15 to 25 minutes)**

Among the principal topics related to the accounting for the property, plant, and equipment of a company are acquisition and retirement.

**Required:**

**a.** What expenditures should be capitalized when equipment is acquired for cash?

**b.** Assume that the market value of equipment acquired is not determinable by reference to a similar purchase for cash. Describe how the acquiring company should determine the capitalizable cost of equipment purchased by exchanging it for each of the following:

1. Bonds having an established market price.
2. Common stock not having an established market price.
3. Similar equipment having a determinable market value.

**c.** Describe the factors that determine whether expenditures relating to property, plant, and equipment already in use should be capitalized.

**d.** Describe how to account for the gain or loss on the sale of property, plant, and equipment for cash.

**M80**
**Number 2**

**Part a.** Cost for inventory purposes should be determined by the inventory cost flow method most clearly reflecting periodic income.

**Required:**

1. Describe the fundamental cost flow assumptions of the average cost, FIFO, and LIFO inventory cost flow methods.
2. Discuss the reasons for using LIFO in an inflationary economy.
3. Where there is evidence that the utility of goods, in their disposal in the ordinary course of business, will be less than cost, what is the proper accounting treatment and under what concept is that treatment justified?

**M80**
**Number 3 (Estimated time —— 15 to 25 minutes)**

**Part a.** Capital leases and operating leases are the two classifications of leases described in FASB pronouncements, from the standpoint of the **lessee.**

**Required:**

1. Describe how a capital lease would be accounted for by the lessee both at the inception of the lease and during the first year of the lease, assuming the lease transfers ownership of the property to the lessee by the end of the lease.
2. Describe how an operating lease would be accounted for by the lessee both at the inception of the lease and during the first year of the lease, assuming equal monthly payments are made by the lessee at the beginning of each month of the lease. Describe the change in accounting, if any, when rental payments are not made on a straight-line basis.

Do **not** discuss the criteria for distinguishing between capital leases and operating leases.

**Part b.** Sales-type leases and direct financing leases are two of the classifications of leases described in FASB pronouncements, from the standpoint of the **lessor.**

**Required:**

Compare and contrast a sales-type lease with a direct financing lease as follows:

1. Gross investment in the lease.
2. Amortization of unearned interest income.
3. Manufacturer's or dealer's profit.

Do **not** discuss the criteria for distinguishing between the leases described above and operating leases.

**M79**
**Number 3 (Estimated time —— 15 to 20 minutes)**

**Part a.** The most common method of accounting for unconsolidated subsidiaries is the equity method.

**Required:**

Answer the questions shown below with respect to the **equity** method.

1. Under what circumstances should the equity method be applied?
2. At what amount should the initial investment be recorded and what events subsequent to the initial investment (if any) would change this amount?
3. How are investment earnings recognized under the equity method, and how is the amount determined?

**Part b.** For the past five years Herbert has maintained an investment (properly accounted for and reported upon) in Broome amounting to a 10% interest in the voting common stock of Broome. The purchase price was $700,000 and the underlying net equity in Broome at the date of purchase was $620,000. On January 2 of the current year, Herbert purchased an additional 15% of the voting common stock of Broome for $1,200,000; the underlying net equity of the additional investment at January 2 was $1,000,000. Broome has been profitable and has paid dividends annually since Herbert's initial acquisition.

**Required:**
Discuss how this increase in ownership affects the accounting for and reporting upon the investment in Broome. Include in your discussion adjustments, if any, to the amount shown prior to the increase in investment to bring the amount into conformity with generally accepted accounting principles. Also include how current and subsequent periods would be reported upon.

## III. Valuation, Recognition, and Presentation of Liabilities in Conformity With Generally Accepted Accounting Principles

**N83**
**Number 5 (Estimated time —— 15 to 25 minutes)**

On January 1, Borman Company, a lessee, entered into three noncancelable leases for brand new equipment, Lease J, Lease K, and Lease L. None of the three leases transfers ownership of the equipment to Borman at the end of the lease term. For each of the three leases, the present value at the beginning of the lease term of the minimum lease payments, excluding that portion of the payments representing executory costs such as insurance, maintenance, and taxes to be paid by the lessor, including any profit thereon, is 75% of the excess of the fair value of the equipment to the lessor at the inception of the lease over any related investment tax credit retained by the lessor and expected to be realized by the lessor.

The following information is peculiar to each lease:

- Lease J does not contain a bargain purchase option; the lease term is equal to 80% of the estimated economic life of the equipment.
- Lease K contains a bargain purchase option; the lease term is equal to 50% of the estimated economic life of the equipment.
- Lease L does not contain a bargain purchase option; the lease term is equal to 50% of the estimated economic life of the equipment.

**Required:**

**a.** How should Borman Company classify each of the three leases above, and why? Discuss the rationale for your answer.

**b.** What amount, if any, should Borman record as a liability at the inception of the lease for each of the three leases above?

**c.** Assuming that the minimum lease payments are made on a straight-line basis, how should Borman record each minimum lease payment for each of the three leases above?

**M83**
**Number 5 (Estimated time —— 15 to 25 minutes)**

**Part a.** Reece Company sells two types of merchandise, Type A and Type B. Each carries a one-year warranty.

- Type A merchandise — Product warranty costs, based on past experience, will normally be 1% of sales.
- Type B merchandise — Product warranty costs cannot be reasonably estimated because this is a new product line. However, the chief engineer believes that product warranty costs are likely to be incurred.

**Required:**
How should Reece report the estimated product warranty costs for each of the two types of merchandise above? Discuss the rationale for your answer. Do not discuss deferred income tax implications, or disclosures that should be made in Reece's financial statements or notes.

**Part b.** Carpenter Company is being sued for $2,000,000 for an injury caused to a child as a result of alleged negligence while the child was visiting the Carpenter Company plant in March 1982. The suit was filed in July 1982. Carpenter's lawyer states that it is probable that Carpenter will lose the suit and be found liable for a judgment costing anywhere from $200,000 to $900,000. However, the lawyer states that the most probable judgment is $400,000.

**Required:**
How should Carpenter report the suit in its 1982 financial statements? Discuss the rationale for your answer. Include in your answer disclosures, if any, that should be made in Carpenter's financial statements or notes.

**N82**

**Number 3 (Estimated time —— 15 to 25 minutes)**

On February 1, 1979, Aubrey Company sold its 5-year, $1,000 par value, 8% bonds, which were convertible at the option of the investor into Aubrey Company common stock at a ratio of 10 shares of common stock for each bond. The convertible bonds were sold by Aubrey Company at a discount. Interest is payable annually each February 1. On February 1, 1982, Mel Company, an investor in the Aubrey Company convertible bonds, tendered 1,000 bonds for conversion into 10,000 shares of Aubrey Company common stock, which had a market value of $110 per share at the date of the conversion.

On May 1, 1982, Aubrey Company sold its 10-year, $1,000 par value, 14% nonconvertible term bonds dated April 1, 1982. Interest is payable semiannually and the first interest payment date is October 1, 1982. Due to market conditions, the bonds were sold at an effective interest rate (yield) of 16%.

**Required:**

**a.** How should Aubrey Company account for the conversion of the convertible bonds into common stock under both the book value and market value methods? Discuss the rationale for each method.

**b.** Were the nonconvertible term bonds sold at par, at a discount, or at a premium? Discuss the rationale for your answer.

**c.** Identify and discuss the effects on Aubrey Company's 1982 income statement associated with the nonconvertible term bonds.

**N80**

**Number 4 (Estimated time —— 15 to 25 minutes)**

One way for a corporation to accomplish long-term financing is through the issuance of long-term debt instruments in the form of bonds.

**Required:**

**a.** Describe how to account for the proceeds from bonds issued with detachable stock purchase warrants.

**b.** Contrast a serial bond with a term (straight) bond.

**c.** For a five-year term bond issued at a premium, why would the amortization in the first year of the life of the bond differ using the interest method of amortization instead of the straight-line method? Include in your discussion whether the amount of amortization in the first year of the life of the bond would be higher or lower using the interest method instead of the straight-line method.

**d.** When a bond issue is sold between interest dates at a discount, what journal entry is made and how is the subsequent amortization of bond discount affected? Include in your discussion an explanation of how the amounts of each debit and credit are determined.

**e.** Describe how to account for and classify the gain or loss from the reacquisition of a long-term bond prior to its maturity.

## IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With Generally Accepted Accounting Principles

**M83**
**Number 3 (Estimated time —— 15 to 25 minutes)**

Lynch Company's Statement of Stockholders' Equity and Statement of Retained Earnings at December 31, 1982, and December 31, 1981 are presented below:

*Lynch Company*
**STATEMENT OF STOCKHOLDERS' EQUITY**

| | December 31, 1982 | December 31, 1981 |
|---|---|---|
| | (000 omitted) | |
| Common stock, par value $1.00 per share; authorized 40,000,000 shares; issued 22,000,000 shares at December 31, 1982 and 20,000,000 shares at December 31, 1981 | $ 22,000 | $ 20,000 |
| Additional paid-in capital | 240,000 | 222,000 |
| Retained earnings | 296,000 | 280,000 |
| | $558,000 | $522,000 |

*Lynch Company*
**STATEMENT OF RETAINED EARNINGS**

| | Year ended December 31, 1982 | Year ended December 31, 1981 |
|---|---|---|
| | (000 omitted) | |
| Retained earnings at beginning of period, as previously reported | $280,000 | $264,000 |
| Adjustment for extraordinary item | 14,000 | — |
| Retained earnings at beginning of period, as restated | 294,000 | 264,000 |
| Net income | 52,400 | 47,400 |
| Adjustment for correction of error | — | (11,000) |
| Cash dividends | (24,400) | (20,400) |
| 10% stock dividend | (20,000) | — |
| Treasury stock | (6,000) | — |
| Retained earnings at end of period | $296,000 | $280,000 |

Additional facts are as follows:

- The extraordinary item of $14,000,000 is net of income taxes of $8,000,000.
- On January 15, 1982, Lynch Company declared a 10% stock dividend from previously unissued stock. The closing market price of Lynch Company common stock on the New York Stock Exchange was $10 per share on January 15, 1982.
- On July 16, 1982, Lynch Company purchased 500,000 shares of its own common stock for $12 per share. The cost method of accounting was used for this treasury stock transaction.

**Required:**

**a.** Determine whether the presentation of the following in the Lynch Company Statement of Retained Earnings is appropriate:

- Adjustment for extraordinary item.
- Adjustment for correction of error.
- 10% stock dividend.
- Treasury stock.

If the presentation is appropriate, explain why. If the presentation is not appropriate, specify the appropriate presentation and explain why.

Do not discuss disclosure requirements for the Notes to the Financial Statements.

**b.** How did the additional facts above concerning the stock dividend and treasury stock transaction affect the cash dividend per-share (pay-out) ratio?

**N80**
**Number 5 (Estimated time —— 15 to 25 minutes)**

Problems may be encountered in accounting for transactions involving the stockholders' equity section of the balance sheet.

**Required:**

**a.** Describe the accounting for the subscription of common stock at a price in excess of the par value of the common stock.

**b.** Describe the accounting for the issuance for cash of no par value common stock at a price in excess of the stated value of the common stock.

**c.** Explain the significance of the three dates that are important in accounting for cash dividends to stockholders. State the journal entry, if any, needed at each date.

**d.** Assume retained earnings can be used for stock dividends distributable in shares. What is the effect of an ordinary 10 percent common stock dividend on retained earnings and total stockholders' equity?

**N79**
**Number 2**

**Part b.** For numerous reasons a corporation may reacquire shares of its own capital stock. When a company purchases treasury stock, it has two options as to how to account for the shares: (1) cost method, and (2) par value method.

**Required:**

Compare and contrast the cost method with the par value method for each of the following:

1. Purchase of shares at a price less than par value.
2. Purchase of shares at a price greater than par value.
3. Subsequent resale of treasury shares at a price less than purchase price, but more than par value.
4. Subsequent resale of treasury shares at a price greater than both purchase price and par value.
5. Effect on net income.

**M79**
**Number 6 (Estimated time —— 15 to 20 minutes)**

**Part a.** Capital stock is an important area of a corporation's equity section. Generally the term "capital stock" embraces common and preferred stock issued by a corporation.

**Required:**

1. What are the basic rights inherent in ownership of common stock, and how are they exercised?
2. What is preferred stock? Discuss the various preferences afforded preferred stock.

**Part b.** In dealing with the various equity securities of a corporate entity it is important to understand certain terminology related thereto.

**Required:** Define the following terms.

1. Treasury stock.
2. Legal capital.
3. Stock right.
4. Stock warrant.

## V. Measurement and Presentation of Income and Expense Items, Their Relationship to Matching and Periodicity, and Their Relationship to Generally Accepted Accounting Principles

**N82**
**Number 5 (Estimated time —— 15 to 25 minutes)**

David Company's Statements of Income for the year ended December 31, 1981, and December 31, 1980 are presented below:

*David Company*
**STATEMENTS OF INCOME**

| | Year ended December 31, 1981 | Year ended December 31, 1980 |
|---|---|---|
| | (000 omitted) | |
| Net sales | $900,000 | $750,000 |
| Costs and expenses: | | |
| Cost of goods sold | 720,000 | 600,000 |
| Selling, general and administrative expenses | 112,000 | 90,000 |
| Other, net | 11,000 | 9,000 |
| Total costs and expenses | 843,000 | 699,000 |
| Income from continuing operations before income taxes | 57,000 | 51,000 |
| Income taxes | 23,000 | 24,000 |
| Income from continuing operations | 34,000 | 27,000 |
| Loss on disposal of Dex Division, including provision of $1,500,000 for operating losses during phase-out period, less applicable income taxes of $8,000,000 | 8,000 | — |
| Cumulative effect on prior years of change in depreciation method, less applicable income taxes of $1,500,000 | — | 3,000 |
| Net income | $ 26,000 | $ 30,000 |
| Earnings per share of common stock: | | |
| Income before cumulative effect of change in depreciation method | $ 2.60 | $ 2.70 |
| Cumulative effect on prior years of change in depreciation method, less applicable income taxes | — | .30 |
| Net income | $ 2.60 | $ 3.00 |

Additional facts are as follows:

- On January 1, 1980, David Company changed its depreciation method for previously recorded plant machinery from the double-declining-balance method to the straight-line method. The effect of applying the straight-line method for the year of and the year after the change is included in David Company's Statements of Income for the year ended December 31, 1981, and December 31, 1980, in "cost of goods sold."
- The loss from operations of the discontinued Dex Division from January 1, 1981, to September 30, 1981, (the portion of the year prior to the measurement date) and from January 1, 1980, to December 31, 1980, is included in David Company's Statements of Income for the year ended December 31, 1981, and December 31, 1980, respectively, in "other, net."
- David Company has a simple capital structure with only common stock outstanding and the net income per share of common stock was based on the weighted-average number of common shares outstanding during each year.
- David Company common stock is listed on the New York Stock Exchange and closed at $13 per share on December 31, 1981, and $15 per share on December 31, 1980.

**Required:**

**a.** Determine from the additional facts above whether the presentation of those facts in David Company's Statements of Income is appropriate. If the presentation is appropriate, discuss the theoretical rationale for the presentation. If the presentation is not appropriate, specify the appropriate presentation and discuss its theoretical rationale.

Do not discuss disclosure requirements for the Notes to the Financial Statements.

**b.** Describe the general significance of the price-earnings ratio. Based on David Company's Statements of Income, and the additional facts above, describe how to determine the price-earnings ratio for 1981 only.

