# CPA PassMaster Questions–Financial 1
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**Sources of GAAP**

**CPA-00001 Type1 M/C A-D Corr Ans: D PM#1 F 1-01**

1. CPA-00001 FARE Nov 95 #1, Released 2006 Page 6

According to the FASB conceptual framework, the objectives of financial reporting for business enterprises are based on:

a. Generally accepted accounting principles.
b. Reporting on management's stewardship.
c. The need for conservatism.
d. The needs of the users of the information.

**CPA-00001 Explanation**
Choice "d" is correct. The FASB conceptual framework states that the objectives of financial reporting stem from the informational needs of the external users of the information. SFAC 1 para. 28

Choice "a" is incorrect. Generally accepted accounting principles (GAAP) are derived from and based on the objectives of financial reporting, not the other way around.

Choice "b" is incorrect. Information concerning management's stewardship is only one aspect of the information financial statements are intended to provide. SFAC 1 para. 50

Choice "c" is incorrect. Conservatism is an underlying concept for financial accounting but is not the basis for the objectives. SFAC 2 para. 91-97

**CPA-00004 Type1 M/C A-D Corr Ans: B PM#2 F 1-01**

2. CPA-00004 FARE Nov 95 #2 Page 7

According to the FASB conceptual framework, the usefulness of providing information in financial statements is subject to the constraint of:

a. Consistency.
b. Cost-benefit.
c. Reliability.
d. Representational faithfulness.

**CPA-00004 Explanation**
Choice "b" is correct. The pervasive constraint on providing information in financial statements is that the cost should be outweighed by the benefit to be derived from providing the information. SFAC 1 para. 23, SFAC 2 para. 133

Choice "a" is incorrect. Consistency is an underlying concept for financial statements (and a secondary quality of accounting information), but it is not a constraint on providing information. SFAC 2 para. 120

Choice "c" is incorrect. Reliability is a primary quality of accounting information and an underlying concept for financial statements, but it is not a constraint on providing information. SFAC 2 para. 58

Choice "d" is incorrect. Representational faithfulness is an underlying concept for financial statements (as an element of reliability), but it is not a constraint on providing information. SFAC 2 para. 63

**CPA-00006 Type1 M/C A-D Corr Ans: D PM#4 F 1-01**

3. CPA-00006 FARE Nov 95 #5 Page 9

According to the FASB conceptual framework, which of the following attributes would **not** be used to measure inventory?

a. Historical cost.
b. Replacement cost.
c. Net realizable value.
d. Present value of future cash flows.


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**CPA-00006 Explanation**
Choice "d" is correct. The present value of future cash flows is used to measure long-term receivables or payables, not inventory, because inventory is a short-term asset, which has more immediate cash flows. SFAC 5 para. 67

Choice "a" is incorrect. Historical cost can be used to measure inventory because it is a relevant and reliable measurement attribute of current assets such as inventory.

Choice "b" is incorrect. Replacement (or current) cost can be used to measure inventory because it is a relevant and reliable measurement attribute of current assets such as inventory.

Choice "c" is incorrect. Net realizable value can be used to measure inventory because it is a relevant and reliable measurement attribute of current assets such as inventory.

**CPA-00007 Type1 M/C A-D Corr Ans: D PM#5 F 1-01**

4. CPA-00007 FARE May 95 #1 Page 8

According to the FASB conceptual framework, which of the following situations violates the concept of reliability?

a. Data on segments having the same expected risks and growth rates are reported to analysts estimating future profits.
b. Financial statements are issued nine months late.
c. Management reports to stockholders regularly refer to new projects undertaken, but the financial statements never report project results.
d. Financial statements include property with a carrying amount increased to management's estimate of market value.

**CPA-00007 Explanation**
Choice "d" is correct. Management's estimate of market value lacks verifiability, which is a component of reliability. SFAC 2 para. 89

Choice "a" is incorrect. Communicating data on segments to analysts does not violate the concept of reliability.

Choice "b" is incorrect. Issuing financial statements nine months late violates timeliness, which is a component of relevance, not reliability. SFAC 2 para. 56

Choice "c" is incorrect. Neglecting to report results of new projects violates full disclosure, not reliability.

**CPA-00011 Type1 M/C A-D Corr Ans: D PM#9 F 1-01**

5. CPA-00011 FARE Nov 94 #2 Page 5

In the hierarchy of generally accepted accounting principles, APB Opinions have the same authority as AICPA:

a. Statements of Position.
b. Industry Audit and Accounting Guides.
c. Issues Papers.
d. Accounting Research Bulletins.

**CPA-00011 Explanation**
Choice "d" is correct. AICPA Accounting Research Bulletins, FASB Standards, FASB Interpretations, FASB Staff Positions, FASB Statement 133 Implementation Issues, and APB Opinions and Interpretations are the most authoritative sources of generally accepted accounting principles.

Choice "a" is incorrect. AICPA Statements of Position, AICPA Accounting and Auditing Guides, and FASB Technical Bulletins are secondary sources of generally accepted accounting principles.


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Choice "b" is incorrect. AICPA Statements of Position, AICPA Accounting and Auditing Guides, and FASB Technical Bulletins are secondary sources of generally accepted accounting principles.

Choice "c" is incorrect. AICPA Issues Papers and Practice Bulletins, FASB Concepts Statements, and other authoritative pronouncements are tertiary sources for generally accepted accounting principles.

**CPA-00012 Type1 M/C A-D Corr Ans: D PM#10 F 1-01**

6. CPA-00012 FARE Nov 94 #3 Page 11

What is the underlying concept that supports the immediate recognition of a contingent loss?

a. Substance over form.
b. Consistency.
c. Matching.
d. Conservatism.

**CPA-00012 Explanation**
Choice "d" is correct. Conservatism is a prudent reaction to uncertainty to try to ensure that uncertainty and risks inherent in business situations are adequately considered. Recognition of a contingent loss is the recording of an amount representing uncertainty and risk in a business situation. SFAC 2, SFAS 5 para. 82

Choice "a" is incorrect. The substance over form concept presumes that the transaction form may not dictate the accounting treatment.

Choice "b" is incorrect. Consistency is conformity from period to period with unchanging policies and procedures. SFAC 2

Choice "c" is incorrect. The matching principle dictates that expenses be matched with the related revenues generated or the time period in which the expense is incurred and known. SFAS #5 cites matching as the one concept supporting the immediate recognition of a contingent loss, but it is not the primary underlying concept. SFAS 5 para. 76

**CPA-00013 Type1 M/C A-D Corr Ans: D PM#11 F 1-01**

7. CPA-00013 FARE May 94 #1 Page 9

According to the FASB conceptual framework, the process of reporting an item in the financial statements of an entity is:

a. Allocation.
b. Matching.
c. Realization.
d. Recognition.