**M82**

**Number 3 (Estimated time —— 15 to 25 minutes)**

The Horizon Company is listed on the New York Stock Exchange. The market value of its common stock was quoted at $18 per share at both December 31, 1981, and December 31, 1980. Horizon's Balance Sheets at December 31, 1981, and December 31, 1980, and Statements of Income and Retained Earnings for the years then ended are presented below:

*Horizon Company*

**BALANCE SHEETS**

| | December 31, 1981 | December 31, 1980 |
|---|---|---|
| | *(000 omitted)* | |
| *Assets:* | | |
| Current assets: | | |
| Cash | $ 3,500 | $ 3,600 |
| Marketable securities, at cost which approximates market | 13,000 | 11,000 |
| Accounts receivable, net of allowance for doubtful accounts | 105,000 | 95,000 |
| Inventories at lower of cost or market | 126,000 | 154,000 |
| Prepaid expenses | 2,500 | 2,400 |
| Total current assets | 250,000 | 266,000 |
| Property, plant and equipment, net of accumulated depreciation | 311,000 | 308,000 |
| Other assets | 29,000 | 34,000 |
| Total assets | $590,000 | $608,000 |
| *Liabilities and Stockholders' Equity:* | | |
| Current liabilities: | | |
| Notes payable | $ 5,000 | $ 15,000 |
| Accounts payable and accrued expenses | 62,500 | 74,500 |
| Income taxes payable | 1,000 | 1,000 |
| Payments due within one year on long-term debt | 6,500 | 7,500 |
| Total current liabilities | 75,000 | 98,000 |
| Long-term debt | 169,000 | 180,000 |
| Deferred income taxes | 74,000 | 67,000 |
| Other liabilities | 9,000 | 8,000 |
| Stockholders' equity: | | |
| Common stock, par value $1.00 per share; authorized 20,000,000 shares; issued and outstanding 10,000,000 shares | 10,000 | 10,000 |
| Additional paid-in capital | 111,000 | 111,000 |
| Retained earnings | 142,000 | 134,000 |
| Total stockholders' equity | 263,000 | 255,000 |
| Total liabilities and stockholders' equity | $590,000 | $608,000 |

*Horizon Company*
**STATEMENTS OF INCOME AND RETAINED EARNINGS**

| | Year ended December 31, 1981 | Year ended December 31, 1980 |
|---|---|---|
| | (000 omitted) | |
| Net sales | $600,000 | $500,000 |
| Costs and expenses: | | |
| Cost of goods sold | 480,000 | 400,000 |
| Selling, general and administrative expenses | 66,000 | 60,000 |
| Other, net | 17,000 | 6,000 |
| Total costs and expenses | 563,000 | 466,000 |
| Income before income taxes | 37,000 | 34,000 |
| Income taxes | 16,800 | 15,800 |
| Net income | 20,200 | 18,200 |
| Retained earnings at beginning of period, as previously reported | 141,000 | 132,000 |
| Adjustment required for correction of an error | (7,000) | (6,000) |
| Retained earnings at beginning of period, as restated | 134,000 | 126,000 |
| Dividends on common stock | 12,200 | 10,200 |
| Retained earnings at end of period | $142,000 | $134,000 |

Additional facts are as follows:

- "Selling, general and administrative expenses" for 1981 included a usual but infrequently occurring charge of $9,000,000.
- "Other, net" for 1981 included an extraordinary item (charge) of $10,000,000. If the extraordinary item (charge) had not occurred, income taxes for 1981 would have been $21,800,000 instead of $16,800,000.
- "Adjustment required for correction of an error" was a result of a change from an accounting principle that is not generally accepted to one that is generally accepted.
- Horizon Company has a simple capital structure and has disclosed earnings per common share for net income in the Notes to the Financial Statements.

**Required:**

**a.** Determine from the additional facts above whether or not the presentation of those facts in the above Horizon Company Statements of Income and Retained Earnings is appropriate. If the presentation is appropriate, discuss the theoretical rationale for the presentation. If the presentation is not appropriate, describe the appropriate presentation and discuss its theoretical rationale.

Do not discuss disclosure requirements for the Notes to the Financial Statements.

**b.** Describe the general significance of the following financial analysis tools:

- Quick (acid-test) ratio.
- Inventory turnover.
- Return on stockholders' equity.

**c.** Based on the Horizon Company Balance Sheets, Statements of Income and Retained Earnings, and additional facts, describe how to determine each of the above financial analysis tools (for the year 1981 only).

**M82**
**Number 4 (Estimated time —— 15 to 25 minutes)**

**Part a.** This year Lorac Company has each of the following items in its income statement:

- Gross profits on installment sales.
- Revenues on long-term construction contracts.
- Estimated costs of product warranty contracts.
- Premiums on officers' life insurance with Lorac as beneficiary.

**Required:**
1. Under what conditions would deferred income taxes need to be reported in the financial statements?
2. Specify when deferred income taxes would need to be recognized for each of the items above, and indicate the rationale for such recognition.

**Part b.** Eneri Company's president has heard that deferred income taxes can be variously classified in the balance sheet.

**Required:**
Identify the conditions under which deferred income taxes would be classified as a noncurrent item in the balance sheet. What justification exists for such classification?

**M80**
**Number 2**

**Part b.** Public enterprises are required to present earnings per share data on the face of the income statement.

**Required:**
Compare and contrast primary earnings per share with fully diluted earnings per share for each of the following:
1. The effect of common stock equivalents on the number of shares used in the computation of earnings per share data.
2. The effect of convertible securities that are **not** common stock equivalents on the number of shares used in the computation of earnings per share data.
3. The effect of antidilutive securities.

**N79**
**Number 2**

**Part a.** When a company has a policy of making sales for which credit is extended, it is reasonable to expect a portion of those sales to be uncollectible. As a result of this, a company must recognize bad debt expense. There are basically two methods of recognizing bad debt expense: (1) direct write-off method, and (2) allowance method.

**Required:**
1. Describe fully both the direct write-off method and the allowance method of recognizing bad debt expense.
2. Discuss the reasons why one of the above methods is preferable to the other and the reasons why the other method is not usually in accordance with generally accepted accounting principles.

**N79**
**Number 4**

**Part a.** Deferred income taxes are required under generally accepted accounting principles. Accounting Principles Board Opinion No. 11 requires the use of the deferred method of comprehensive interperiod tax allocation. Two ways to account for timing differences under the deferred method are: (1) gross change method, and (2) net change method.

**Required:**
1. Describe the gross change method.
2. Describe the net change method.

## VI. Other Financial Topics

**N83**
**Number 3 (Estimated time —— 15 to 25 minutes)**

The Michael Company is accounting for a long-term construction contract using the percentage-of-completion method. It is a four-year contract that is presently in its second year. The latest estimates of total contract costs indicate that the contract will be completed at a profit to Michael Company.

**Required:**
**a.** What theoretical justification is there for Michael Company's use of the percentage-of-completion method?

**b.** How would progress billings be accounted for? Include in your discussion the classification of progress billings in the Michael Company financial statements.

**c.** How would the income recognized in the second year of the four-year contract be determined using the cost-to-cost method of determining percentage of completion?

**d.** What would be the effect on earnings per share in the second year of the four-year contract of using the percentage-of-completion method instead of the completed-contract method? Discuss.

**N81**
**Number 2 (Estimated time —— 15 to 25 minutes)**

It is important in accounting theory to be able to distinguish the types of accounting changes.

**Required:**

**a.** If a public company desires to change from the sum-of-the-years-digits depreciation method to the straight-line method for its fixed assets, what type of accounting change would this be? Discuss the permissibility of this change.

**b.** When pro forma disclosure is required for an accounting change, how are these pro forma amounts determined?

**c.** If a public company obtained additional information about the service lives of some of its fixed assets which showed that the service lives previously used should be shortened, what type of accounting change would this be? Include in your discussion how the change should be reported in the income statement of the year of the change, and what disclosures should be made in the financial statements or notes.

**d.** Changing specific subsidiaries comprising the group of companies for which consolidated financial statements are presented is an example of what type of accounting change, and what effect does it have on the consolidated income statements?

**N81**
**Number 4**

**Part b.** The Bert Company and the Lyle Company entered into a business combination accounted for as a pooling of interests.

**Required:**

1. How should the expenses related to effecting the business combination be handled, and why?
2. How should the results of operations for the year in which the business combination occurred be reported? Why is this reporting appropriate?

**M81**
**Number 5 (Estimated time —— 15 to 25 minutes)**

Many companies have pension plans for their employees. Accounting for the cost of pension plans is a complex subject in which many technical terms are encountered.

**Required:**

**a.** Describe normal cost.

**b.** Describe vested benefits. Include in your discussion what the actuarially computed value of vested benefits represents.

**c.** How should actuarial gains and losses directly related to the operation of a pension plan be accounted for?

**d.** What disclosures concerning pension plans should be made in the company's financial statements or notes?

**N80**
**Number 3 (Estimated time —— 15 to 25 minutes)**

**Part a.** Loss contingencies may exist for companies.

**Required:**

1. What conditions should be met for an estimated loss from a loss contingency to be accrued by a charge to income?
2. When is disclosure required, and what disclosure should be made for an estimated loss from a loss contingency that need not be accrued by a charge to income?

**Part b.** Income determination for long-term construction contracts presents special problems because the construction work often extends over two or more accounting periods. The two methods commonly followed are the percentage-of-completion method and the completed-contract method.

**Required:**

Evaluate the use of the percentage-of-completion method for income determination purposes for long-term construction contracts. Discuss only theoretical arguments.

**M80**
**Number 4 (Estimated time —— 15 to 25 minutes)**

**Part a.** The various types of accounting changes may significantly affect the presentation of both financial position and results of operations for an accounting period and the trends shown in comparative financial statements and historical summaries.

**Required:**

1. Describe a change in accounting principle and how it should be reported in the income statement of the period of the change.
2. Describe a change in accounting estimate and how it should be reported in the income statement of the period of the change.
3. Describe a change in reporting entity and how it should be reported. Give an appropriate example of a change in reporting entity.

**Part b.** A corporation has a noncompensatory stock purchase plan for all of its employees and a compensatory stock option plan for some of its corporate officers.

**Required:**

1. Compare and contrast the accounting at the date the stock is issued for the noncompensatory stock purchase plan and the compensatory stock option plan.
2. What entry should be made for the compensatory stock option plan at the date of the grant?

**N79**
**Number 4**

**Part b.** Timely financial information is important to users of financial statements. As a result, many companies produce financial information more frequently than annually.

**Required:**
1. How are revenues, costs, and expenses recognized for interim reporting related to those recognized for year-end reporting?
2. How are income taxes recognized at interim dates?

**N79**
**Number 5 (Estimated time —— 15 to 20 minutes)**

When a business combination is effected by an exchange of common stock, the transaction is accounted for as a purchase or as a pooling of interests, depending on the circumstances. The methods are not optional and each yields significantly different results as to financial position and results of operations.

**Required:**
Discuss the **supportive** arguments for each of the following:
**a.** Purchase method.
**b.** Pooling of interests method.

Do **not** discuss in your answer the rules for distinguishing between a purchase and a pooling of interests.

**M79**
**Number 4 (Estimated time —— 15 to 20 minutes)**

In accounting for long-term contracts (those taking longer than one year to complete), the two methods commonly followed are the percentage-of-completion method and the completed-contract method.

**Required:**
**a.** Discuss how earnings on long-term contracts are recognized and computed under these two methods.
**b.** Under what circumstances is it preferable to use one method over the other?
**c.** Why is earnings recognition as measured by interim billings not generally accepted for long-term contracts?
**d.** How are job costs and interim billings reflected on the balance sheet under the percentage-of-completion method and the completed-contract method?

**M79**
**Number 5 (Estimated time —— 15 to 20 minutes)**

**Part a.** In order to properly understand current generally accepted accounting principles with respect to accounting for and reporting upon segments of a business enterprise, as stated by the Financial Accounting Standards Board in its Statement 14, it is necessary to be familiar with certain unique terminology.

**Required:**
With respect to segments of a business enterprise, explain the following terms:
1. Industry segment.
2. Revenue.
3. Operating profit and loss.
4. Identifiable assets.

**Part b.** A central issue in reporting on industry segments of a business enterprise is the determination of which segments are reportable.

**Required:**
1. What are the tests to determine whether or not an industry segment is reportable?
2. What is the test to determine if enough industry segments have been separately reported upon and what is the guideline on the maximum number of industry segments to be shown?

## VII. Cost Accumulation, Planning, and Control

**M83**
**Number 4 (Estimated time —— 15 to 25 minutes)**

**Part a.** Noble Manufacturing Company uses the weighted-average method of process costing when computing manufacturing cost per equivalent unit. The work-in-process inventory at the beginning of the period was complete as to materials, and one-third complete as to conversion costs. The work-in-process inventory at the end of the period was complete as to materials, and one-quarter complete as to conversion costs.

**Required:**
1. Describe how the cost of the beginning work-in-process inventory is handled using the weighted-average method of process costing when computing manufacturing cost per equivalent unit. Do not describe determination of equivalent units.
2. Identify the conditions under which the weighted-average method of process costing would be inappropriate.
3. Specify the advantages of the weighted-average method of process costing in contrast to the first-in, first-out method.
4. How would Noble compute the amount of the conversion cost portion of its ending work-in-process inventory using the weighted-average method?

**Part b.** Daly Company has determined the number of units of Product Y that Daly would have to sell in order to break even. However, Daly would like to attain a 20 percent profit on sales of Product Y.

**Required:**

1. Explain how breakeven analysis can be used to determine the number of units of Product Y that Daly would have to sell to attain a 20 percent profit on sales.
2. If variable cost per unit increases as a percentage of the sales price, how would that affect the number of units of Product Y that Daly would have to sell in order to break even and why?
3. Identify the limitations of breakeven analysis in managerial decision-making.

**N82**
**Number 4 (Estimated time —— 15 to 25 minutes)**

**Part a.** Grisp Company, a manufacturer with heavy investments in property, plant, and equipment, is presently using absorption costing for both its external and internal reporting. The management of Grisp Company is considering using the direct costing method for internal reporting only.

**Required:**

1. What would be the rationale for using the direct costing method for internal reporting?
2. Assuming that the quantity of ending inventory is higher than the quantity of beginning inventory, would operating income using direct costing be different from operating income using absorption costing? If so, specify if it would be higher or lower. Discuss the rationale for your answer.

**Part b.** The net present value method and the internal rate of return method are both sophisticated capital budgeting techniques.

**Required:**

1. State the advantages that both the net present value method and the internal rate of return method have over the payback method.
2. State the limitations of the net present value method.
3. State the limitations of the internal rate of return method.
4. How does each method (net present value and internal rate of return) handle depreciation? Discuss the rationale for your answer. Ignore income tax considerations in your answer.

**M82**
**Number 5 (Estimated time —— 15 to 25 minutes)**

**Part a.** Stein Company is going to use a predetermined annual factory overhead rate to charge factory overhead to products. In conjunction with this, Stein Company must decide whether to use direct labor hours or machine hours as the overhead rate base.

**Required:**

Discuss the objectives and criteria that Stein Company should use in selecting the base for its predetermined annual factory overhead rate.

**Part b.** Meyer Company's cost accounting department has prepared a factory overhead variance analysis report using the two-variance method. The plant manager of Meyer Company is interested in understanding the managerial usefulness of this report.

**Required:**

1. What are the purposes of a factory overhead variance analysis report?
2. Identify and explain the underlying assumptions associated with the two-variance method. Discuss the significance of each variance.

**M81**
**Number 2 (Estimated time —— 15 to 25 minutes)**

**Part a.** A company is presently using the payback method for evaluating capital budgeting projects and is considering using other more sophisticated capital budgeting techniques. The president has requested an explanation of the advantages and disadvantages of the payback method.

**Required:**

1. State the advantages and disadvantages of the payback method.
2. What other capital budgeting techniques could be used?

**Part b.** A company is presently using breakeven analysis. The president has requested an explanation of this analytical tool.

**Required:**

1. What is the breakeven point and how is it computed?
2. What are the major uses of breakeven analysis?

**M80**
**Number 5 (Estimated time —— 15 to 25 minutes)**

**Part a.** An important concept in process costing is that of equivalent units.

**Required:**

1. Describe the difference between units placed in process for a period and equivalent units for a period when there is no beginning work-in-process inventory and the ending work-in-process inventory is 50 percent complete.

2. Describe the difference between units completed for a period and equivalent units for a period when there is no beginning work-in-process inventory and the ending work-in-process inventory is 50 percent complete.
3. Describe how equivalent units for a period are used to compute the cost of the ending work-in-process inventory.

**Part b.** Indirect manufacturing costs (factory overhead) include indirect materials, indirect labor, and other indirect costs.

**Required:**
1. Describe indirect materials and give an appropriate example.
2. Describe indirect labor and give an appropriate example.
3. Describe fixed indirect manufacturing costs (factory overhead).
4. Describe variable indirect manufacturing costs (factory overhead).
5. Describe semivariable indirect manufacturing costs (factory overhead).

**N79**
**Number 6 (Estimated time — — 15 to 20 minutes)**

**Part a.** Although direct costing is not a current generally accepted method of costing inventory for external reporting, it is useful for internal purposes.

**Required:**
1. Describe the difference between direct costing and the current generally accepted method of costing inventory for external reporting.
2. Describe how a direct costing structure facilitates calculation of the contribution margin and the breakeven point.

**Part b.** The success of a standard cost system depends on the reliability, accuracy, and acceptance of the standards. Variances from the standards must be analyzed to ascertain why they occurred.

**Required:**
1. Describe the two standards that must be developed for materials cost and how the variances (both favorable and unfavorable) from these standards are calculated.
2. Describe the two standards that must be developed for labor cost and how the variances (both favorable and unfavorable) from these standards are calculated.

## VIII. Not-for-Profit and Governmental Accounting

**N81**
**Number 3 (Estimated time — — 15 to 25 minutes)**

Governmental accounting gives substantial recognition to budgets, with those budgets being recorded in the accounts of the governmental unit.

**Required:**

**a.** What is the purpose of a governmental accounting system and why is the budget recorded in the accounts of a governmental unit? Include in your discussion the purpose and significance of appropriations.

**b.** Describe when and how a governmental unit records its budget, and closes it out.

## I. General Concepts, Principles, Terminology, Environment, and Other Professional Standards

**N83**
**Answer 4** (10 points)

**a.** Inventories are presented appropriately as a current asset in the current assets section of the balance sheets.

Cost of goods sold is presented appropriately in the statements of income as a separate item of costs and expenses to arrive at income from continuing operations because it is part of the continuing operations.

Inventories are presented appropriately in the summary of significant accounting policies because the accounting policy regarding inventories, lower of cost (first-in, first-out) or market is disclosed.

Inventories are presented appropriately in the note to financial statements on inventories because the following items are disclosed:

- The composition of the inventories.
- The reduction of inventories from cost to market at December 31, 1982, which is an adjustment that due to its significance should be adequately disclosed in the notes to the financial statements.
- The fact that the cost of inventories at December 31, 1981, approximated their market value.

**b.** 1. The components of the quick (acid-test) ratio are as follows:

- The quick assets that make up the numerator are cash, short-term marketable securities, short-term notes receivable, and accounts receivable. In the Pace Company current assets section of balance sheets it would be the cash, the marketable securities, and the accounts receivable.
- Total current liabilities is the denominator.

2. The quick (acid-test) ratio tests the ability to meet sudden demands upon liquid current assets. It is used as a test of immediate liquidity by short-term creditors and others.

**c.** The provision for deferred income taxes should not be included in the statements of income in "other-net." Deferred income taxes are part of income taxes and should be presented in the statements of income in "income taxes."

The breakdown between current income taxes and deferred income taxes should be presented in the statements of income or disclosed in the notes to the financial statements. If the breakdown between current income taxes and deferred income taxes is disclosed in the notes to the financial statements, it should be disclosed in the note on deferred income taxes, not in summary of significant accounting policies.

**d.** The accounting change is a change in estimate, not a change in principle, and should not be included in the statements of income separately as "cumulative effect, less applicable income taxes of $1,500,000." The effect of the change should be reflected in depreciation expense in the current and future years as a separate component of income from continuing operations before income taxes because it is a material event that is usual but infrequently occurring. "Income taxes" should be adjusted each year. A separate per share amount for this change should not be presented in the statements of income under "earnings per share of common stock."

**N81**
**Answer 4**

**Part a.**

1. Whit Company should allocate the purchase price to the assets acquired and liabilities assumed. First, all identifiable assets acquired, either individually or by type, and liabilities assumed in the business combination, whether or not shown in the financial statements of Berry Company, should be assigned a portion of the cost of Berry Company, normally equal to their fair values at the date of acquisition.

Goodwill is determined as the excess of the purchase price over the sum of the amounts assigned to identifiable assets acquired less liabilities assumed.

2. In deciding upon consolidation policy, the aim should be to make the financial presentation that is most meaningful in the circumstances. Berry Company should be included in the entity's consolidated financial statements from the date of the purchase.

The usual condition for consolidation is control as evidenced by ownership of a majority voting interest. Therefore, as a general rule, ownership by one company, directly or indirectly, of over 50 percent of the outstanding voting shares of another company is a condition pointing toward consolidation.

**M81**
**Answer 3** (10 points)

**a.** The historical cost/constant dollar method of accounting is based on measures of historical prices in dollars, each of which has the same general purchasing power.

Historical cost amounts outdated in terms of current prices are restated on a current basis by the application of the Consumer Price Index for All Urban Consumers to the historical cost amounts.

Measurements of historical cost/constant dollar amounts are computed by multiplying the components of the historical cost/nominal dollar measurements by the average level of the Consumer Price Index for the current fiscal year (or the level of the index at the end of the year if comprehensive financial statements are presented) and dividing the result by the level of the index at the date on which the measurement of the associated items was established (that is, the date of acquisition or the date of any measurement not based on historical cost).

**b.** The principal advantage of the historical cost/constant dollar method of accounting over the historical cost method is that it assists in the analysis of the effects of changing general price levels. In a period of rising prices, the historical cost method of accounting matches dollars of different purchasing power on the income statement.

**c.** The current cost method of accounting is based on measuring and reporting assets and expenses associated with the use or sale of assets at their current cost or lower recoverable amount at the balance sheet date or at the date of use or sale.

**d.** Depreciation expense using the current cost method of accounting would differ from depreciation expense using the historical cost method of accounting because depreciation expense is based on the current rather than historical cost of the fixed asset involved.

In a period of rising prices, depreciation expense is likely to be higher using the current cost method of accounting because the current cost of the fixed asset is likely to be higher.

**N79**

**Answer 3** (10 points)

**a.** Accrual accounting recognizes and reports the effects of transactions and other events on the assets and liabilities of a business enterprise in the time periods to which they relate rather than only when cash is received or paid. Accrual accounting attempts to match revenues and the expenses associated with those revenues in order to determine net income for an accounting period. Revenues are recognized and recorded when earned. Expenses are recognized and recorded as follows:

- Associating Cause and Effect. Some expenses are recognized and recorded on a presumed direct association with specific revenue.
- Systematic and Rational Allocation. In the absence of a direct association with specific revenue, some expenses are recognized and recorded by attempting to allocate expenses in a systematic and rational manner among the periods in which benefits are provided.
- Immediate Recognition. Some costs are associated with the current accounting period as expenses because (1) costs incurred during the period provide no discernible future benefits, (2) costs recorded as assets in prior periods no longer provide discernible benefits, or (3) allocating costs either on the basis of association with revenues or among several accounting periods is considered to serve no useful purpose.

An accrual represents a transaction that affects the determination of income for the period but has not yet been reflected in the cash accounts of that period. Accrued revenue is revenue earned but not yet collected in cash. An example of accrued revenue is accrued interest revenue earned on bonds from the last interest payment date to the end of the accounting period. An accrued expense is an expense incurred but not yet paid in cash. An example of an accrued expense is salaries incurred for the last week of the accounting period that are not payable until the subsequent accounting period.

A deferral represents a transaction that has been reflected in the cash accounts of the period but has not yet affected the determination of income for that period. Deferred (prepaid) revenue is revenue collected or collectible in cash but not yet earned. An example of deferred (prepaid) revenue is rent collected in advance by a lessor in the last month of the accounting period, which represents the rent for the first month of the subsequent accounting period. A deferred (prepaid) expense is an expense paid or payable in cash but not yet incurred. An example of a deferred (prepaid) expense is an insurance premium paid in advance in the current accounting period, which represents insurance coverage for the subsequent accounting period.

**b.** In cash 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. Because cash accounting does not attempt to match revenues and the expenses associated with those revenues, cash accounting is not in conformity with generally accepted accounting principles.

**M79**

**Answer 2** (11 points)

*Statement of Financial Position*

The deferred income tax liability should not be shown on the statement because it arose from a permanent difference, not a timing difference. The trademark should be amortized over a maximum period of forty years, using the straight-line method of amortization. Accounts receivable should be shown at the gross amount and an amount net of the allowance for doubtful accounts. Also, the number of common shares authorized, issued, and outstanding should be disclosed in the stockholders' equity section.

*Footnotes*

The lease discussed in footnote 1 is a capital lease because of the bargain purchase option. Therefore, lease expense shown in the earnings statement is incorrect. The present value of the future minimum lease payments (net of executory costs and any profit thereon) should be determined and recorded on the statement of financial position as an asset. The cost of the leased assets is then matched with earnings as amortization expense over the life of the assets and the cost of the deferral of payment as interest expense over the life of the lease.

The pay-as-you-go or terminal funding methods are not generally accepted methods of accounting for pension cost. An acceptable method, such as unit credit, entry age normal, individual level premium, aggregate, or attained age normal should be adopted in order to reflect the cost of providing pension benefits.

Even though there is no income tax deferral to be recorded on the statement of financial position because the difference between taxable income and accounting income is a permanent difference, not a timing difference that would turn around at a later date, footnote 4 describes an incorrect method of determining the deferral. Had the deferred income tax recognition been required to be used, the deferral method is the generally accepted method, not the liability method.

The warranty contingency meets the two tests for the accrual of a contingent loss (probable, and amount reasonably estimable) and should be accrued as a liability and an expense shown in the earnings statement.

Preceding the footnotes to the financial statements, or as the initial footnote, there should be a description of all significant accounting policies used by the company. Based on the statements as presented, this footnote should address itself to the following areas: (1) inventory, (2) amortization of trademark, (3) basis for valuation of land, (4) pension plan accounting procedures, and (5) capitalized lease amortization.

*Earnings Statement*

An analysis of the earnings statement discloses the following violations of generally accepted accounting principles.

Earnings per share as shown is incorrect for several reasons. First, the title "earnings per common share" is incorrect because there are warrants outstanding calling for a dual presentation using the titles "primary earnings per share" and "fully diluted earnings per share." The amount shown as earnings per share is incorrect for three reasons:

1. The dilutive effect of the warrants outstanding is not considered (that is, not properly accounted for using the treasury stock method).
2. The extraordinary item should be considered in the computation of primary and fully diluted earnings per share.
3. Primary earnings per share and fully diluted earnings per share should be stated for earnings before extraordinary items, for extraordinary items, and for net earnings.

Net earnings are incorrect because the extraordinary gain is omitted. To correct this, the extraordinary gain should be taken out of the statement of retained earnings and shown in the earnings statement.

*Statement of Retained Earnings*

The extraordinary item does not belong in this statement; properly, it should be reflected in the earnings statement. Also, the correction of the deferred tax amount should be reflected in this statement as a correction of an error made in a prior period.

*General*

The statement of changes in financial position is missing; one should be prepared and included with the other statements and disclosures in order to make this a complete set of financial statements.

## II. Measurement, Valuation, Realization, and Presentation of Assets in Conformity With Generally Accepted Accounting Principles

**N83**
**Answer 2** (10 points)

**a.** Expenditures should be capitalized when they benefit future periods. The cost to acquire the land should be capitalized and classified as land, a nondepreciable asset. Since tearing down the small factory is readying the land for its intended use, its cost is part of the cost of the land and should be capitalized and classified as land. As a result, this cost will not be depreciated as it would if it were classified with the capitalizable cost of the building.

Since rock blasting and removal is required for the specific purpose of erecting the building, its cost is part of the cost of the building and should be capitalized and classified with the capitalizable cost of the building. This cost should be depreciated over the estimated useful life of the building.

The road is a land improvement, and its cost should be capitalized and classified separately as a land improvement. This cost should be depreciated over its estimated useful life.

The added four stories is an addition, and its cost should be capitalized and classified with the capitalizable cost of the building. This cost should be depreciated over the remaining life of the original office building because that life is shorter than the estimated useful life of the addition.

**b.** The gain should be recognized on the sale of the land and building because income is realized whenever the earning process has been completed and the sale has taken place.

The net book value at the date of sale would be composed of the capitalized cost of the land, the land improvement, and the building, as determined above, less the accumulated depreciation on the land improvement and the building. The excess of the proceeds received from the sale over the net book value at the date of sale would be accounted for as income from continuing operations in the income statement.

**b.** Inventories would be lower using the LIFO inventory method instead of the FIFO method over a substantial time period when purchase prices of household appliances are rising because the inventories are at the oldest (lower) purchase prices instead of the most recent (higher) purchase prices. Correspondingly, cost of goods sold would be higher because the cost of goods sold is at more recent (higher) purchase prices instead of older (lower) purchase prices. Consequently, net income and retained earnings would be lower.

More cash flow would generally be available using the LIFO inventory method instead of the FIFO method because taxable income is decreased, resulting generally in accrual and payment of lower income taxes. Correspondingly, income tax expense would generally be lower.

**c.** The lower of cost-or-market rule is used for valuing inventories when the FIFO method is used because of (a) the matching principle, that is, the decline in the utility of the household appliances inventories below its cost should be recognized as a loss in the current period, and (b) the concept of balance sheet conservatism.

**M83**
**Answer 2** (10 points)

**a.**

1. Cash discounts should not be accounted for as financial income when payments are made. Income should be recognized when the earning process is complete (when Taylor sells the inventory). Furthermore, cash discounts should not be recorded when the payments are made because in order to properly match a cash discount with the related purchase, the cash discount should be recorded when the related purchase is recorded.

2. Cash discounts should not be accounted for as a reduction of cost of goods sold for period when payments are made. Cost of goods sold should be reduced when the earning process is complete (when Taylor sells the inventory which has been reduced by the cash discounts). Furthermore, cash discounts should not be recorded when the payments are made because in order to properly match a cash discount with the related purchase, the cash discount should be recorded when the related purchase is recorded.

3. Cash discounts should be accounted for as a direct reduction of purchase cost because they reduce the cost of the inventories. Purchases should be recorded net of cash discount to reflect the net cash to be paid. The primary basis of accounting for inventories is cost, which represents the price paid or consideration given to acquire an asset.

**N82**
**Answer 2** (10 points)

**Part a.**

1. Carme Company should report a portion of the interest income from the note receivable in 1981 (interest earned for the six-month period from July 1, 1981, to December 31, 1981) and a portion in 1982 (interest earned for the six-month period from January 1, 1982, to June 30, 1982). Interest accrues with the passage of time, and thus it should be accounted for as an element of income over the life of the note receivable.

2. First, determine the maturity value of the note receivable (the face value of the note receivable plus the interest income to be earned over the life of the note receivable [twelve-month period from July 1, 1981, to June 30, 1982]). Then, multiply the maturity value of the note receivable by one half of the discount rate (six-month period from December 31, 1981, to June 30, 1982) to arrive at the amount of the discount.

To account for the discounting transaction, cash would be debited for the amount received from the bank. Notes receivable would be credited for the face value of the note receivable. Interest expense for the amount of the discount would be debited and interest revenue for the interest income to be earned over the life of the note receivable would be credited. These latter two entries, however, are usually netted against each other instead of being recognized separately.

**Part b.**

1. The allowance method based on credit sales attempts to match bad debts with the revenues generated by the sales in the same period. Thus, it focuses on the income statement rather than the balance sheet.

On the other hand, the allowance method based on the balance in the trade receivables accounts attempts to value the accounts receivable at the end of a period at their future collectible amounts. Thus, it focuses on the balance sheet rather than the income statement.

It should be noted, however, that both the allowance method based on credit sales and the allowance method based on the balance in the trade receivables accounts are acceptable under generally accepted accounting principles.

2. Carme Company should report on its balance sheet at December 31, 1981, the balance in the allowance for bad debts account as a valuation or contra asset account; that is, a subtraction from the asset accounts receivable.