**CPA-00013 Explanation**
Choice "d" is correct. Recognition is the process of recording an item in the financial statements of an entity. SFAC 5 para. 6

Choice "a" is incorrect. Allocation is the accounting process of assigning or distributing an amount according to a plan or a formula. SFAC 6 para. 142

Choice "b" is incorrect. Matching of costs and revenues is simultaneous or combined recognition of the revenues and expenses that result directly and jointly from the same transactions or other events. SFAC 6 para. 146

Choice "c" is incorrect. Realization is the process of converting noncash resources and rights into money. SFAC 6 para. 143

**CPA-00014 Type1 M/C A-D Corr Ans: C PM#12 F 1-01**


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8. CPA-00014 FARE May 94 #2 Page 6

What are the Statements of Financial Accounting Concepts intended to establish?

a. Generally accepted accounting principles in financial reporting by business enterprises.
b. The meaning of "Present fairly in accordance with generally accepted accounting principles."
c. The objectives and concepts for use in developing standards of financial accounting and reporting.
d. The hierarchy of sources of generally accepted accounting principles.

**CPA-00014 Explanation**
Choice "c" is correct. Statements of Financial Accounting Concepts are intended to establish the objectives and concepts that the Financial Accounting Standards Board will use in developing standards of financial accounting and reporting. SFAC 1 para. 3

Choice "a" is incorrect. The Statements of Financial Accounting Concepts do not specify financial accounting standards prescribing accounting procedures or practices. SFAC 1 para. 3

Choice "b" is incorrect. Auditing standards develop the meaning of "Present fairly in accordance with generally accepted accounting principles."

Choice "d" is incorrect. The hierarchy of sources of generally accepted accounting principles is determined by GAAP.

**CPA-00015 Type1 M/C A-D Corr Ans: C PM#13 F 1-01**

9. CPA-00015 FARE May 94 #4 Page 6

During a period when an enterprise is under the direction of a particular management, its financial statements will directly provide information about:

a. Both enterprise performance and management performance.
b. Management performance but not directly provide information about enterprise performance.
c. Enterprise performance but not directly provide information about management performance.
d. Neither enterprise performance nor management performance.

**CPA-00015 Explanation**
Choice "c" is correct. Financial reporting, and especially financial statements, usually cannot and do not separate management performance from enterprise performance. Financial reporting provides information about an enterprise during a period when it was under the direction of a particular management but does not directly provide information about that management's performance. SFAC 1 para. 53

**CPA-00017 Type1 M/C A-D Corr Ans: B PM#15 F 1-01**

10. CPA-00017Th Nov 93 #6 Page 10

According to the FASB conceptual framework, which of the following statements conforms to the realization concept?

a. Equipment depreciation was assigned to a production department and then to product unit costs.
b. Depreciated equipment was sold in exchange for a note receivable.
c. Cash was collected on accounts receivable.
d. Product unit costs were assigned to cost of goods sold when the units were sold.

**CPA-00017 Explanation**
Choice "b" is correct. Revenues and gains are realized when assets are exchanged for cash or claims to cash. SFAC 5 para. 83.

Choice "a" is incorrect. Assigning depreciation in a production department is an example of allocating overhead. There is no realization associated with the assignment.


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Choice "c" is incorrect. The realization concept is integral to accounting for revenues and expenses and is not connected to collection of receivables.

Choice "d" is incorrect. Assignment of overhead costs to products and thus to cost of goods sold is an example of matching. There is no realization associated with this assignment.

**CPA-00018 Type1 M/C A-D Corr Ans: A PM#16 F 1-01**

11. CPA-00018 PI Nov 93 #53 Page 11

In Yew Co.'s 1992 annual report, Yew described its social awareness expenditures during the year as follows:

> "The Company contributed $250,000 in cash to youth and educational programs. The Company also gave $140,000 to health and human-service organizations, of which $80,000 was contributed by employees through payroll deductions. In addition, consistent with the Company's commitment to the environment, the Company spent $100,000 to redesign product packaging."

What amount of the above should be included in Yew's income statement as charitable contributions expense?

a. $310,000
b. $390,000
c. $410,000
d. $490,000

**CPA-00018 Explanation**
Choice "a" is correct. Charitable contributions include amounts the company gave to recognized charities. This includes:

| | |
|---|---|
| Youth and education programs | $ 250,000 |
| Health ($140,000 - $80,000) | 60,000 |
| Total | $ 310,000 |

Note: Of the $140,000, employees gave $80,000, and the company $60,000. Redesigning packaging is not a contribution to a charity.

Choice "b" is incorrect. The company gave only $60,000 of the $140,000. Employees gave $80,000.

Choice "c" is incorrect. Redesigning packaging is not a contribution to a charity.

Choice "d" is incorrect. The company gave only $60,000 of the $140,000. Employees gave $80,000. Redesigning packaging is not a contribution to a charity.

**CPA-00022 Type1 M/C A-D Corr Ans: A PM#19 F 1-01**

12. CPA-00022 Th Nov 92 #2 Page 7

According to the FASB conceptual framework, which of the following relates to both relevance and reliability?

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

**CPA-00022 Explanation**
Choice "a" is correct. Comparability and consistency are secondary qualities of both relevance and reliability. SFAC 2 para. 111-122

Choice "b" is incorrect. Feedback value is a key characteristic of relevance only.

Choice "c" is incorrect. Verifiability is a key characteristic of reliability only.


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Choice "d" is incorrect. Timeliness is a key characteristic of relevance only.

**CPA-05420 Type1 M/C A-D Corr Ans: D PM#30 F 1-01**

13. CPA-05420 Released 2007 Page 4

Which of the following is true regarding the comparison of managerial to financial accounting?

a. Managerial accounting is generally more precise.
b. Managerial accounting has a past focus and financial accounting has a future focus.
c. The emphasis on managerial accounting is relevance and the emphasis on financial accounting is timeliness.
d. Managerial accounting need **not** follow generally accepted accounting principles (GAAP) while financial accounting must follow them.

**CPA-05420 Explanation**
Choice "d" is correct. Public companies must follow GAAP for (external) financial reporting purposes. GAAP need not be followed for (internal) managerial accounting purposes.