Bad debt expense may be presented in the income statement as a selling expense, general and administrative expense, financial expense, or as a subtraction to arrive at net sales.

**M82**
**Answer 2** (10 points)

**Part a.**

The carrying amount of a marketable equity securities portfolio should be the lower of its aggregate cost or market value. At the end of its first year of operations, Key Company should report the current marketable equity securities portfolio in its balance sheet at cost ($500,000) and report no gain or loss in the income statement, because a gain should not be recognized until it is realized.

At the end of its second year of operations, Key Company should report the current marketable equity securities portfolio in its balance sheet at market value ($475,000) by establishing a valuation allowance and charging in the income statement the amount by which the aggregate cost exceeds the market value ($50,000). As a result, Key Company would generally need to report deferred income taxes in its balance sheet and income statement.

A realized gain ($20,000) should be reported in the income statement for the second year as a result of the sale of one security (cost $80,000) for $100,000 during the second year.

Carrying a marketable equity securities portfolio at original cost after its market value has declined has the effect of deferring recognition of the decline in the realizable value of such securities based on the expectation of a future market value recovery that may or may not occur. Because of the uncertainty of recovery, it is conservative to carry a marketable equity securities portfolio at market value when market value is below cost.

**Part b.**

Dynamic Company should follow the equity method of accounting for its investment in Cart Company because Dynamic Company is presumed, because of the size of its investment, to be able to exercise significant influence over the operating and financial policies of Cart Company.

In 1981, Dynamic Company should report its interest in Cart Company's outstanding capital stock as a long-term investment. Following the equity method of accounting, Dynamic Company should record the cash purchase of 40 percent of Cart Company at cost, which is the amount paid.

Forty percent of Cart Company's total net income from July 1, 1981, to December 31, 1981, should be added to the carrying amount of the investment in Dynamic Company's balance sheet and shown as revenue in its income statement to recognize Dynamic Company's share of the net income of Cart Company after the date of acquisition. This amount should reflect adjustments similar to those made in preparing consolidated statements, including adjustments to eliminate intercompany gains and losses, and to amortize, if appropriate, any difference between Dynamic Company's cost and the underlying equity in net assets of Cart Company on July 1, 1981.

The cash dividends paid by Cart Company to Dynamic Company should reduce the carrying amount of the investment in Dynamic Company's balance sheet and have no effect on Dynamic Company's income statement.

As a result of following the equity method of accounting, Dynamic Company would generally need to report deferred income taxes in its balance sheet and income statement.

**N81**
**Answer 5** (10 points)

**a.** Doherty Company has entered into a capital lease if at its inception the lease meets one or more of the following criteria:

1. The lease transfers ownership of the equipment to Doherty Company by the end of the lease term.
2. The lease contains a bargain purchase option.
3. The lease term is equal to 75 percent or more of the estimated economic life of the leased equipment.
4. The present value of the minimum lease payments at the beginning of the lease term— excluding that portion of the payments representing executory costs such as insurance, maintenance, and taxes to be paid by Lambert Company, including any profit thereon— equals or exceeds 90 percent of the amount by which the fair value of the equipment leased to Lambert Company at the inception of the

lease exceeds any related investment tax credit that the Lambert Company retains and expects to realize.

The criteria in items 3 and 4 do not apply if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased equipment, including earlier years of use.

**b.** Lambert Company has entered into a sales-type lease or direct financing lease if at its inception the lease meets one or more of the criteria listed in *a.*, above, and in addition, meets both of the following criteria:

1. The collectibility of the minimum lease payments is reasonably predictable.
2. No important uncertainties surround the amount of unreimbursable costs yet to be incurred by the Lambert Company under the lease.

**c.** In a sales-type lease, manufacturer's or dealer's profit is recognized and represents the excess of the fair value of the leased property over the cost at the inception of the lease.

In a direct financing lease, the cost and the fair value of the leased property are the same at the inception of the lease. Thus, the lessor has no manufacturer's or dealer's profit; instead, the lessor has only interest income that will be earned over the life of the lease.

**M81**

**Answer 4** (10 points)

**a.** If the terms of the purchase are FOB shipping point (manufacturer's plant), Retail, Inc., should include in its inventory goods purchased from its suppliers when the goods are shipped. For accounting purposes, title is presumed to pass at that time.

**b.** Freight-in expenditures should be considered an inventoriable cost because they are part of the price paid or the consideration given to acquire an asset.

**c.** Because the cooking utensils were purchased three times during the current year, each time at a higher price than previously, Retail, Inc.'s ending inventory would be lower and the cost of goods sold would be higher using the weighted-average cost method instead of the FIFO method.

**d.** Because Retail, Inc., calculates the estimated cost of its ending inventory using the conventional (lower-of-cost-or-market) retail inventory method, net markdowns are excluded from the computation of the cost ratio and included in the computation of the ending inventory at retail. Net markdowns are excluded in order to approximate a lower-of-cost-or-market valuation. Excluding net markdowns from the computation of the cost ratio reduces the cost ratio, which in turn reduces the estimated cost of the ending inventory.

**e.** Products on consignment represents inventories owned by Retail, Inc., which are physically transferred to The Mall Space Company. Retail, Inc., retains title to the goods until their sale by The Mall Space Company.

The goods consigned are still included by Retail, Inc., in the inventory section of its balance sheet. Retail, Inc., reclassifies the inventory from regular inventory to consigned inventory. The Mall Space Company, on the other hand, reports neither inventory nor a liability in its balance sheet.

**N80**

**Answer 2** (10 points)

**a.** The expenditures that should be capitalized when equipment is acquired for cash should include the invoice price of the equipment (net of discounts) plus all incidental outlays relating to its purchase or preparation for use, such as insurance during transit, freight, duties, ownership search, ownership registration, installation, and breaking-in costs. Any available discounts, whether taken or not, should be deducted from the capitalizable cost of the equipment.

**b.**

1. When the market value of the equipment is not determinable by reference to a similar cash purchase, the capitalizable cost of equipment purchased with bonds having an established market price should be the market value of the bonds.

2. When the market value of the equipment is not determinable by reference to a similar cash purchase, and the common stock used in the exchange does not have an established market price, the capitalizable cost of equipment should be the equipment's estimated fair value if that is more clearly evident than the fair value of the common stock. Independent appraisals may be used to determine the fair values of the assets involved.

3. When the market value of equipment acquired is not determinable by reference to a similar cash purchase, the capitalizable cost of equipment purchased by exchanging similar equipment having a determinable market value should be the lower of the recorded amount of the equipment relinquished or the market value of the equipment exchanged.

**c.** The factors that determine whether expenditures relating to property, plant, and equipment already in use should be capitalized are as follows:

- Expenditures are relatively large in amount.
- They are nonrecurring in nature.
- They extend the useful life of the property, plant, and equipment.
- They increase the usefulness of the property, plant, and equipment.

**d.** The net book value at the date of the sale (cost of the property, plant, and equipment less the accumulated depreciation) should be removed from the accounts. The excess of cash from the sale over the net book value removed is accounted for as a gain on the sale, while the excess of net book value removed over cash from the sale is accounted for as a loss on the sale.

**M80**
**Answer 2**

**Part a.**

1. The average cost method is based on the assumption that the average costs of the goods in the beginning inventory and the goods purchased during the period should be used for both the inventory and the cost of goods sold.

The FIFO (first-in, first-out) method is based on the assumption that the first goods purchased are the first sold. As a result, the inventory is at the most recent purchase prices, while cost of goods sold is at older purchase prices.

The LIFO (last-in, first-out) method is based on the assumption that the latest goods purchased are the first sold. As a result, the inventory is at the oldest purchase prices, while cost of goods sold is at more recent purchase prices.

2. In an inflationary economy, LIFO provides a better matching of current costs with current revenue because cost of goods sold is at more recent purchase prices. Net cash inflow is generally increased because taxable income is generally decreased, resulting in payment of lower income taxes.

3. Where there is evidence that the utility of goods to be disposed of in the ordinary course of business will be less than cost, the difference should be recognized as a loss in the current period, and the inventory should be stated at market value in the financial statements. In accordance with the concept of conservatism, inventory should be valued at the lower of cost or market.

**M80**
**Answer 3** (10 points)

**Part a.**

1. A lessee would account for a capital lease as an asset and an obligation at the inception of the lease. Rental payments during the year would be allocated between a reduction in the obligation and interest expense. The asset would be amortized in a manner consistent with the lessee's normal depreciation policy for owned assets, except that in some circumstances, the period of amortization would be the lease term.

2. No asset or obligation would be recorded at the inception of the lease. Normally, rental on an operating lease would be charged to expense over the lease term as it becomes payable. If rental payments are not made on a straight-line basis, rental expense nevertheless would be recognized on a straight-line basis unless another systematic or rational basis is more representative of the time pattern in which use benefit is derived from the leased property, in which case that basis would be used.

**Part b.**

1. The gross investment in the lease is the same for both a sales-type lease and a direct-financing lease. The gross investment in the lease is the minimum lease payments (net of amounts, if any, included therein for executory costs such as maintenance, taxes, and insurance to be paid by the lessor, together with any profit thereon) plus the unguaranteed residual value accruing to the benefit of the lessor.

2. For both a sales-type lease and a direct-financing lease, the unearned interest income would be amortized to income over the lease term by use of the interest method to produce a constant periodic rate of return on the net investment in the lease. However, other methods of income recognition may be used if the results obtained are not materially different from the interest method.

3. In a sales-type lease, the excess of the sales price over the carrying amount of the leased equipment is considered manufacturer's or dealer's profit and would be included in income in the period when the lease transaction is recorded.

In a direct-financing lease, there is no manufacturer's or dealer's profit. The income on the lease transaction is composed solely of interest.

**M79**
**Answer 3** (10 points)

**Part a.**

1. The equity method of accounting for an investment in the voting stock of another company is called for under generally accepted accounting principles when the investor can, or is presumed to be able to, exercise significant influence over the investee by virtue of the investment. Significant influence is a subjective factor, and, as such, each case must be looked upon individually, but the Accounting Principles Board stated that, unless there is evidence to the contrary, an investment equal to 20 percent or more of the voting stock of an investee enables the investor to exercise significant influence over the investee. The equity method is sometimes referred to as a "one line consolidation," but the equity method may not be used in lieu of full consolidation when adherence to generally accepted accounting principles indicates full consolidation is necessary.

2. The initial investment using the equity method is recorded at the actual cost paid. This amount is adjusted for several reasons. The first adjustment is for the investor's proportionate amount of investee earnings that represents an increase in the investment for earnings and a decrease for investee losses. Second,

dividends received from the investee decrease the investment amount. Third, any excess of the purchase price paid over the underlying net equity in the investee at the date of initial investment is written off against the investment as depreciation or amortization. And finally, if there is evidence that since the date of investment there has been a decline in the value of the investment that is other than temporary, the investment should be written down at that point.

3. Earnings under the equity method are recognized as earned by the investee. This amount is the investor's proportionate amount of the earnings reported by the investee, whether or not paid in dividends. If the net earnings of the investee include extraordinary items or if there are prior period adjustments, these items should be reported separately by the investor. Further, if there was an excess of the purchase price over the underlying net equity of the investee, net earnings will differ on the books of the investor due to depreciation or amortization of this difference. Finally, income tax deferral may be necessary because of a difference between the proportionate share of income reported by the investor and taxable income based on dividends paid by the investee.

**Part b.**

When Herbert increased its investment in Broome common stock from 10 percent to 25 percent, Herbert obtained the presumed ability to exercise significant influence over Broome and accordingly should report its investment in Broome using the equity method.

The change from the cost method of reporting the investment in Broome to the equity method should be made by retroactively restating all prior periods in which the investment was held as if the equity method were used from inception. In making this change, Herbert must return to the original purchase price paid for the initial investment (cost) and make the following adjustments:

1. Record 10 percent of all reported earnings since the date of purchase as increases in the investment.
2. Record dividends received as a reduction in the amount shown for the investment.
3. Allocate the excess of cost over underlying net equity at the date of the initial investment to additional fair value of assets or goodwill, and depreciate or amortize such excess accordingly.

The change in the amount shown in the investment should be reflected in retained earnings in a manner consistent with the accounting for a step-by-step acquisition of a subsidiary.

Starting with the current period and for subsequent periods, Herbert should report its investment in Broome at an amount arrived at in the following manner:

1. Record 25 percent of all reported earnings (or losses) as an increase (or decrease) in the investment.
2. Record dividends received as a reduction in the amount shown for the investment.
3. Continue to depreciate or amortize excess of cost over underlying net equity for the initial investment.
4. Allocate the excess of cost over underlying net equity at the date of the increase in the investment to additional fair value of assets or goodwill, and depreciate or amortize such excess accordingly.

## III. Valuation, Recognition, and Presentation of Liabilities in Conformity With Generally Accepted Accounting Principles

**N83**
**Answer 5** (10 points)

**a.** A lease should be classified as a capital lease when it transfers substantially all of the benefits and risks inherent to the ownership of property by meeting any one of the four criteria established by FAS 13 for classifying a lease as a capital lease.

Lease J should be classified as a capital lease because the lease term is equal to 80 percent of the estimated economic life of the equipment, which exceeds the 75 percent or more criterion.

Lease K should be classified as a capital lease because the lease contains a bargain purchase option.

Lease L should be classified as an operating lease because it does not meet any of the four criteria for classifying a lease as a capital lease.

**b.** For Lease J, Borman Company should record as a liability at the inception of the lease an amount equal to the present value at the beginning of the lease term of minimum lease payments during the lease term, excluding that portion of the payments representing executory costs such as insurance, maintenance, and taxes to be paid by the lessor, including any profit thereon. However, if the amount so determined exceeds the fair value of the equipment at the inception of the lease, the amount recorded as a liability should be the fair value.

For Lease K, Borman Company should record as a liability at the inception of the lease an amount determined in the same manner as for Lease J, and the payment called for in the bargain purchase option should be included in the minimum lease payments.

For Lease L, Borman Company should not record a liability at the inception of the lease.

**c.** For Lease J, Borman Company should allocate each minimum lease payment between a reduction of the liability and interest expense so as to produce a constant periodic rate of interest on the remaining balance of the liability.

For Lease K, Borman Company should allocate each minimum lease payment in the same manner as for Lease J.

For Lease L, Borman Company should charge minimum lease (rental) payments to rental expense as they become payable.

**M83**
**Answer 5** (10 points)

**Part a.**

For Type A merchandise, the estimated product warranty costs should be accrued by a charge to income and a credit to a liability because both of the following conditions were met:

1. It is probable that a liability has been incurred based on past experience. Thus, the matching principle is being followed.
2. The amount of loss can be reasonably estimated as 1 percent of sales.

For Type B merchandise, the estimated product warranty costs should not be accrued by a charge to income because the amount of loss cannot be reasonably estimated.

**Part b.**

The probable judgment ($400,000) should be accrued by a charge to income and a credit to a liability because both of the following conditions were met:

1. It is probable that a liability has been incurred because Carpenter's lawyer states that it is probable that Carpenter will lose the suit.
2. The amount of loss can be reasonably estimated because Carpenter's lawyer states that the most probable judgment is $400,000.

Thus, the principle of conservatism is being followed.

Carpenter should disclose the following in its financial statements or notes:

- The amount of the suit ($2 million)
- The nature of the accrual
- The nature of the contingency
- The range of loss ($200,000 to $900,000)

**N82**
**Answer 3** (10 points)

**a.** Under the book value method, the carrying value of the convertible bonds at the date of the conversion (the bonds payable less the unamortized discount at that date) would be used to account for the conversion, and there would be no gain or loss recognized on the conversion.

The book value method views the convertible bonds as equity capital, and thus the conversion represents the completion of a prior transaction (the issuance of the convertible debt), not the culmination of an earning process.

Under the market value method, the market value of the common stock at the date of the conversion ($110 per share) would be used to account for the conversion. If the market value of the common stock at the date of the conversion exceeded the carrying value of the convertible bonds at that date, a loss would be recognized on the conversion. If the carrying value of the convertible bonds at the date of the conversion exceeded the market value of the common stock at that date, a gain would be recognized on the conversion.