Choice "a" is incorrect. Financial accounting is generally more precise.

Choice "b" is incorrect. Managerial accounting has a future focus, while financial accounting focuses on reporting past results.

Choice "c" is incorrect. The emphasis of financial accounting is providing useful information to financial statement users (including the characteristic of relevance), while the emphasis of managerial accounting is providing timely information to management decision makers.

**CPA-05434 Type1 M/C A-D Corr Ans: D PM#31 F 1-01**

14. CPA-05434 Released 2007 Page 11

Which of the following is a generally accepted accounting principle that illustrates the practice of conservatism during a particular reporting period?

a. Capitalization of research and development costs.
b. Accrual of a contingency deemed to be reasonably possible.
c. Reporting investments with appreciated market values at market value.
d. Reporting inventory at the lower of cost or market value.

**CPA-05434 Explanation**
Choice "d" is correct. The rule of conservatism states that revenues and gains should be recognized when the earnings process is complete, but that expenses and losses should be expensed immediately.

Reporting inventory at the lower of cost or market requires the recording of a loss on inventory when market is lower than cost in the period the loss is sustained, rather than when the inventory is sold, consistent with the rule of conservatism.

Choice "a" is incorrect. Because the future benefits of R&D costs are questionable, these cost should be expensed immediately, consistent with the rule of conservatism and the matching principle.

Choice "b" is incorrect. The rule of conservatism only requires the accrual of "probable" losses. The accrual of a reasonably possible loss is not required and the accrual of any contingent gain, whether probable, reasonably possible, or remote, is prohibited.

Choice "c" is incorrect. The reporting of marketable securities with appreciated values at market value requires the recording of a gain on the asset before the gain is realized. This contradicts the rule of conservatism, but is allowed because fair value is a more relevant measure of the value of marketable securities.

**CPA-05195 Type1 M/C A-D Corr Ans: D PM#31 F 1-01**


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15. CPA-05195 Released 2006 Page 6

Arpco, Inc., a for-profit provider of healthcare services, recently purchased two smaller companies and is researching accounting issues arising from the two business combinations. Which of the following accounting pronouncements are the most authoritative?

a. AICA Statements of Position.
b. AICPA Industry and Audit Guides.
c. FASB Statements of Financial Accounting Concepts.
d. FASB Statements of Financial Accounting Standards.

**CPA-05195 Explanation**
Choice "d" is correct. Since Arpco is a for-profit provider of healthcare services, it is covered under normal GAAP. Thus, the most authoritative pronouncements are the FASB Statements of Financial Accounting Standards (SFAS).

Choice "a" is incorrect. AICPA Statements of Position are not the most authoritative pronouncement for almost anything (other than for some issues that only they cover). They are normally "merely" the opinion of the AICPA.

Choice "b" is incorrect. AICPA Industry and Audit Guides are not the most authoritative pronouncement for almost anything (other than for some issues that only they cover).

Choice "c" is incorrect. FASB Statements of Financial Accounting Concepts are not authoritative pronouncements except where they have been incorporated by reference into an SFAS. They are the basis on which SFAS can be constructed.

**CPA-05197 Type1 M/C A-D Corr Ans: B PM#32 F 1-01**

16. CPA-05197 Released 2006 Page 6

According to the FASB conceptual framework, the quality of information that helps users increase the likelihood of correctly forecasting the outcome of past or present events is called:

a. Feedback value.
b. Predictive value.
c. Representational faithfulness.
d. Reliability.

**CPA-05197 Explanation**
Choice "b" is correct. The quality of information that helps users increase the likelihood of correctly forecasting the outcome of past or present events is called predictive value. Forecasting is predicting.

Choice "a" is incorrect. The quality of information that helps users increase the likelihood of correctly forecasting the outcome of past or present events is called predictive value, **not** feedback value. Feedback value enables decision makers to confirm prior expectations or to adjust or correct the decisions made previously.

Choice "c" is incorrect. The quality of information that helps users increase the likelihood of correctly forecasting the outcome of past or present events is called predictive value, **not** representational faithfulness. Representational faithfulness is the agreement between financial reporting and the resources or events represented.

Choice "d" is incorrect. The quality of information that helps users increase the likelihood of correctly forecasting the outcome of past or present events is called predictive value, **not** reliability. Reliability is the combination of neutrality, representational faithfulness, and verifiability.

**CPA-05234 Type1 M/C A-D Corr Ans: C PM#33 F 1-01**

17. CPA-05234 Released 2006 Page 10


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Which of the following assumptions means that money is the common denominator of economic activity and provides an appropriate basis for accounting measurement and analysis?

a. Going concern.
b. Periodicity.
c. Monetary unit.
d. Economic entity.

**CPA-05234 Explanation**
Choice "c" is correct. The monetary unit assumption means that money is the common denominator for economic activity and provides an appropriate basis for accounting measurements and analysis.

Choice "a" is incorrect. The going concern assumption has nothing to do with money per se. The going concern assumption presumes that an entity will continue to operate in the foreseeable future.

Choice "b" is incorrect. The periodicity has nothing to do with money per se. The periodicity assumption is that economic activity can be divided into meaningful time periods.

Choice "d" is incorrect. The economic entity assumption has nothing to do with money per se. The economic entity assumption is that economic activity can be accounted for when considering an identifiable set of activities.

**CPA-05235 Type1 M/C A-D Corr Ans: C PM#34 F 1-01**

18. CPA-05235 Released 2006 Page 3

Which of the following statements best describes an operating procedure for issuing a new Financial Accounting Standards Board (FASB) statement?

a. The emerging issues task force must approve a discussion memorandum before it is disseminated to the public.
b. The exposure draft is modified per public opinion before issuing the discussion memorandum.
c. A new statement is issued only after a majority vote by the members of the FASB.
d. A new FASB statement can be rescinded by a majority vote of the AICPA membership.

**CPA-05235 Explanation**
Choice "c" is correct. A new statement from the FASB is issued only after a majority vote of the members of the FASB.

Choice "a" is incorrect. There is no necessity for the EITF to approve a discussion memorandum (presumably the question means a discussion memorandum of the FASB statement itself and not an EITF statement) before it is disseminated to the public.

Choice "b" is incorrect. There is no necessity for an exposure draft to be modified per public opinion before issuing the discussion memorandum (a question can be raised here as to "what" discussion memorandum"). Exposure drafts are quite/most often modified before they are issued as FASB statements, but they do not have to be. Whether they are or are not modified is a function of whether the FASB thinks they should be modified, partly due to the public comments that have been received.

Choice "d" is incorrect. There is no way to rescind a new FASB statement, although, in reality, a FASB statement can be rescinded by the issuance of a new statement on the same subject. However, even if there was a way to rescind a new FASB statement, it would not be by a majority vote of the AICPA membership, but by a majority vote of the members of the FASB.

**Reporting Net Income**

**CPA-00032 Type1 M/C A-D Corr Ans: D PM#3 F 1-02**

19. CPA-00032 FARE R99 #2 Page 14

Income tax-basis financial statements differ from those prepared under GAAP in that income tax-basis financial statements:


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a. Do not include nontaxable revenues and nondeductible expenses in determining income.
b. Include detailed information about current and deferred income tax liabilities.
c. Contain no disclosures about capital and operating lease transactions.
d. Recognize certain revenues and expenses in different reporting periods.

**CPA-00032 Explanation**
Choice "d" is correct. Income tax-basis financial statements recognize events when taxable income or deductible expenses are recognized on the entity's tax return. Non-taxable income and non-deductible expenses are shown on the financial statement and included in the determination of income (and become M-1 adjustments to arrive at **taxable** income).

Please Note: This question appeared in the releases for 1999 in FARE; however, it may also apply to OCBOA financial statements discussed in the Auditing textbook. The question did not apply well to any FARE CSO line item, so we included it here so that you could read the explanation and learn from it.

**CPA-05458 Type1 M/C A-D Corr Ans: A PM#3 F 1-02**

20. CPA-05458 Released 2007 Page 15

An extraordinary gain should be reported as a direct increase to which of the following?

a. Net income.
b. Comprehensive income.
c. Income from continuing operations, net of tax.
d. Income from discontinued operations, net of tax.

**CPA-05458 Explanation**
Choice "a" is correct. Extraordinary items are reported as a component of net income, after income from continuing operations and discontinued operations.

Choice "b" is incorrect. An extraordinary gain (or loss) only indirectly affects comprehensive income as a component of net income.

Choice "c" is incorrect. Extraordinary items are reported net of tax after income from continuing operations and discontinued operations.

Choice "d" is incorrect. Extraordinary items are reported net of tax after income from continuing operations and discontinued operations.

**Income Statement**

**CPA-00035 Type1 M/C A-D Corr Ans: C PM#1 F 1-03**

21. CPA-00035 FARE R01 #8 (Adapted) Page 20

On December 2, 20X1, Flint Corp.'s board of directors voted to discontinue operations of its frozen food division and to sell the division's assets on the open market as soon as possible. The division reported net operating losses of $20,000 in December and $30,000 in January. On February 26, 20X2, sale of the division's assets resulted in a gain of $90,000. Assuming that the frozen foods division qualifies as a component of the business and ignoring income taxes, what amount of gain/loss from discontinued operations should Flint recognize in its income statement for 20X2?

a. $0
b. $40,000
c. $60,000
d. $90,000

**CPA-00035 Explanation**
Choice "c" is correct. The $60,000 gain from discontinued operations would be reported in Flint's 20X2 income statement. The operating loss for January would offset the gain from disposal in February, and the net amount would be reported as a gain (in this case) from discontinued operations.


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The operating losses for December would have been reported in Flint's 20X1 income statement.

Choice "a" is incorrect per the above. It would be correct if all of the gains and losses were included in 20X1 instead of 20X2. However, gains and losses from discontinued operations are included in the year they occur.

Choice "b" is incorrect. It includes the operating loss for December, 20X1 in with the 20X2 amounts.

Choice "d" is incorrect. It ignores the January operating loss. Operating losses are included in gain/loss from discontinued operations, along with impairment losses and gains/losses on disposal.

**CPA-00037 Type1 M/C A-D Corr Ans: A PM#2 F 1-03**

22. CPA-00037 FARE R99 #12 Page 25

At December 31, 1998, Off-Line Co. changed its method of accounting for demo costs from writing off the costs over two years to expensing the costs immediately. Off-Line made the change in recognition of an increasing number of demos placed with customers that did not result in sales. Off-Line had deferred demo costs of $500,000 at December 31, 1997, $300,000 of which were to be written off in 1998 and the remainder in 1999. Off-Line's income tax rate is 30%. In its 1998 financial statements, what amount should Off-Line report as cumulative effect of change in accounting principle?

a. $0
b. $200,000
c. $350,000
d. $500,000

**CPA-00037 Explanation**
Choice "a" is correct. When a change in accounting principle is considered inseparable from a change in estimate, the change is handled as a change in estimate - prospectively. No cumulative effect adjustment is made.

Choices "b", "c", and "d" are incorrect since no cumulative effect adjustment is made.

**CPA-00038 Type1 M/C A-D Corr Ans: A PM#3 F 1-03**

23. CPA-00038 FARE R97 #4 Page 26

How should the effect of a change in accounting principle that is inseparable from the effect of a change in accounting estimate be reported?

a. As a component of income from continuing operations.
b. By restating the financial statements of all prior periods presented.
c. As a correction of an error.
d. By footnote disclosure only.

**CPA-00038 Explanation**
Choice "a" is correct. When the effect of a change in accounting principle is inseparable from the effect of a change in accounting estimate, the reporting treatment for the overall effect is as a change in estimate. Thus, the effect is reported prospectively as a component of income from continuing operations. Under SFAS No. 154, this type of change is now called a change in accounting estimate affected by a change in accounting principle.

Choice "b" is incorrect. Restatement of all prior periods is the retroactive accounting treatment that is applied to the correction of an error and the retrospective accounting treatment given to changes in accounting principle. However, a change in accounting principle that is inseparable from the effect of a change in accounting estimate is now treated as a change in accounting estimate.

Choice "c" is incorrect. Correction of an error is given retroactive treatment as a prior period adjustment to retained earnings with restatement of prior periods. This is not the treatment appropriate for the effect of a change in accounting principle that is inseparable from the effect of a change in accounting estimate.


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Choice "d" is incorrect. While footnote disclosure is always appropriate for an accounting change, such disclosure alone is never the appropriate accounting treatment.