The market value method views the convertible bonds as debt whose conversion was a significant economic transaction, and thus the conversion represents the culmination of an earning process. Furthermore, the market value method views the market value of the common stock at the date of the conversion to be the proper measurement at which to carry the common stock.

**b.** The nonconvertible term bonds were sold at a discount because the effective interest rate (yield) of 16 percent was higher than the stated interest rate of 14 percent. Although the bonds provide for the payment of interest of 14 percent, this rate was less than the prevailing or market rate for bonds of similar quality at the time the issue was sold. As a result, the bonds sold on the market at a price less than their par value.

**c.** The effects associated with the nonconvertible term bonds on Aubrey Company's 1982 income statement are as follows:

- Interest expense for eight months (May 1, 1982, to December 31, 1982) would be included in Aubrey Company's 1982 income statement. Interest accrues with the passage of time, and the bonds were outstanding for only eight months in 1982.
- Interest expense would be increased for the amortization of bond discount from May 1, 1982 (the date of sale) to December 31, 1982. Amortization of bond discount is justified on the basis of the matching principle. Bond discount should be amortized using the interest method over the period the bond is outstanding, that is, the period from the date of sale to maturity date.

**N80**
**Answer 4** (10 points)

**a.** Because detachable stock purchase warrants are equity instruments that have a separate fair value at the issue date, the portion of the proceeds from bonds issued with detachable stock purchase warrants allocable to the warrants should be accounted for as paid-in capital. The remainder of the proceeds should be allocated to the debt security portion of the transaction. This usually results in issuing the debt security at a discount (or, occasionally, a reduced premium).

**b.** A serial bond progressively matures at a series of stated installment dates, for example, one-fifth each year. A term (straight) bond completely matures on a single date.

**c.** The amortization in the first year of the life of a five-year term bond issued at a premium would differ using the interest method instead of the straight-line method because the interest method employs a uniform interest rate based upon a changing balance, whereas the straight-line method provides for the recognition of an equal amount of premium amortization each period. Because the interest method provides for an increasing premium amortization each period, the amount of amortization in the first year of the life of the bond would be lower.

**d.** The journal entry to record a bond issue sold between interest dates is as follows:

- Debit cash for the price of the bond plus the accrued interest from the last interest date.
- Debit discount on bonds payable for the amount of discount to be amortized over the remaining life of the issue.
- Credit bonds payable for the par value of the bonds.
- Credit accrued interest payable (or interest expense) for the accrued interest from the last interest date.

The subsequent amortization of bond discount is affected when a bond issue is sold between interest dates because the discount should be amortized over the period from the date of sale (not the date of the bond) to the maturity date.

**e.** The gain or loss from the reacquisition of a long-term bond prior to its maturity should be included in the determination of net income for the period reacquired and, if material, classified as an extraordinary item, net of related income taxes.

## IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With Generally Accepted Accounting Principles

**M83**
**Answer 3** (10 points)

**a.** The adjustment for an extraordinary item of $14 million should not be presented as a prior period adjustment in the Lynch Company Statement of Retained Earnings. The extraordinary item should be included in net income and presented in the income statement as a separate item, net of income taxes because net income should reflect all items of profit and loss recognized during the period. Furthermore, the amount of income taxes netted to arrive at the $14 million should be presented in the income statement.

The adjustment for correction of error in the financial statements of prior periods of $11 million in 1981 should not be presented in the portion of the Lynch Company Statement of Retained Earnings with the activity during the year. A correction of an error should be reported as a prior period adjustment. It should be presented in the Lynch Company Statement of Retained Earnings as "adjustment for correction of error" between "retained earnings at beginning of period, as previously reported" and "retained earnings at beginning of period, as restated." Furthermore, the amount of income taxes netted to arrive at the $11 million should be presented in the Lynch Company Statement of Retained Earnings.

The 10 percent stock dividend of $20 million is presented appropriately in the Lynch Company Statement of Retained Earnings. In accounting for a small stock dividend, retained earnings is debited for the market value of the stock at the date of the stock dividend, common stock is credited for the par value of the stock, and the difference is credited to additional paid-in capital. Total stockholders' equity does not change; but recognition has been made of a capitalization of retained earnings equivalent to the fair value of the additional shares resulting from the stock dividend.

The treasury stock of $6 million should not be presented in the Lynch Company Statement of Retained Earnings. Under the cost method of accounting for treasury stock transactions, the cost of the stock (market value on the date of the purchase) should be debited to treasury stock and presented as a separate item in the Lynch Company Statement of Stockholders' Equity because it is an unallocated reduction of stockholders' equity.

**b.** The additional facts above concerning the stock dividend and treasury stock transaction affected the cash dividend per share (pay-out) ratio because the earnings per share of common stock was affected as follows:

- The 10 percent stock dividend decreased the earnings per share because there were more shares outstanding after the 10 percent stock dividend; thus the cash dividend per share (pay-out) ratio was increased.
- The treasury stock transaction increased the earnings per share because there were less shares outstanding after the treasury stock transaction (treasury stock is not part of outstanding common stock and no dividends are paid out on treasury stock); thus the cash dividend per share (pay-out) ratio was decreased.

**N80**
**Answer 5** (10 points)

**a.** The subscription of common stock at a price in excess of the par value of the common stock is accounted for at the date of subscription as follows:

- Stock subscriptions receivable is debited for the subscription price of the common stock.
- Common stock subscribed is credited for an amount representing the par value of the common stock that will be issued when the stock subscription is collected.
- Additional paid-in capital is credited for the excess of the subscription price of the common stock over its par value.

**b.** The issuance for cash of no par value common stock at a price in excess of the stated value of the common stock is accounted for as follows:

- Cash is debited for the proceeds from the issuance of the common stock.
- Common stock is credited for the stated value of the common stock.
- Additional paid-in capital is credited for the excess of the proceeds from the issuance of the common stock over its stated value.

**c.** The date of declaration is the date when the liability for dividends payable is recorded by a debit to retained earnings and a credit to dividends payable.

The date of stockholders of record is the date that determines which stockholders will receive dividends on the payment date. No journal entry is made at this date.

The date of payment is the date when the dividends are paid and is recorded by a debit to dividends payable and a credit to cash.

**d.** The effect of an ordinary 10 percent common stock dividend is that an amount equal to the fair value of the additional common stock issued is transferred from retained earnings to common stock and additional paid-in capital. There is no effect on total stockholders' equity.

**N79**
**Answer 2**

**Part b.**

1. Under the cost method, treasury stock is debited for the purchase price of the shares even though the purchase price is less than the par value.

Under the par value method, treasury stock is debited for the par value of the shares, and a separate paid-in capital account is credited for the excess of the par value over the purchase price.

2. Under the cost method, treasury stock is debited for the purchase price of the shares.

Under the par value method, treasury stock is debited for the par value of the shares, and the debit for the excess of the purchase price over the par value is assigned to additional paid-in capital arising from past transactions in the same class of stock and/or retained earnings.

3. Under the cost method, treasury stock is credited for the original cost (purchase price) of the shares, and the excess of the original cost (purchase price) over the sales price first is debited to additional paid-in capital from earlier sales or retirements of treasury stock, and any remainder then is debited to retained earnings.

Under the par value method, treasury stock is credited for the par value of the shares, and the excess of the sales price over the par value is credited to additional paid-in capital from sale of treasury stock.

4. Under the cost method, treasury stock is credited for the original cost (purchase price) of the shares, and the excess of the sales price over the original cost (purchase price) is credited to additional paid-in capital from sale of treasury stock.

Under the par value method, treasury stock is credited for the par value of the shares, and the excess of the sales price over the par value is credited to additional paid-in capital from sale of treasury stock.

5. There is no effect on net income as a result of treasury stock transactions.

**M79**
**Answer 6** (10 points)

**Part a.**

1. There are four basic rights inherent in ownership of common stock. The first right is that common shareholders may participate in the actual management of the corporation through participation and voting at the corporate stockholders meeting. Second, a common shareholder has the right to share in the profits of the corporation through dividends declared by the board of directors (elected by the common shareholders) of the corporation. Third, a common shareholder has a pro rata right to the residual assets of the corporation if it liquidates. Finally, common shareholders have the right to maintain their interest (percent of ownership) in the corporation if additional common shares are issued by the corporation, by being given the opportunity to purchase a proportionate number of shares of the new offering. This last is most commonly referred to as a "preemptive right."

2. Preferred stock is a form of capital stock that is afforded special privileges not normally afforded common shareholders in return for giving up one or more rights normally conveyed to common shareholders. The most common right given up by preferred shareholders is the right to participate in management (voting rights), and, in return, the corporation grants one or more pref-

erences to the preferred shareholder. The most common preferences granted to preferred shareholders are these:

*a.* Dividends may be paid to common shareholders only after dividends have been paid to preferred shareholders.

*b.* Claim ahead of common shareholders to residual assets (after creditors have been paid) in the case of corporate liquidation.

*c.* Although the board of directors is under no obligation to declare dividends in any particular year, preferred shareholders may be granted a cumulative provision stating that any dividends not paid in a particular year must be paid in subsequent years before common shareholders may be paid any dividend.

*d.* Preferred shareholders may be granted a participation clause that allows them to receive additional dividends beyond their normal dividend if common shareholders receive dividends of greater percentage than preferred shareholders. This participation may be on a one-to-one basis (fully participating); common shareholders may be allowed to exceed the rate paid to preferred shareholders by a defined amount before preferred shareholders begin to participate; or, the participation clause may have a maximum rate of participation to which preferred shareholders are entitled.

*e.* Preferred shareholders may have the right to convert their preferred shares to common shares at a set future price no matter what the current market price of the common stock is.

*f.* Preferred shareholders may also agree to have their stock callable by the corporation at a higher price than when the stock was originally issued. This item is generally coupled with another preference item to make the issue appear attractive to the market.

**Part b.**

1. Treasury stock is stock previously issued by the corporation but subsequently repurchased by the corporation and not retired but available for use at a subsequent date by the corporation.

2. Legal capital is that portion of corporate capital required by statute to be retained in the business to afford creditors a minimum degree of protection.

3. A stock right represents a privilege extended by the corporation to acquire additional shares (or fractional shares) of its capital stock.

4. A stock warrant is physical evidence of stock rights. The warrant specifies the number of rights conveyed, the number of shares to which the rightholder is entitled, the price at which the rightholder may purchase the additional shares, and the life of the rights (time period over which the rights may be exercised).

## V. Measurement and Presentation of Income and Expense Items, Their Relationship to Matching and Periodicity, and Their Relationship to Generally Accepted Accounting Principles

**N82**
**Answer 5** (10 points)

**a.** The change in depreciation method from the double-declining-balance method to the straight-line method constitutes a change in accounting principle and is presented appropriately in David Company's statements of income for the year ended December 31, 1981, and December 31, 1980. The effect of applying the straight-line method for both the year of and the year after the change should be included in cost of goods sold because the periods subsequent to the change should be reported on the basis of the newly adopted accounting principle to assure comparability. The cumulative effect on prior years of the change should not be presented in the continuing operations section of the income statement because it is not part of the continuing operations of David Company.

The loss from operations of the discontinued Dex Division from January 1, 1981, to September 30, 1981 (the portion of the year prior to the measurement date) and from January 1, 1980, to December 31, 1980, should not be presented in the continuing operations section of the income statement. For comparability purposes, each should be presented in the income statement after income from continuing operations as a separate item, less applicable income taxes, because it is not part of the continuing operations of David Company.

David Company's statements of income should be corrected as follows:

- "Other, net" and "total costs and expenses" should be decreased to exclude the loss from operations of the discontinued Dex Division.
- "Income from continuing operations before income taxes" should be increased to exclude the loss from operations of the discontinued Dex Division.
- "Income taxes" should be increased to exclude the tax reduction applicable to the loss from operations of the discontinued Dex Division.
- "Income from continuing operations" should be increased to exclude the loss from operations of the discontinued Dex Division, less applicable income taxes.
- A new caption, "discontinued operations," should be added.

- A new subcaption, "loss from operations of the discontinued Dex Division, less the amount of applicable income taxes," should be added under the caption "discontinued operations."
- The subcaption, "loss on disposal of Dex Division, including provision of $1,500,000 for operating losses during phase-out period, less applicable income taxes of $8,000,000," should be under the caption "discontinued operations."
- "Earnings per share of common stock" should be presented on the face of the income statement for income from continuing operations. As for income from discontinued operations, earnings per share of common stock may be presented on the face of the income statement or in the notes to the financial statements.

**b.** The price-earnings ratio is of particular interest to investors for evaluating stock price because it relates the earnings of the business to the current market price of the stock. Other internal and external factors besides earnings would also influence the current market price of the stock and hence the price-earnings ratio.

The price-earnings ratio for 1981 is determined by dividing the market value per share by the earnings per share of common stock. The ratio generally would be computed on the basis of the earnings per share of common stock for income from continuing operations.

**M82**

**Answer 3** (10 points)

**a.** A usual but infrequently occurring charge does not meet the unusual-in-nature criterion, and, thus, it is not an extraordinary item. Therefore, it is presented appropriately in the ordinary operations section of the income statement; however, it should have been reported as a separate item rather than as part of "selling, general and administrative expenses" because it meets the criteria of being material and infrequently occurring.

An extraordinary item should not be presented in the ordinary operations section of the income statement because it is not part of the ordinary operations of Horizon Company. An extraordinary item should be presented in the income statement as a separate item, net of income taxes. The Horizon Company Statements of Income and Retained Earnings should be revised as follows:

- "Other, net" and "total costs and expenses" should be decreased by $10,000,000 to exclude the extraordinary item (charge).
- "Income before income taxes" should be increased by $10,000,000 to exclude the extraordinary item (charge) and the caption "income before income taxes" should be changed to "income before income taxes and extraordinary item (charge)."
- "Income taxes" should be increased by $5,000,000 to exclude the income tax reduction applicable to the extraordinary item (charge).
- A new caption "income before extraordinary item (charge)" should be added ($25,200,000).
- A new caption "extraordinary item (charge)" should be added showing the extraordinary item (charge) of $10,000,000, applicable income taxes of $5,000,000, and the net extraordinary item (charge) of $5,000,000.

A change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error and should be reported as a prior period adjustment. Therefore, the presentation in the foregoing Horizon Company Statements of Income and Retained Earnings is appropriate.

Because of the significance attached by investors and others to earnings-per-share data, together with the importance of evaluating the data in conjunction with the financial statements, earnings per common share should be shown on the face of the income statement. Furthermore, earnings per common share for income before extraordinary items should be presented as well as earnings per common share for net income.

**b.** The *quick (acid-test) ratio* tests the ability to meet sudden demands upon liquid current assets.

*Inventory turnover* provides information about the number of times inventory is replaced each year.

The *return on stockholders' equity* indicates the percentage return accruing to the owners based upon the book value of their interest in the company.

**c.** The *quick (acid-test) ratio* for 1981 is determined by dividing the sum of "cash" ($3,500,000), "marketable securities" ($13,000,000), and "accounts receivable" ($105,000,000) on the Horizon Company Balance Sheet by the "total current liabilities" ($75,000,000) on the Horizon Company Balance Sheet.

*Inventory turnover* for 1981 is determined by dividing the "cost of goods sold" ($480,000,000) on the Horizon Company Statements of Income and Retained Earnings by the average "inventory" ($126,000,000 and $154,000,000 ÷ 2) during the year on the Horizon Company Balance Sheet. If possible, the average monthly inventory should be used.

The *return on stockholders' equity* for 1981 is determined by dividing the "net income" ($20,200,000) on the Horizon Company Statements of Income and Retained Earnings by the "total stockholders' equity" ($263,000,000) or the average "total stockholders' equity" ($263,000,000 and $255,000,000 ÷ 2) on the Horizon Company Balance Sheet.

**M82**

**Answer 4** (10 points)

**Part a.**

1. When profits or expenses are included in taxable income on the income tax return later or earlier than

they are included on the income statement, a timing difference arises and deferred income taxes should be reported.