**CPA-00043 Type1 M/C A-D Corr Ans: C PM#4 F 1-03**

24. CPA-00043 FARE R97 #5 Page 22

In September 1996, Koff Co.'s operating plant was destroyed by an earthquake. Earthquakes are rare in the area in which the plant was located. The portion of the resultant loss not covered by insurance was $700,000. Koff's income tax rate for 1996 was 40%. In its 1996 income statement, what amount should Koff report as extraordinary loss?

a. $0
b. $280,000
c. $420,000
d. $700,000

**CPA-00043 Explanation**
Choice "c" is correct. For a loss to be reported as an extraordinary loss, the event causing the loss must be both unusual in nature and infrequent in occurrence. The earthquake in this case does meet these criteria so the loss is reported net of income tax effect as an extraordinary loss of $420,000 (60% of the total $700,000 loss). APB 30.11, .19-.26

Choice "a" is incorrect. Review the criteria for reporting an extraordinary loss.

Choice "b" is incorrect. This is the tax effect of the loss. Review your calculations.

Choice "d" is incorrect. It is not appropriate to report the full loss as an extraordinary loss.

**CPA-00046 Type1 M/C A-D Corr Ans: D PM#6 F 1-03**

25. CPA-00046 FARE Nov 95 #40 (Adapted) Page 20

In April 30, 20X4, Deer Corp. approved a plan to dispose of a component of its business. For the period January 1 through April 30, 20X4, the component had revenues of $500,000 and expenses of $800,000. The assets of the component were sold on October 15, 20X4 at a loss. In its income statement for the year ended December 31, 20X4, how should Deer report the component's operations from January 1 to April 30, 20X4?

a. $500,000 and $800,000 should be included with revenues and expenses, respectively, as part of continuing operations.
b. $300,000 should be reported as part of the loss on disposal of a component and included as part of continuing operations.
c. $300,000 should be reported as an extraordinary loss.
d. $300,000 should be reported as a loss from operations of a component and included in loss from discontinued operations.

**CPA-00046 Explanation**
Choice "d" is correct. Once the decision has been made to dispose of a component of a business and that component meets the criteria to be classified as held for sale, the operating results of the component for the period reported on, and any gain or loss from the disposal, should be reported separately from continuing operations, net of tax. In this question, the component was classified as held for sale and was sold in the same year.

Thus, in 20X4, the results of operations, the $300,000 ($500,000-$800,000) loss, are reported as a loss from discontinued operations. The loss on disposal would be reported as part of that loss from discontinued operations also.

Choice "a" is incorrect. The results of operations prior to the decision date, and also after the decision date, are reported separately from the results of continuing operations as a part of discontinued operations.


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Choice "b" is incorrect. The results of operations prior to the decision date, and also after the decision date, are reported separately from the results of continuing operations as a loss from operations of a component and included in loss from discontinued operations.

Choice "c" is incorrect. The results of discontinued operations are not reported as an extraordinary item.

**CPA-00047 Type1 M/C A-D Corr Ans: D PM#7 F 1-03**

26. CPA-00047 FARE Nov 95 #41 (Adapted) Page 23

In open market transactions, Gold Corp. simultaneously sold its long-term investment in Iron Corp. bonds and purchased its own outstanding bonds. The broker remitted the net cash from the two transactions. Gold's gain on the purchase of its own bonds exceeded its loss on the sale of the Iron bonds. Assume the transaction to purchase its own outstanding bonds is unusual in nature and has occurred infrequently. Gold should report the:

a. Net effect of the two transactions as an extraordinary gain.
b. Net effect of the two transactions in income before extraordinary items.
c. Effect of its own bond transaction gain in income before extraordinary items, and report the Iron bond transaction as an extraordinary loss.
d. Effect of its own bond transaction as an extraordinary gain, and report the Iron bond transaction loss in income before extraordinary items.

**CPA-00047 Explanation**

Choice "d" is correct, these are two separate transactions because Gold Corp. (1) sold Iron Corp. bonds (an investment) for a loss, and, (2) bought back its own (Gold) Corp. bonds (a debt) for a gain.

This is not a "refinancing" (where one would sell new bond debt to buy back old bond debt outstanding). The gain from the purchase of its own bonds is an "extraordinary gain" because it is both unusual in nature and infrequently occurring (per APB Opinion No. 30 and SFAS No. 145). The Iron Corp. transaction is a loss in "income before extraordinary items."

Choices "a" and "b" are incorrect. The two transactions are separate and cannot be netted.

Choice "c" is incorrect. Just the opposite. The sale of the investment is a loss in "income before extraordinary items," while the purchase of its bond debt is an "extraordinary gain" according to the provisions of APB Opinion No. 30.

**CPA-00051 Type1 M/C A-D Corr Ans: A PM#9 F 1-03**

27. CPA-00051 FARE Nov 95 #43 Page 29

Lore Co. changed from the cash basis of accounting to the accrual basis of accounting during 1994. The cumulative effect of this change should be reported in Lore's 1994 financial statements as a:

a. Prior period adjustment resulting from the correction of an error.
b. Prior period adjustment resulting from the change in accounting principle.
c. Component of income before extraordinary item.
d. Component of income after extraordinary item.

**CPA-00051 Explanation**

Choice "a" is correct. The cash basis for financial reporting is not a generally accepted accounting basis of accounting (GAAP); therefore, it is an error. Correction of an error from a prior period is a reported as prior period adjustment to retained earnings.

Choice "b" is incorrect. Cash basis reporting is not an accounting principle under accrual accounting principles. Thus, the change from cash basis is not reported as a change in accounting principle. In addition, changes in accounting principle are not prior period adjustments; instead, they are treated retrospectively.

Choices "c" and "d" are incorrect. Correction of prior period errors has no effect on the current year's income statement.


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**CPA-00054 Type1 M/C A-D Corr Ans: D PM#11 F 1-03**

28. CPA-00054 FARE May 95 #40 Page 23

A material loss should be presented separately as a component of income from continuing operations when it is:

a. An extraordinary item.
b. A cumulative effect type change in accounting principle.
c. Unusual in nature and infrequent in occurrence.
d. Not unusual in nature but infrequent in occurrence.

**CPA-00054 Explanation**
Choice "d" is correct. Gains or losses that are unusual in nature or occur infrequently but not both, are presented as a component of income from continuing operations.

Choice "a" is incorrect. Extraordinary items are shown net of tax in a separate section of the income statement after income from continuing operations.

Choice "b" is incorrect. Cumulative effects of changes in accounting principle are now shown net of tax as an adjustment to the opening balance of retained earnings in the retained earnings statement. This treatment is called retrospective application. There really are no longer any cumulative effect types of changes in accounting principle. The cumulative effect is merely how the amount of the change is measured.

Choice "c" is incorrect. This is the definition of an extraordinary item.

**CPA-00063 Type1 M/C A-D Corr Ans: A PM#13 F 1-03**

29. CPA-00063 FARE May 95 #46 Page 27

During 1994, Orca Corp. decided to change from the FIFO method of inventory valuation to the weighted-average method. Inventory balances under each method were as follows:

| | *FIFO* | *Weighted-average* |
|---|---|---|
| January 1, 1994 | $71,000 | $77,000 |
| December 31, 1994 | 79,000 | 83,000 |

Orca's income tax rate is 30%.

Orca should report the cumulative effect of this accounting change as a(n):

a. Adjustment to beginning retained earnings.
b. Component of income from continuing operations.
c. Extraordinary item.
d. Component of income after extraordinary items.

**CPA-00063 Explanation**
Choice "a" is correct. The cumulative effect of a change in accounting principle is shown as an adjustment to beginning retained earnings.

Choice "b" is incorrect. The cumulative effect of a change in accounting principle is now presented as a separate category on the retained earnings statement and is not a component of net income.

Choice "c" is incorrect. Extraordinary items are unusual and infrequent in nature. Extraordinary items have nothing to do with changes in accounting principle.

Choice "d" is incorrect. A change in accounting principle affects retained earnings, not the income statement, under SFAS No. 154.

**CPA-00066 Type1 M/C A-D Corr Ans: D PM#15 F 1-03**


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30. CPA-00066 FARE Nov 94 #53 Page 22

A transaction that is unusual in nature and infrequent in occurrence should be reported separately as a component of income:

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

**CPA-00066 Explanation**
Choice "d" is correct. An extraordinary item (a transaction that is both "unusual in nature" and "infrequent in occurrence") should be reported separately as a component of income after discontinued operations of a segment of a business.

The cumulative effect of a change in accounting principle is shown on the retained earnings statement.

This is why memorizing the mnemonic "idea" is so important.

**CPA-00068 Type1 M/C A-D Corr Ans: D PM#16 F 1-03**

31. CPA-00068 FARE Nov 94 #54 Page 25

How should the effect of a change in accounting estimate be accounted for?

a. By restating amounts reported in financial statements of prior periods.
b. By reporting pro forma amounts for prior periods.
c. As a prior period adjustment to beginning retained earnings.
d. In the period of change and future periods if the change affects both.

**CPA-00068 Explanation**
Choice "d" is correct, a "change in accounting estimate" affects only the current and subsequent (future) periods, if the change affects both. It does not affect "prior periods," nor "retained earnings."

Choice "a" is incorrect. Restating prior years' financial statements is required when comparative financial statements are shown for prior period adjustments of "corrections of errors," "changes in entities," and changes in accounting principle.

Choices "b" and "c" are incorrect. A "change in accounting estimate" does not affect prior periods.

**CPA-00069 Type1 M/C A-D Corr Ans: C PM#17 F 1-03**

32. CPA-00069 FARE Nov 94 #55 Page 29

Foy Corp. failed to accrue warranty costs of $50,000 in its December 31, 1992, financial statements. In addition, a $30,000 change from straight-line to accelerated depreciation was made at the beginning of 1993. Both the $50,000 and the $30,000 are net of related income taxes. What amount should Foy report as prior period adjustments in 1993?

a. $0
b. $30,000
c. $50,000
d. $80,000

**CPA-00069 Explanation**
Choice "c" is correct. $50,000.


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The cumulative effect of a change in accounting principle is now shown on the retained earnings statement as an adjustment to the beginning balance of retained earnings, assuming that the cumulative effect can be calculated.

An exception is made however, for a change in depreciation method, since a change in depreciation method is no longer considered to be a change in accounting principle. A change in depreciation method is now considered to be both a change in method and a change in estimate. These changes should now be accounted for as a change in estimate and handled prospectively. The new depreciation method should be used as of the beginning of the year of change and should start with the current book value of the underlying asset. No retroactive or retrospective calculations should be made, and no adjustment should be made to retained earnings.

The correction of the failure to accrue warranty costs is treated as a correction of an error and thus as a prior period adjustment.

Choices "a", "b", and "d" are incorrect, per the above explanation.

**CPA-00070 Type1 M/C A-D Corr Ans: C PM#18 F 1-03**

33. CPA-00070 FARE May 94 #10 Page 18

The following question is based on the following:

Vane Co.'s trial balance of income statement accounts for the year ended December 31, 2002, included the following:

| | *Debit* | *Credit* |
|---|---|---|
| Sales | | $575,000 |
| Cost of sales | $240,000 | |
| Administrative expenses | 70,000 | |
| Loss on sale of equipment | 10,000 | |
| Sales commissions | 50,000 | |
| Interest revenue | | 25,000 |
| Freight out | 15,000 | |
| Loss on early retirement of long-term debt (unusual & infrequent item) | 20,000 | |
| Uncollectible accounts expense | 15,000 | |
| Totals | $420,000 | $600,000 |

*Other information*

| | |
|---|---|
| Finished goods inventory: | |
| January 1, 2002 | $400,000 |
| December 31, 2002 | $360,000 |

**Vane's income tax rate is 30%.**

In Vane's 2002 multiple-step income statement, what amount should Vane report as income from continuing operations?

a. $126,000
b. $129,500
c. $140,000
d. $147,000

**CPA-00070 Explanation**

Choice "c" is correct, $140,000.

| | |
|---|---|
| Net of credits over debits ($600-420) | $180,000 |
| add: extraordinary item - loss on early retirement of long-term debt | 20,000 |
| Income from continuing operations | 200,000 |
| "Net of tax" rate (100%-30% tax) | 70% |
| Income after income taxes from continuing operations | $140,000 |


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**CPA-00072 Type1 M/C A-D Corr Ans: A PM#20 F 1-03**

34. CPA-00072 FARE May 94 #40 Page 23

The effect of a material transaction that is infrequent in occurrence but not unusual in nature should be presented separately as a component of income from continuing operations when the transaction results in a:

| | *Gain* | *Loss* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | No |
| d. | No | Yes |

**CPA-00072 Explanation**
Choice "a" is correct, Yes - Yes. A material transaction that is "infrequent in occurrence" but not "unusual in nature" should be presented separately as a component of "income from continuing operations" when the transaction results in a gain or loss.

**CPA-00073 Type1 M/C A-D Corr Ans: B PM#21 F 1-03**

35. CPA-00073 FARE May 94 #48 Page 22

An extraordinary item should be reported separately on the income statement as a component of income:

| | *Net of income taxes* | *Before discontinued operations of a segment of a business* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | No |
| d. | No | Yes |

**CPA-00073 Explanation**
Choice "b" is correct, Yes - No. An extraordinary item should be reported separately on the income statement as a component of income:

Yes - net of income taxes.
No - after (not before) "discontinued operations of a segment of a business."