2. *Gross profits on installment sales*—Deferred income taxes would generally be recognized because gross profits on installment sales would generally be recognized in Lorac Company's income statement in the year of sale and recognized in its tax return when later collected.

*Revenues on long-term construction contracts*—Deferred income taxes could be recognized because revenues on long-term construction contracts could be recognized in Lorac Company's income statement on the percentage-of-completion basis and recognized in its tax return on the completed-contract basis.

*Estimated costs of product warranty contracts*—Deferred income taxes should be recognized because estimated costs of product warranty contracts should be recognized in Lorac Company's income statement in the year of sale and recognized in its tax return when paid.

*Premiums on officers' life insurance with Lorac as beneficiary*—This is a permanent difference and deferred income taxes should not be recognized. Premiums on officers' life insurance with Lorac as beneficiary should be recognized in Lorac Company's income statement but are not a deductible expense in its tax return.

**Part b.**

Deferred income taxes related to a noncurrent asset or liability would be classified as a noncurrent item in the balance sheet. Deferred income taxes are related to an asset or liability if reduction of the asset or liability causes the timing difference to reverse.

Deferred income taxes that are not related to an asset or liability because (*a*) there is no associated asset or liability or (*b*) reduction of an associated asset or liability will not cause the timing difference to reverse would be classified based on the expected reversal date of the specific timing difference. An expected reversal date beyond one year (or the normal operating cycle) would require noncurrent classification of the deferred income taxes.

Deferred income taxes would be classified in the balance sheet as a noncurrent liability when the noncurrent deferred credits related to timing differences exceed the noncurrent deferred charges related to timing differences. Conversely, they would be classified in the balance sheet as a noncurrent asset when the noncurrent deferred charges related to timing differences exceed the noncurrent deferred credits related to timing differences.

**M80**
**Answer 2**

**Part b.**

1. Common stock equivalents are included in the computation of the number of shares for both primary earnings per share and fully diluted earnings per share as long as the common stock equivalents have a dilutive effect.

2. Convertible securities that are not common stock equivalents are excluded from the computation of the number of shares for primary earnings per share; however, they are included in the computation of the number of shares for fully diluted earnings per share as long as they have a dilutive effect.

3. Antidilutive securities are excluded from both primary earnings per share and fully diluted earnings per share.

**N79**
**Answer 2**

**Part a.**

1. There are basically two methods of recognizing bad debt expense: (1) direct write-off and (2) allowance.

The direct write-off method requires the identification of specific balances that are deemed to be uncollectible before any bad debt expense is recognized. At the time that a specific account is deemed uncollectible, the account is removed from accounts receivable and a corresponding amount of bad debt expense is recognized.

The allowance method requires an estimate of bad debt expense for a period of time by reference to the composition of the accounts receivable balance at a specific point in time (aging) or to the overall experience with credit sales over a period of time. Thus, total bad debt expense expected to arise as a result of operations for a specific period is estimated, the valuation account (allowance for doubtful accounts) is appropriately adjusted, and a corresponding amount of bad debt expense is recognized. As specific accounts are identified as uncollectible, the account is written off; that is, it is removed from accounts receivable and a corresponding amount is removed from the valuation account (allowance for doubtful accounts). Net accounts receivable do not change, and there is no charge to bad debt expense when specific accounts are identified as uncollectible and written off using the allowance method.

2. The allowance method is preferable because it matches the cost of making a credit sale with the revenues generated by the sale in the same period and achieves a proper carrying value for accounts receivable at the end of a period. Since the direct write-off method does not recognize the bad debt expense until a specific amount is deemed uncollectible, which may be in a subsequent period, it does not comply with the matching concept and does not achieve a proper carrying value for accounts receivable at the end of a period.

**N79**
**Answer 4**

**Part a.**

1. Under the gross change method, the tax effects of timing differences originating in the current period are determined at the current income tax rates. The tax effects of timing differences originating in prior periods and reversing in the current period are determined at the applicable income tax rates reflected in the accounts as of the beginning of the current period.

2. Under the net change method, the tax effects of the net change in the originating and reversing timing differences are determined at the current income tax rates.

## VI. Other Financial Topics

**N83**
**Answer 3** (10 points)

**a.** Michael Company should earn revenue as it performs the work on the contract (the percentage-of-completion method) because the right to revenue is established and collectibility is reasonably assured. Furthermore, the use of the percentage-of-completion method avoids distortion of income from period to period and provides for better matching of revenues with the related expenses.

**b.** Progress billings would be accounted for by increasing accounts receivable and increasing progress billings on contract, a contra-asset account that is offset against the construction costs in progress account. If the construction-costs-in-progress account exceeds the progress-billings-on-contract account, the two accounts would be shown in the current asset section of the balance sheet. If the progress-billings-on-contract account exceeds the construction-costs-in-progress account, the two accounts would be shown, in most cases, in the current liabilities section of the balance sheet.

**c.** The income recognized in the second year of the four-year contract would be determined using the cost-to-cost method of determining percentage of completion as follows:

- First, the estimated total income from the contract would be determined by deducting the estimated total costs of the contract (the actual costs to date plus the estimated cost to complete) from the contract price.
- Second, the actual costs to date would be divided by the estimated total costs of the contract to arrive at a percentage completed, which would be multiplied by the estimated total income from the contract to arrive at the total income recognized to date.
- Third, the total income recognized in the second year of the contract would be determined by deducting the income recognized in the first year of the contract from the total income recognized to date.

**d.** Earnings per share in the second year of the four-year contract would be higher using the percentage-of-completion method instead of the completed-contract method because income would be recognized in the second year of the contract using the percentage-of-completion method, whereas no income would be recognized in the second year of the contract using the completed-contract method.

**N81**
**Answer 2** (10 points)

**a.** A change from the sum-of-the-years-digits depreciation method to the straight-line method for fixed assets is a change in accounting principle. The concept of consistency presumes that an accounting principle, once adopted, should not be changed in accounting for events and transactions of a similar type. A change is permissible only if the enterprise justifies the preferability of an alternative acceptable accounting principle.

**b.** When pro forma disclosure is required for an accounting change, the pro forma amounts will include both the direct effects of the change and the nondiscretionary adjustments in items based on income before taxes or net income, such as profit-sharing expense and certain royalties, that would have been recognized if the newly adopted accounting principle had been followed in prior periods. Related income tax effects should be recognized for both direct effects of the change and nondiscretionary adjustments.

**c.** If a public company obtained additional information about the service lives of some of its fixed assets showing that the service lives previously used should be shortened, such a change would be a change in accounting estimate. The change in accounting estimate should be accounted for in the year of change and future years since the change affects both. Specifically, the operating item, depreciation expense, would be increased. In addition, the effect on income before extraordinary items, net income, and related per-share amounts of the current period should be disclosed.

**d.** Changing specific subsidiaries comprising the group of companies for which consolidated financial statements are presented is an example of change in the reporting entity (a special type of change in accounting principle). Such a change requires that the consolidated income statements be restated to reflect the different reporting entity.

**N81**
**Answer 4**

**Part b.**

1. The expenses related to effecting the business combination should be deducted in determining net income of the combined company for the period in which the expenses were incurred. Because the pooling-of-interests method records neither the acquiring of assets nor the obtaining of capital, expenses related to effecting a business combination accounted for as a pooling of interests are expenses of the combined company rather than additions to assets or direct reductions of stockholders' equity.

2. The results of operations for the year in which the business combination occurs should include the combined results of the separate companies from the beginning of the year to the date the combination is consummated and those of the combined operations from that date to the end of the year. This reporting is appropriate because in a pooling of interests two companies come together to form one company as though they had always been together.

**M81**
**Answer 5** (10 points)

**a.** Normal cost is the annual cost assigned, under the actuarial cost method in use, to years subsequent to a particular valuation date.

**b.** Vested benefits are benefits that are not contingent on the employee's continuing in the service of the employer.

The actuarially computed value of vested benefits represents the present value, at the date of determination, of the sum of (*a*) the benefits expected to become payable to former employees who have retired, or who have terminated service with vested rights, at the date of determination; and (*b*) the benefits, based on service rendered prior to the date of determination, expected to become payable at future dates to present employees, taking into account the probable time that employees will retire, at the vesting percentage applicable at the date of determination.

**c.** Actuarial gains and losses directly related to the operation of a pension plan should be given effect in the provision for pension cost in a consistent manner that reflects the long-range nature of pension cost. Accordingly, they should be allocated to current and future periods by using the spreading or averaging method.

**d.** The following disclosures concerning pension plans should be made in the company financial statements or notes:

- A statement that pension plans exist, identifying or describing the employee groups covered.
- A statement of the company accounting and funding policies.
- The provision for pension cost for the period.
- The nature and effect of significant matters affecting comparability for all periods presented, such as changes in accounting methods, changes in circumstances, or adoption or amendment of a plan.

For defined benefit pension plans, the company should disclose for each complete set of financial statements the following data as of the most recent benefit information date for which the data are determinable and available:

- The actuarial present value of vested accumulated plan benefits.
- The actuarial present value of nonvested accumulated plan benefits.
- The plans' net assets available for benefits.
- The assumed rates of return used in determining the actuarial present values of vested and nonvested accumulated plan benefits.
- The date as of which the benefit information was determined.

**N80**
**Answer 3** (10 points)

**Part a.**

1. An estimated loss from a loss contingency shall be accrued by a charge to income if both of the following conditions are met:

- Information available prior to 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. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.
- The amount of loss can be reasonably estimated.

2. Disclosure should be made for an estimated loss from a loss contingency that need not be accrued by a charge to income when there is at least a reasonable possibility that a loss may have been incurred. The disclosure should indicate the nature of the contingency and should estimate the possible loss or range of loss or state that such an estimate cannot be made.

Disclosure of a loss contingency involving an unasserted claim is required when it is probable that the claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable.

**Part b.**

Arguments for the percentage-of-completion method are that it recognizes income periodically as work is performed on a contract, thus matching revenue with effort and allowing for comparability between accounting periods.

Arguments against the percentage-of-completion method are that it recognizes income based on estimates for unperformed work that may involve unforeseen costs and possible losses, thus resulting in a lack of objectivity and verifiability. Furthermore, the realization concept is not strictly adhered to when revenue is recognized before a sale is completed, and it is less conservative than the completed-contract method because income is recognized before the total income for the completed job is certain. It should be noted, however, that when the current estimate of total contract costs indicates a loss, in most circumstances provision should be made for the loss on the entire contract.

**M80**
**Answer 4** (10 points)

**Part a.**

1. A change in accounting principle results from adoption of a generally accepted accounting principle different from the one used previously for reporting purposes. A change in accounting principle is characteristically a change from one generally accepted accounting principle to a preferable one.

A change in accounting principle should be recognized by including the cumulative effect of changing to a new accounting principle in net income of the period of the change. The amount of the cumulative effect is the difference between (*a*) the amount of retained earnings at the beginning of the period of change and (*b*) the amount of retained earnings that would have been reported at that date if the new accounting principle had been applied retroactively for all prior periods that would have been affected and by recognizing only the direct effects of the change and related income tax effect. The amount of the cumulative effect should be shown in the income statement between the captions "extraordinary items" and "net income." The per-share information shown on the face of the income statement should include the per-share amount of the cumulative effect of the accounting change. Pro forma disclosure of the effect of retroactive restatement should be shown on the face of the income statement.

It should be noted, however, that Accounting Principles Board Opinion no. 20 describes a few specific changes in accounting principles that should be reported by restating the financial statements of prior periods.

2. A change in accounting estimate occurs as new events occur, as more experience is acquired, or as additional information is obtained.

A change in accounting estimate should be accounted for in (*a*) the period of change if the change affects that period only or (*b*) the period of change and future periods if the change affects both.

3. A change in reporting entity is a special type of change in accounting principle that results in financial statements, which, in effect, are those of a different reporting entity.

A change in reporting entity should be reported by restating the financial statements of all prior periods presented in order to show financial information for the new reporting entity for all periods.

Presenting consolidated statements in place of statements of individual companies and a business combination accounted for by the pooling-of-interests method are two examples of a change in reporting entity.

**Part b.**

1. For the noncompensatory stock purchase plan, the entry at the date the stock is issued is as follows:

- Debit to cash (or appropriate liability account if amounts were previously withheld through payroll deductions) for the cash price.
- Credit to capital stock for the par value of the stock.
- Credit to additional paid-in capital for the excess of the cash price over the par value.

For the compensatory stock option plan, the entry at the date the stock is issued is as follows:

- Debit to cash for the cash price.
- Debit to stock options outstanding (when the compensation expense has already been recognized) or debit to compensation expense.
- Credit to capital stock for the par value of the stock.
- Credit to additional paid-in capital for the excess of (*a*) the debit to cash (cash price) and (*b*) the debit to stock options outstanding, over the par value.

2. If the date of the grant and the measurement date are the same, the entry for the compensatory stock option plan at the date of the grant is to debit compensation or deferred compensation expense and credit stock options outstanding for the excess of the market price of the stock over the option price.

If the date of the grant and the measurement date are different, no entry is made for the compensatory stock option plan at the date of the grant.

**N79**
**Answer 4**

**Part b.**

1. Revenues should be recognized as earned for interim reporting on the same basis as followed for year-end reporting.

In general, costs associated with revenue are recognized in the same interim period in which the related revenue is recognized. However, the following exceptions are permitted for determining the costs of inventory for interim reporting on a different basis than for year-end reporting:

a. The gross profit method or some other method of estimating inventory may be used for interim reporting as long as the method used and any significant adjustments that result from reconciliations with the annual physical inventory are disclosed.
b. For interim reporting, a temporary LIFO liquidation that is expected to be replaced by the end of the year should not be recognized, and cost of sales in the interim period should be adjusted for the expected cost of replacement of the LIFO liquidation.
c. Inventory losses from market declines that cannot be reasonably expected to be restored by the end of the year should be recognized in the interim period that the decline occurs. Recoveries of such losses in a later interim period of the same year should be recognized in the interim period that the recovery occurs, as long as the recovery does not exceed the previously recognized loss.
d. For interim reporting, purchase price variances or volume or capacity cost variances that are planned and expected to be absorbed by the end of the year should not ordinarily be recognized in the interim period.

In general, all other costs and expenses should be recognized for interim reporting in the interim period that the cost or expense is incurred, which is the same basis as is followed for year-end reporting. However, when it is clearly evident that a cost or expense incurred in an interim period will benefit more than one interim period, the cost or expense may be allocated among the interim periods benefited based on estimates of time expired, benefits received, or activities associated with those interim periods.

2. Income tax accruals at interim dates should be based upon the effective tax rate expected to be applicable for the entire fiscal year. The effective tax rate should reflect anticipated investment tax credits, foreign tax rates, percentage depletion, capital gains rates, and other available tax planning alternatives. However, in arriving at this effective tax rate no effect should be included for the tax related to significant, unusual, or extraordinary items that will be separately reported or reported net of their related effects in the reports for the interim period or for the fiscal year.

**N79**
**Answer 5** (10 points)

**a.** Those who support the purchase method believe that one company acquires another company in almost every business combination. The acquisition of one company by another and the identities of the acquiring and acquired companies are usually obvious. Generally, one company in a business combination is clearly the dominant and continuing entity and one or more other companies cease to control their own assets and operations because control passes to the acquiring corporation.

Proponents of purchase accounting hold that a business combination is a significant economic event that results from bargaining between independent parties. Each party bargains on the basis of an assessment of the current status and future prospects of each constituent as a separate enterprise and as a contributor to the proposed combined enterprise. The agreed terms of the combination recognize primarily the bargained values and only secondarily the constituent's recorded costs of assets and liabilities.

Those who support the purchase method of accounting for business combinations effected by issuing stock believe that an acquiring corporation accounts for the economic substance of the transaction by applying those principles and by recording

1. All assets and liabilities that compose the bargained cost of an acquired company, not merely those items previously shown in the financial statements of an acquired company.
2. The bargained costs of assets acquired less liabilities assumed, not the costs to a previous owner.
3. The fair value of the consideration received for stock issued, not the equity shown in the financial statements of an acquired company.
4. Retained earnings from the acquiring company's operations, not a fusion of its retained earnings and previous earnings of an acquired company.
5. Expenses and net income after an acquisition computed on the bargained cost of acquired assets less assumed liabilities, not on the costs to a previous owner.