**CPA-00076 Type1 M/C A-D Corr Ans: D PM#22 F 1-03**

36. CPA-00076 PI Nov 93 #4 Page 25

On January 2, 20X5, to better reflect the variable use of its only machine, Holly, Inc. elected to change its method of depreciation from the straight-line method to the units of production method. The original cost of the machine on January 2, 20X3, was $50,000, and its estimated life was 10 years. Holly estimates that the machine's total life is 50,000 machine hours. Machine hours usage was 8,500 during 20X4 and 3,500 during 20X3.

Holly's income tax rate is 30%. Holly should report the accounting change in its 20X5 financial statements as a(n):

a. Cumulative effect of a change in accounting principle of $2,000 in its income statement.
b. Adjustment to beginning retained earnings of $2,000.
c. Cumulative effect of a change in accounting principle of $1,400 in its income statement.
d. None of the above.

**CPA-00076 Explanation**


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Choice "d" is correct. A change in the method of depreciation is now considered to be both a change in method and a change in estimate. These changes should be accounted for as changes in estimate and handled prospectively. The new depreciation method should be used as of the beginning of the year of change and should start with the current book value of the underlying asset. No retroactive or retrospective calculations should be made, and no adjustment should be made to retained earnings.

The cumulative effect treatment on the income statement was the treatment of most changes in accounting principle prior to SFAS No. 154. The adjustment to beginning retained earnings is the treatment now given to changes in accounting principle by SFAS No. 154. However a change in depreciation method is no longer accounted for as a change in accounting principle.

Choices "a", "b", and "c" are incorrect, per the above explanation.

**CPA-00077 Type1 M/C A-D Corr Ans: D PM#23 F 1-03**

37. CPA-00077Th Nov 93 #18 (Adapted) Page 20

On November 1, 20X2, Smith Co. contracted to dispose of an industry segment. Throughout 20X2 the segment had operating losses. These losses were expected to continue until the segment's disposition. If a loss is projected on final disposition, how much of the operating losses should be included in the loss from discontinued operations reported in Smith's 20X2 income statement?

I. Operating losses for the period January 1 to October 31, 20X2.
II. Operating losses for the period November 1 to December 31, 20X2.
III. Estimated operating losses for the period January 1 to February 28, 20X3.

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

**CPA-00077 Explanation**

Choice "d" is correct. The operating losses to be included in Smith's 20X2 income statement would be the total 20X2 operating losses, regardless of whether those losses occurred before or after the date the decision to dispose of the component was made, and not any 20X3 operating losses. Projected operating losses are not anticipated and accrued.

Choice "a" is incorrect. The operating losses to be included in Smith's 20X2 income statement would be the total 20X2 operating losses, regardless of whether those losses occurred before or after the date the decision to dispose of the component was made, and not any 20X3 operating losses.

Choice "b" is incorrect. The operating losses to be included in Smith's 20X2 income statement would be the total 20X2 operating losses, regardless of whether those losses occurred before or after the date the decision to dispose of the component was made, and not any 20X3 operating losses.

Choice "c" is incorrect. The operating losses to be included in Smith's 20X2 income statement would be the total 20X2 operating losses, regardless of whether those losses occurred before or after the date the decision to dispose of the component was made, and not any 20X3 operating losses.

**CPA-00079 Type1 M/C A-D Corr Ans: B PM#24 F 1-03**

38. CPA-00079Th Nov 93 #22 Page 29

If a company is not presenting comparative financial statements, the correction of an error in the financial statements of a prior period should be reported, net of applicable income taxes, in the current:

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 and before extraordinary items.
d. Income statement after income from continuing operations and after extraordinary items.

**CPA-00079 Explanation**


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Choice "b" is correct. The correction of an error in the financial statements of a prior period should be reported, net of tax, in the current statement of retained earnings as an adjustment of the opening balance.

Choice "a" is incorrect. The adjustment is before net income, not after net income.

Choices "c" and "d" are incorrect. Corrections of errors of prior periods go to retained earnings and do not affect the income statement.

**CPA-00083 Type1 M/C A-D Corr Ans: D PM#26 F 1-03**

39. CPA-00083 Th Nov 93 #26 Page 25

The cumulative effect of a change in accounting estimate should be shown separately:

a. On the income statement above income from continuing operations.
b. On the income statement after income from continuing operations and before extraordinary items.
c. On the retained earnings statement as an adjustment to the beginning balance.
d. It should not be recorded separately on any financial statement.

**CPA-00083 Explanation**
Choice "d" is correct. A change in estimate is handled prospectively. No cumulative effect adjustment is made and no separate line item presentation is made on any financial statement. If a material change is being made, appropriate footnote disclosure is necessary.

Choices "a", "b", and "c" are incorrect, per the above explanation.

**CPA-00085 Type1 M/C A-D Corr Ans: A PM#27 F 1-03**

40. CPA-00085 PI Nov 93 #52 Page 18

The following costs were incurred by Griff Co., a manufacturer, during 1992:

| | |
|---|---|
| Accounting and legal fees | $ 25,000 |
| Freight-in | 175,000 |
| Freight-out | 160,000 |
| Officers salaries | 150,000 |
| Insurance | 85,000 |
| Sales representatives salaries | 215,000 |

What amount of these costs should be reported as general and administrative expenses for 1992?

a. $260,000
b. $550,000
c. $635,000
d. $810,000

**CPA-00085 Explanation**
Choice "a" is correct. General and administrative expenses include:

| | |
|---|---|
| Accounting and legal | $ 25,000 |
| Officers salaries | 150,000 |
| Insurance | 85,000 |
| Total | $260,000 |

Freight-in is part of cost of sales; freight-out is a selling expense; and sales salaries are selling expenses.

Choice "b" is incorrect. Freight-in is part of cost of inventory; freight-out is a selling expense; and sales salaries are selling expenses.

Choice "c" is incorrect. Freight-in is part of cost of inventory; freight-out is a selling expense; and sales salaries are selling expenses.


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Choice "d" is incorrect. Freight-in is part of cost of inventory; freight-out is a selling expense; and sales salaries are selling expenses.