**b.** Those who support the pooling-of-interests method believe that a business combination effected by issuing common stock is different from a purchase in that no corporate assets are disbursed to stockholders, and the net assets of the issuing corporation are enlarged by the net assets of the corporation whose stockholders accept common stock of the combined corporation. There is no newly invested capital nor have owners withdrawn assets from the group since the stock of a corporation is not one of its assets. Accordingly, the net assets of the constituents remain intact but combined; the stockholder groups remain intact but combined. Aggregate income is not changed since the total resources are not changed. Consequently, the historical costs and earnings of the separate corporations are appropriately combined. In a business combination effected by exchanging stock, groups of stockholders combine their resources, talents, and risks to form a new entity to carry on in combination the previous businesses and to continue their earnings streams. The sharing of risks by the constituent stockholder groups is an important element in a business combination effected by exchanging stock. By pooling equity interests, each group continues to maintain risk elements of its former investment, and they mutually exchange risks and benefits.

A pooling-of-interests transaction is regarded as, in substance, an arrangement among stockholder groups. A fundamental concept of entity accounting is that a corporation is separate and distinct from its stockholders.

Proponents of pooling-of-interests accounting point out that the pooling concept was developed within the boundaries of the historical-cost system and is compatible with it.

**M79**
**Answer 4** (9 points)

**a.** The revenue recognized on a long-term contract under the percentage-of-completion method is determined by applying a percentage representing the degree of completion to the total contract price at the end of the accounting period. The percentage is derived by dividing the costs incurred to date by the total estimated costs of the entire contract based on the most recent information. The percentage may also be derived by other measures of progress, such as engineering or architectural estimates, the ratio of direct labor costs incurred to date to total estimated labor costs, or the ratio of direct labor hours incurred to estimated total direct labor hours. Percentages derived under these various methods should yield essentially comparable data. The revenue so derived is then reduced by the direct contract costs to determine the gross profit recognized in the initial period.

In subsequent periods, since the percentage-of-completion method described produces cumulative results, gross profit recognized in prior periods must be subtracted to obtain current earnings to be recognized.

Under the completed-contract method, no earnings are recognized until the contract is substantially completed. For the period in which completion occurs, gross revenues include the total contract price. Total job costs incurred are deducted from gross revenues, resulting in recognition of the entire amount of gross profit in the completion period. If it is expected that a loss will occur on the contract, a provision for loss should be recognized immediately.

**b.** The percentage-of-completion method is preferable when estimates of the bases upon which progress is measured are reasonably dependable. The completed-contract method is preferable when inherent hazards or lack of dependable estimates cause the forecasts to be of doubtful value.

**c.** Interim billings on long-term contracts are not generally accepted as a method of recognizing earnings because such billings often do not bear a meaningful relationship to the work performed on the contract. Typically, billings may be accelerated in the early stages of the contract to provide the contractor with the working capital needed to begin performance. If earnings were recognized on a billings basis, it would be possible for a contractor to materially distort the contractor's earnings merely by rendering billings without regard to any degree of progress on the contract.

**d.** Under the percentage-of-completion method, a schedule is made of the contracts in process, showing the total costs incurred as of the end of a given period, the estimated gross profit recognized based on the degree of completion, and the total billings rendered on each individual contract. If costs incurred plus recognized profits exceed the related billings on a contract, this net figure is shown as a current asset. This treatment shows that the contractor has not fully billed the customer for work performed to date and has a claim against the customer for that portion of work completed but not yet billed. If billings on a contract exceed costs incurred plus estimated profits, this net figure is shown as a current liability, which means that the contractor has overbilled the customer for work done to date and must complete the work represented by the excess billings. Under the completed-contract method, the treatment of excess costs and billings is the same as under the percentage-of-completion method except that estimated profits are not computed because profit recognition is deferred until a contract is completed. The excess of costs over related billings on a contract is a current asset while the excess of billings over related costs on a contract is a current liability.

**M79**
**Answer 5** (10 points)

**Part a.**

1. An industry segment is a component of an enterprise engaged in providing a product or service or group of related products or services primarily to unaffiliated customers for a profit. By defining an industry segment in terms of products and services sold primarily to unaffiliated customers, it can be seen that vertically integrated operations of an enterprise are not segments.

2. The revenue of an industry segment includes revenue both from sales to unaffiliated customers and from intersegment sales or transfers, if any, of products and services similar to those sold to unaffiliated customers. Interest earned from sources outside the enterprise and from intersegment trade receivables is included in revenue if the asset on which the interest is earned is included among the industry segment's identifiable assets, but interest earned on advances or loans to other industry segments is not included unless the primary function of the segment is financial in nature. Also, revenue from intersegment sales or transfers is accounted for on the basis used by the enterprise to price the intersegment sales or transfers.

3. The operating profit or loss of an industry segment is its revenue minus all operating expenses. Operating expenses include expenses that relate to both revenue

from sales to unaffiliated customers and revenue from intersegment sales or transfers. An enterprise's operating expenses that are not directly traceable to an industry segment should be allocated on a reasonable basis among those segments for whose benefit the expenses were incurred. Intersegment purchases should be accounted for on the same basis as intersegment sales or transfers. Statement of Financial Accounting Standards no. 14 does, however, specify certain items of revenue and expense that should not be considered in determining operating profit or loss for an industry segment:

*a.* Revenue earned at the corporate level and not derived from the operations of any industry segment.

*b.* General corporate expenses.

*c.* Interest expense (unless the segment's principal purpose is of a financial nature).

*d.* Domestic and foreign income taxes.

*e.* Equity in the earnings or losses of unconsolidated subsidiaries.

*f.* Gains or losses on discontinued operations.

*g.* Extraordinary items.

*h.* Minority interest.

*i.* Cumulative effect of a change in accounting principles.

4. The identifiable assets of an industry segment are those tangible and intangible enterprise assets that are used by the industry segment, including assets used exclusively by that segment and an allocated portion of assets used jointly by two or more segments. Goodwill allocable to a particular industry segment is a part of that segment's identifiable assets. However, assets maintained for general corporate purposes (i.e., those not used in the operations of any industry segment) should not be allocated to industry segments. Identifiable assets of industry segments should not include loans or transfers to other segments unless the primary business of the segment is financial in nature. The identifiable assets of an industry segment also include the appropriate valuation allowances, such as allowance for doubtful accounts, accumulated depreciation, and marketable securities valuation allowance.

**Part b.**

1. There are three basic tests to be applied to segments of an industry to see if they are significant enough to be separately reportable. If a segment meets any one of the tests it is deemed significant and reportable.

The first test is based upon revenue. If a segment's revenue from sales to unaffiliated customers and intersegment sales and transfers is equal to 10 percent or more of the enterprise's combined revenues, the segment is reportable.

The second test is based upon operating profits or losses. There are two subtests in this category based upon absolute amounts of operating profits or losses. A segment is deemed reportable if the operating profit or loss shown by the segment is equal to or greater than 10 percent of the higher of the following two absolute amounts:

- Sum of all operating profits for all segments reporting operating profits.
- Sum of all operating losses for all segments reporting operating losses.

Third, a segment is significant and reportable if the identifiable assets of the segment equal or exceed 10 percent of the combined identifiable assets of all of the industry segments within the enterprise.

Finally, all segments, whether deemed reportable or not, must be reviewed from the standpoint of interperiod comparability, because the primary purpose of presenting segment information is to aid the financial statement reader.

2. Statement of Financial Accounting Standards no. 14 states that enough industry segments must be separately reported so that the total of revenues from sales to unaffiliated customers for the reportable segments equals or exceeds 75 percent of the combined revenues from sales to unaffiliated customers for the entire enterprise. If applying the prescribed tests does not yield the required percentage of revenues described above, additional segments must be reported on until the 75 percent test is met.

The Financial Accounting Standards Board has stated that if an enterprise has many reportable segments, benefit to the reader may be lost if more than ten segments are reported. In such a situation, the board suggests combining related reportable segments until the total is ten or fewer.

## VII. Cost Accumulation, Planning, and Control

**M83**
**Answer 4** (10 points)

**Part a.**

1. The weighted-average method of process costing combines beginning work-in-process inventory costs with costs of the new period by adding the cost of the work-in-process inventory at the beginning of the period to the costs of the new period.

2. The weighted-average method of process costing would be inappropriate when beginning and ending inventories change radically from month to month and conversion costs per unit change radically from month to month.

3. The weighted-average method of process costing is generally easier to use than the first-in, first-out method primarily because the beginning work-in-process inventory is averaged in as part of current production. Furthermore, if several unit cost figures are used at the same time, extensive detail is required in the first-in, first-out method, which can lead to complex procedures and even inaccuracy; and under such conditions the weighted-average method leads to more satisfactory cost computations.

The weighted-average method of process costing averages out uneven but expected cost incurrences over the entire period. This will reduce the fluctuations in unit costs and reflect operating experience for the period as a whole.

4. The units of the work-in-process inventory at the end of the period would be multiplied by one quarter (the portion complete as to conversion costs). The result would then be multiplied by the conversion cost per equivalent unit to arrive at the conversion cost portion of the ending work-in-process inventory.

**Part b.**

1. Daly would determine the number of units of Product Y that it would have to sell to attain a 20 percent profit on sales by dividing total fixed costs plus desired profit (20 percent of the sales price per unit multiplied by the units to attain a 20 percent profit) by unit contribution margin (sales price per unit less variable cost per unit).

2. If variable cost per unit increases as a percentage of the sales price, Daly would have to sell more units of Product Y to break even. Because the unit contribution margin (sales price per unit less variable cost per unit) would be lower, Daly would have to sell more units to cover the fixed costs.

3. The limitations of breakeven analysis in managerial decision-making are as follows:

- The breakeven chart is fundamentally a static analysis, and, in most cases, changes can only be shown by drawing a new chart or series of charts.
- The amount of fixed and variable cost, as well as the slope of the sales line, is meaningful in a defined range of activity and must be redefined for activity outside the relevant range.
- It is difficult to determine the fixed and variable components of cost.
- It is assumed that product mix will be unchanged.
- It is assumed that product technology will be unchanged.
- It is assumed that labor productivity will be unchanged.
- It is assumed that selling prices and other market conditions will be unchanged.

**N82**
**Answer 4** (10 points)

**Part a.**

1. The direct costing method is useful for internal reporting because it focuses attention on the fixed-variable cost relationship and the contribution margin concept. It facilitates managerial decision-making, product pricing, and cost control. It allows certain calculations to be readily made, such as breakeven points and contribution margins. The focus on the contribution margin (sales revenues less variable costs) enables management to emphasize profitability in making short-run business decisions. Fixed costs are not easily controllable in the short run and hence may not be particularly relevant for short-run business decisions.

2. Assuming that the quantity of ending inventory is higher than the quantity of beginning inventory, operating income using direct costing would be lower than operating income using absorption costing. Direct costing excludes fixed manufacturing overhead from inventories as it considers such costs to be period costs, which are expensed immediately; whereas, absorption costing includes fixed manufacturing overhead in inventories as it considers such costs to be product costs, which are expensed when the goods are sold. When the quantity of inventory increases during a period, direct costing produces a lower dollar increase in inventory than absorption costing. As a result, operating income would be lower.

**Part b.**

1. Both the net present value method and the internal rate-of-return method have the following advantages over the payback method:

- Consider the time value of money.
- Consider cash flow over the entire life of the project.

2. The limitations of the net present value method are as follows:

- It is more difficult to use than other less sophisticated capital budgeting techniques.
- The discount rate (hurdle rate of return) must be determined in advance.
- Certainty about cash flow is assumed.
- Cash flows are reinvested at the discount rate (hurdle rate of return).

3. The limitations of the internal rate-of-return method are as follows:

- It is more difficult to use than other less sophisticated capital budgeting techniques.
- Cash flows are reinvested at the rate earned by the investment.
- Certainty about cash flow is assumed.

4. Depreciation is excluded from the calculations for both the net present value method and the internal rate-of-return method. Deduction of depreciation would constitute a double-counting of a cost that has already been considered as a lump-sum outflow (the initial cost of the asset). Both the net present value method and the internal rate-of-return method focus on cash flow, while depreciation is an allocation of past cost and is not a cash flow.

**M82**
**Answer 5** (10 points)

**Part a.**

An objective in selecting the base for Stein Company's predetermined annual factory overhead rate is to ensure the application of factory overhead in reasonable proportion to a beneficial or causal relationship to products. Ordinarily, the base selected should be closely related to functions represented by the applied overhead cost. If factory overhead costs are predominantly labor-oriented, such as supervision and indirect labor, the proper base would probably be direct labor hours. If factory overhead costs are predominantly related to the costs incurred in the ownership and operation of the machinery, the proper base would probably be machine hours.

Another objective in selecting the base is to minimize clerical cost and effort relative to the benefits attained. When two or more bases provide approximately the same applied overhead cost to specific units of production, the simplest base should be used.

A predetermined annual factory overhead rate provides a feasible method of computing product costs promptly enough to serve management needs, such as identifying inefficiencies and minimizing month-to-month distortions in unit costs created by uneven expenditure patterns.

**Part b.**

1. A factory overhead variance analysis report provides periodic identification of deviations from planned outcomes. It provides a basis for further analysis, investigation, and follow-up action. It is useful in developing budgets and standards for future operations. Variances can be used to identify changes in operations that need to be reflected in such activities as product pricing, compensation rates, maintenance levels, and so forth. The report can be helpful in identifying costs incurred that should be classified as losses rather than product costs.

2. The two-variance method breaks down the overall factory overhead variance—that is, the difference between the actual factory overhead and the factory overhead applied to production—into two components. They are (*a*) the controllable (budget) variance and (*b*) the volume (denominator) variance.

The controllable (budget) variance is the difference between the actual factory overhead and the budget allowance based on standard hours allowed. The department managers have the responsibility to exercise control over the costs to which the variances relate.

The volume (denominator) variance is the difference between the budget allowance based on standard hours allowed and the factory overhead applied to production. The variance indicates the cost of capacity available but not utilized or not utilized efficiently, and such variance is generally considered the responsibility of management.

**M81**
**Answer 2** (10 points)

**Part a.**

1. The advantages of the payback method are these:

- It is simple to compute.
- It is easy to understand.
- It may be used to select those investments yielding a quick return of cash.
- It permits a company to determine the length of time required to recapture its original investment.
- The reciprocal of the payback period may be used under certain conditions as a rough approximation of the rate of return calculated by the internal rate-of-return method. The approximation is valid when the project's life is long, approximately double or more that of the payback period, and when the annual savings and/or cash inflow are relatively uniform in amount.

The disadvantages of the payback method are these:

- It ignores the time value of money.
- It ignores cash flow, including salvage value, which may be produced beyond the payback period.

2. Other capital budgeting techniques that could be used are the accounting rate-of-return (average annual return on investment) method, and the two discounted cash flow methods—net present value and internal rate of return.

**Part b.**

1. The breakeven point is that level of activity (sales) at which neither profit nor loss results. The factors used in determining the breakeven point are sales price, variable cost, and fixed cost.

The breakeven point in units is computed by dividing the total fixed cost by the unit contribution margin (sales price less variable cost). The breakeven point in dollars is computed by dividing the total fixed cost by the contribution margin ratio (sales price divided into contribution margin).

2. The major uses of breakeven analysis are these:

- It assists management in achieving profit objectives by enabling management to analyze fixed versus variable cost characteristics and production volumes.
- It assists management in formulating pricing and product mix decisions.

**M80**
**Answer 5** (10 points)

**Part a.**

1. The units placed in process for a period represent the units started during a period. The equivalent units for a period when there is no beginning work-in-process inventory and the ending work-in-process inventory is 50 percent complete represent the units that are placed in process for a period and are fully completed during a period (units completed for a period), plus 50 percent of the units that are placed in process for a period and are included in the ending work-in-process inventory.

2. The units completed for a period when there is no beginning work-in-process inventory and the ending work-in-process inventory is 50 percent complete represent the units that are placed in process for a period and are fully completed during a period. The equivalent units for a period when there is no beginning work-in-process inventory and the ending work-in-process inventory is 50 percent complete represent the units that are completed for a period plus 50 percent of the units that are placed in process for a period and are included in the ending work-in-process inventory.

3. The equivalent units for a period are divided into the total costs for a period to compute the unit cost. The equivalent units in the ending work-in-process inventory are then multiplied by the unit cost to compute the cost of the ending work-in-process inventory.

**Part b.**

1. Indirect materials are those materials needed for the completion of the product but whose consumption is either so small or so complex that their treatment as direct materials would not be feasible. For example, nails used to make the product are indirect materials.

2. Indirect labor, in contrast to direct labor, is labor expended that does not affect the construction or the composition of the finished product. For example, the labor of custodians is indirect labor.

3. The total of fixed indirect manufacturing costs (factory overhead) remains unchanged over a given range of activity.

4. The total of variable indirect manufacturing costs (factory overhead) changes in proportion to changes in activity.

5. Semivariable indirect manufacturing costs (factory overhead) contain both fixed and variable elements.

**N79**
**Answer 6** (10 points)

**Part a.**

1. Under direct costing, only variable manufacturing costs are included in inventory; whereas, under absorption costing (the current generally accepted method of costing inventory for external reporting), all manufacturing costs, both variable and fixed, are included in inventory.

2. Direct costing charges the product with only those manufacturing costs that vary directly with volume. In order to do this, a direct-costing structure must separate variable (product) costs and fixed (period) costs. As a result, a direct-costing structure facilitates calculation of the contribution margin and breakeven point because sales less variable costs equals the contribution margin, and the contribution margin, as a percentage of sales divided into fixed costs, equals the breakeven point.

**Part b.**

1. The materials price standard is usually based on current market prices. When the actual price is more than the standard, there is an unfavorable materials price variance. When the actual price is less than the standard, there is a favorable materials price variance.

The materials quantity (usage or efficiency) standard is usually based on engineering studies. When the actual quantity used is more than the standard, there is an unfavorable materials quantity (usage or efficiency) variance. When the actual quantity used is less than the standard, there is a favorable materials quantity (usage or efficiency) variance.

2. The labor rate (wage, cost, or price) standard is usually based on collective bargaining agreements or local conditions of labor supply and demand. When the actual rate is more than the standard, there is an unfavorable labor rate (wage, cost, or price) variance. When the actual rate is less than the standard, there is a favorable labor rate (wage, cost, or price) variance.

The labor efficiency (time or usage) standard is usually based on time and motion studies by industrial engineers. When the actual hours worked are more than the standard, there is an unfavorable labor efficiency (time or usage) variance. When the actual hours worked are less than the standard, there is a favorable labor efficiency (time or usage) variance.

## VIII. Not-for-Profit and Governmental Accounting

**N81**

**Answer 3** (10 points)

**a.** A governmental accounting system must make it possible to

- Present fairly and with full disclosure, in conformity with generally accepted accounting principles, the financial position and results of financial operations of the funds and account groups of the governmental unit.
- Determine and demonstrate compliance with finance-related legal and contractual provisions.

Because the legislative body enacts the budget into law, the budget is recorded in the accounts of a governmental unit. This enables a governmental unit to show legal compliance with the budget by providing an accounting system that measures actual expenditures and obligations against amounts appropriated, and actual revenues against estimated revenues. Appropriations enacted into law constitute maximum expenditure authorizations during the fiscal year, and they cannot legally be exceeded unless subsequently amended by the legislative body.

**b.** As the new fiscal year begins, the budget, already enacted into law by the legislative body, is recorded. Budgetary accounts are set up to record the estimated revenues and appropriations in the fund accounts by debiting estimated revenues and crediting appropriations. If there is a difference between estimated revenues and appropriations, the excess or deficit is credited or debited, respectively, to fund balance. In addition, subsidiary ledger accounts are maintained for estimated revenues by source and for appropriation/expenditure items.

At the end of the fiscal year, the estimated revenues balance and the appropriations balance are closed out to fund balance.

## SUGGESTED REFERENCES


AICPA, Industry Audit Guide, *Audits of Colleges and Universities,* 2d ed. (AICPA, 1975).

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**APPENDIX**

# Content Specification Outline

## Background Information

The Board of Examiners of the American Institute of Certified Public Accountants believes that content specification outlines will help assure the continuing validity and reliability of the Uniform CPA Examination. The development of the current content specification outlines was accomplished over several years. The Board of Examiners first requested Subcommittees of the Board of Examiners (Accounting Practice, Accounting Theory, Auditing, and Business Law) to draft content specification outlines for their respective sections.

The content specification outlines were drafted by each subcommittee with the assistance of the AICPA Examinations Division staff. The Chairman of the Board of Examiners then appointed an AICPA task force to coordinate the outlines and to recommend how the content specifications should be exposed to the profession. The task force recommended that the Board of Examiners approve the content specification outlines for exposure to the profession through an AICPA Exposure Draft for public comment.

On March 10, 1980, the Exposure Draft — *Proposed Content Specification Outlines for the Uniform Certified Public Accountant Examination* was issued. The Exposure Draft was sent to:

- *Members of AICPA Council,*
- *State Boards of Accountancy,*
- *Representatives of the National Association of State Boards of Accountancy (NASBA),*
- *AICPA Education Executive Committee,*
- *American Accounting Association — Committee on Professional Examinations,*
- *Persons who requested copies.*

The Board considered written comments received from the public, oral comments delivered at Board of Examiners' open meetings, and information submitted by NASBA, which gathered data through various state boards sponsoring special seminar sessions to review the *Proposed Content Specification Outlines for the Uniform Certified Public Accountant Examination.* Based on this input, the Board made certain modifications to the Exposure Draft. The Content Specification Outlines were approved by the Board of Examiners on August 31, 1981.

## Meaning and Use of Content Specification Outlines

The content specification outlines are divided into three levels — areas, groups, and topics, with the following outline notations:

- Areas by Roman numerals (I. Area),
- Groups by capital letters (A. Group),
- Topics by Arabic numbers (1. Topic).

The content specification outlines list the areas, groups, and topics to be tested, and also indicate the approximate percentage of the total test score devoted to each area. Some of the uses of the outlines will be to:

- Assure consistent subject matter coverage from one examination to the next.
- Assist candidates in preparing for the examination by indicating subjects that may be covered by the examination.
- Provide guidance to those who are responsible for preparing the examination in order to assure a balanced examination.
- Alert accounting educators as to the subject matter considered necessary to prepare for the examination.

The relative weight given to each area is indicated by its approximate percentage allocation. The examination will sample from the groups and topics listed within each area in order to meet the approximate percentage allocation. Generally, the group title should be sufficient to indicate the subject matter to be covered. However, in certain instances, topics have been explicitly listed in order to clarify or limit the subject matter covered within a group.

No weight allocations are given for groups or topics. For example, if there are several groups within an area or several topics within a group, no inference should be drawn about the relative importance or weight to be given to these groups or topics on an examination.

The content specification outlines are considered to be complete as to the subjects to be tested on an examination, including recent professional developments as they affect these subjects. Candidates should answer examination questions, developed from these outlines, in terms of the most recent developments, pronouncements, and standards in the accounting profession. When new subject matter is identified the outlines will be amended to include it and this will be communicated to the profession.

**Accounting Theory Section**

The Accounting Theory section tests the candidates' conceptual knowledge of accounting. This knowledge includes a rather wide assortment of ideas variously described as assumptions, axioms, standards, postulates, conventions, principles, rules, and objectives. Such ideas that have received substantial authoritative support are referred to as Generally Accepted Accounting Principles. The scope of the Accounting Theory section includes financial accounting concepts relating to general principles, assets, liabilities, equity, income and expense, and other financial topics; cost/managerial accounting concepts of cost accumulation, planning, and control; and not-for-profit and governmental accounting.

In preparing for this section, candidates should study the pronouncements of the Financial Accounting Standards Board, accounting textbooks, leading accounting journals, and other literature pertaining to accounting. Answers should be in accord with current accounting theory and not necessarily with accounting methods and practices promulgated by governmental agencies, such as the Internal Revenue Service and the Securities and Exchange Commission, unless specifically required or vital to a complete discussion of the issues involved.

**Accounting Theory — Content Specification Outline**

I. General Concepts, Principles, Terminology, Environment, and Other Professional Standards (15%).

   A. Authority of Pronouncements (substantial authoritative support - GAAP)
   B. Departures from Generally Accepted Accounting Principles
   C. Conceptual Framework
   D. Basic Concepts and Accounting Principles
   E. Nonmonetary Transactions Concepts
   F. Working Capital - Current Assets and Current Liabilities (terminology)
   G. Comparative Financial Statements
   H. Consolidated Financial Statements
   I. Historical Cost, Constant Dollar, Current Cost, and Other Accounting Concepts

II. Measurement, Valuation, Realization, and Presentation of Assets in Conformity with Generally Accepted Accounting Principles (15%).

   A. Cash
   B. Marketable Securities and Investments

      1. Marketable Equity Securities
      2. Other Securities
      3. Investment in Bonds
      4. Investment in Stocks
      5. Sinking and Other Funds

C. Receivables and Accruals

1. Accounts and Notes Receivable
2. Affiliated Company Receivables
3. Discounting of Notes
4. Installment Accounts
5. Interest and Other Accrued Income
6. Allowance for Doubtful Accounts

D. Inventories

1. Acquisition Costs
2. Costing Methods
3. Valuation Methods

E. Property, Plant, and Equipment

1. Acquisition Costs
2. Additions and Betterments
3. Depreciation, Amortization, and Depletion
4. Insurance
5. Involuntary Conversion
6. Leasehold Improvements
7. Maintenance and Repairs
8. Obsolescence and Write-Downs
9. Rearrangement and Moving Costs
10. Disposition

F. Capitalized Leased Assets

1. Acquisition Costs
2. Amortization

G. Intangibles

1. Acquisition Costs
2. Amortization
3. Intangibles Carried as Investments (equity method)

H. Prepaid Expenses and Deferred Charges

1. Prepaid Expenses
2. Deferred Income Taxes
3. Deferred Pension Costs

III. Valuation, Recognition, and Presentation of Liabilities in Conformity with Generally Accepted Accounting Principles (10%).

A. Payables and Accruals

1. Accounts and Notes Payable
2. Accrued Employees' Costs
3. Interest and Other Accrued Expenses
4. Accrued Pension Expense
5. Taxes Payable
6. Guaranties and Warranties
7. Deposits and Escrows

B. Deferred Revenues

1. Unperformed Service Contracts
2. Subscriptions or Tickets Outstanding
3. Installment Sales
4. Sale and Leaseback

C. Deferred Income Tax Liabilities

1. Equity Method of Accounting for Investments
2. Depreciation of Plant Assets
3. Long-Term Construction Contracts
4. Other Timing Differences

D. Capitalized Lease Liability

1. Measurement at Present Value
2. Amortization

E. Bonds Payable

1. Issue of Bonds
2. Issue Costs
3. Amortization of Discount or Premium
4. Types of Bonds
5. Conversion of Bonds
6. Detachable Stock Warrants
7. Retirement of Bonds

F. Long-Term Notes Payable
G. Contingent Liabilities and Commitments

IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity with Generally Accepted Accounting Principles (5%).

A. Preferred and Common Stock

1. Issued
2. Outstanding
3. Legal Capital
4. Retirement of Stock
5. Book Value Per Share
6. Classification

B. Additional Paid-in Capital
C. Retained Earnings and Dividends

1. Prior Period Adjustments
2. Net Income
3. Cash Dividends
4. Property Dividends
5. Liquidating Dividends
6. Stock Dividends and Splits
7. Appropriations of Retained Earnings

D. Treasury Stock and Other Contra Accounts

1. Cost Method
2. Par Value Method
3. Restrictions on Acquisition of Treasury Stock

E. Stock Options, Warrants, and Rights
F. Reorganization and Change in Entity

   1. Incorporation of an Unincorporated Enterprise
   2. Business Combinations
   3. Quasi-Reorganization
   4. Bankruptcy

G. Partnerships

   1. Formation
   2. Admission, Retirement, and Dissolution
   3. Profit or Loss Distribution and Other Special Allocations

V. Measurement and Presentation of Income and Expense Items, Their Relationship to Matching and Periodicity, and Their Relationship to Generally Accepted Accounting Principles (20%).

A. Sales or Revenues

   1. Cash
   2. At Time of Sale
   3. At Completion of Production
   4. During Production (percentage of completion)
   5. Installment Method or Cost Recovery
   6. Equity in Earnings of Investee
   7. Interest
   8. Dividends
   9. Royalties
   10. Rent
   11. Disposal of Assets and Liquidation of Liabilities
   12. Foreign Exchange

B. Cost of Goods Sold
C. Expenses

   1. General and Administrative
   2. Selling
   3. Financial (interest)
   4. Depreciation, Amortization, and Depletion
   5. Research and Development
   6. Foreign Exchange
   7. Bad Debts
   8. Royalties
   9. Rent
   10. Compensation
   11. Unusual Gains or Losses

D. Provision for Income Tax

   1. Current
   2. Deferred

E. Recurring Versus Nonrecurring Transactions and Events

   1. Discontinued Operations
   2. Extraordinary Items

F. Accounting Changes
G. Earnings Per Share

VI. Other Financial Topics (10%).

A. Statement of Changes in Financial Position
B. Accounting Policies
C. Accounting Changes

1. Principle
2. Estimate
3. Entity

D. Business Combinations
E. Interim Financial Statements
F. Loss or Gain Contingencies
G. Segments and Lines of Business
H. Long-Term Contracts
I. Employee Benefits
J. Analysis of Financial Statements
K. Development Stage Enterprises
L. Personal Financial Statements

VII. Cost Accumulation, Planning, and Control (15%).

A. Nature of Cost Elements

1. Direct Materials
2. Direct Labor
3. Overhead (actual, applied, and allocation methods)

B. Job Order Costing
C. Process Costing
D. Standard Costing and Variance Analysis
E. Joint Costing
F. By-Product Costing
G. Spoilage, Waste, and Scrap
H. Absorption and Direct Costing
I. Transfer Pricing
J. Product Pricing
K. Budgeting and Flexible Budgeting
L. Breakeven and Cost-Volume-Profit Analysis
M. Gross Profit Analysis
N. Differential Cost Analysis

1. Activity Levels
2. Sunk Costs
3. Contribution to Profit
4. Uncertainty
5. Time Periods

O. Capital Budgeting Techniques

1. Net Present Value
2. Internal Rate of Return
3. Payback Period
4. Accounting Rate of Return

P. Performance Analysis

1. Return on Investment
2. Residual Income
3. Controllable Revenue and Costs

Q. Quantitative Techniques for Planning and Control

1. Regression and Correlation Analysis
2. Learning Curves
3. Economic Order Quantity
4. PERT/Cost
5. Sensitivity Analysis
6. Probability Analysis
7. Linear Programming

VIII. Not-for-Profit and Governmental Accounting (10%).

A. Conceptual Framework
B. Fund Accounting

1. Fund Balance
2. Estimated Revenues
3. Appropriations
4. Encumbrances
5. Reserve for Encumbrances
6. Revenues
7. Expenditures

C. Types of Funds and Fund Accounts

1. General Fund
2. Special Revenue Funds
3. Debt Service Funds
4. Capital Projects Funds
5. Enterprise Funds
6. Internal Service Funds
7. Trust and Agency Funds
8. Special Assessment Funds
9. General Fixed Asset Account Group
10. General Long-Term Debt Account Group
11. Endowment and Quasi-Endowment Funds
12. Restricted Funds
13. Nonrestricted Funds
14. Property Funds

D. Presentation of Financial Statements for Various Not-for-Profit and Governmental Organizations
E. Various Types of Not-for-Profit and Governmental Organizations

1. Local and State Governments
2. Educational Institutions
3. Hospitals
4. Charitable, Religious, and Other Organizations

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