**CPA-00086 Type1 M/C A-D Corr Ans: D PM#28 F 1-03**

41. CPA-00086 PI Nov 93 #60 Page 26

On January 2, 1989, Union Co. purchased a machine for $264,000 and depreciated it by the straight-line method using an estimated useful life of eight years with no salvage value. On January 2, 1992, Union determined that the machine had a useful life of six years from the date of acquisition and will have a salvage value of $24,000. An accounting change was made in 1992 to reflect the additional data. The accumulated depreciation for this machine should have a balance at December 31, 1992, of:

a. $176,000
b. $160,000
c. $154,000
d. $146,000

**CPA-00086 Explanation**
Choice "d" is correct, $146,000 accumulated depreciation balance at Dec. 31, 1992.

| | depreciable cost | | useful life | | annual deprec | | years elapsed | | accumulated deprec |
|---|---|---|---|---|---|---|---|---|---|
| Original | $264 | ÷ | 8 yrs | = | $33 | x | 3yrs | = | $99 ('89-'91) |
| Accum deprec | (99) | | | | | | | | |
| NBV 12/31/91 | 165 | | | | | | | | |
| Salvage | <24> | | | | | | | | |
| Revised Balance, 12/31/92 | 141 | ÷ | 3 yrs | = | 47 | x | 1 yr | = | 47 (1992) $146 |

**CPA-00088 Type1 M/C A-D Corr Ans: C PM#29 F 1-03**

42. CPA-00088 Th May 93 #19 Page 25

During 1992, Krey Co. increased the estimated quantity of copper recoverable from its mine. Krey uses the units of production depletion method. As a result of the change, which of the following should be reported in Krey's 1992 financial statements?

| | *Cumulative effect of a change in accounting principle* | *Pro forma effects of retroactive application of new depletion base* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | No |
| d. | No | Yes |

**CPA-00088 Explanation**
Choice "c" is correct, No - No. This is a change in "accounting estimate," which affects only the current and subsequent periods (not prior periods and not retained earnings). "Cumulative effect of a change in accounting principle" is only used for changes in "accounting principle."

**CPA-00090 Type1 M/C A-D Corr Ans: A PM#30 F 1-03**

43. CPA-00090 Th May 93 #20 Page 25


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On August 31, 1992, Harvey Co. decided to change from the FIFO periodic inventory system to the weighted average periodic inventory system. Harvey is on a calendar year basis. The cumulative effect of the change is determined:

a. As of January 1, 1992.
b. As of August 31, 1992.
c. During the eight months ending August 31, 1992, by a weighted average of the purchases.
d. During 1992 by a weighted average of the purchases.

**CPA-00090 Explanation**
Choice "a" is correct, as of January 1, 1992, the beginning of the year.

**Rule:** The cumulative effect of a change in accounting principle equals the difference between retained earnings at the beginning of period of the change and what retained earnings would have been if the change was applied to all affected prior periods, assuming comparative financial statements are not presented. If comparative statements are presented, then beginning retained earnings of the earliest year presented is adjusted for the cumulative effect of the change. We are assuming, based on the answer options given, that Harvey is not presenting comparative financial statements.

Choice "b" is incorrect. The cumulative effect of the change is not determined as of the date the decision is made.

Choices "c" and "d" are incorrect. The cumulative effect of the change is not determined by a weighted average.

**CPA-00091 Type1 M/C A-D Corr Ans: B PM#31 F 1-03**

44. CPA-00091Th May 93 #35 Page 22

In 1992, hail damaged several of Toncan Co.'s vans. Hailstorms had frequently inflicted similar damage to Toncan's vans. Over the years, Toncan had saved money by not buying hail insurance and either paying for repairs, or selling damaged vans and then replacing them. In 1992, the damaged vans were sold for less than their carrying amount. How should the hail damage cost be reported in Toncan's 1992 financial statements?

a. The actual 1992 hail damage loss as an extraordinary loss, net of income taxes.
b. The actual 1992 hail damage loss in continuing operations, with **no** separate disclosure.
c. The expected average hail damage loss in continuing operations, with **no** separate disclosure.
d. The expected average hail damage loss in continuing operations, with separate disclosure.

**CPA-00091 Explanation**
Choice "b" is correct. Actual hail damage must be reported. Since the hailstorms are frequent, the damage is not considered an extraordinary gain/loss. Thus, the damages would be shown in continuing operations. No separate disclosure is necessary since hail damage is a common occurrence.

Choice "a" is incorrect. Hailstorms are not unusual and infrequent so the loss could not be classified as extraordinary. APB 30 para. 20

Choice "c" is incorrect. Actual hail damage must be reported. Estimated hail damage may be probable but is not estimable; so it should not be included in income calculations.

Choice "d" is incorrect. Estimated hail damage may be probable but is not estimable; so it should not be included in income calculations.

**CPA-00093 Type1 M/C A-D Corr Ans: B PM#32 F 1-03**

45. CPA-00093Th May 93 #37 (Adapted) Page 20

A segment of Ace Inc. was discontinued during 1992. Ace's loss from discontinued operations should **not**:

a. Include employee relocation costs associated with the decision to dispose.


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b. Exclude operating losses from the date the decision to dispose of the segment was made until the end of 1992.
c. Include additional pension costs associated with the decision to dispose.
d. Include operating losses of the current period up to the date the decision to dispose of the segment was made.

**CPA-00093 Explanation**
Choice "b" is correct. Ace's loss on discontinued operations should not exclude operating losses from the date the decision to dispose of the segment was made until the end of 1992. All 1992 operating losses should be included.

Choice "a" is incorrect. Employee relocation costs associated with the decision to dispose should be included in the loss from discontinued operations.

Choice "c" is incorrect. Additional pension costs associated with the decision to dispose should be included in the loss from discontinued operations.

Choice "d" is incorrect. Ace's loss on discontinued operations should include operating losses of the current period up to the date the decision to dispose of the segment was made and also after that date. All 1992 operating losses should be included.

**CPA-00096 Type1 M/C A-D Corr Ans: B PM#33 F 1-03**

46. CPA-00096 PI May 93 #57 (Adapted) Page 20

On December 31, 20X2, the Board of Directors of Maxy Manufacturing, Inc. committed to a plan to discontinue the operations of its Alpha division. Maxy estimated that Alpha's 20X3 operating loss would be $500,000 and that the fair value of Alpha's facilities was $300,000 less than their carrying amounts. Alpha's 20X2 operating loss was $1,400,000, and the division was actually sold for $400,000 less than its carrying amount in 20X3. Maxy's effective tax rate is 30%.

In its 20X2 income statement, what amount should Maxy report as loss from discontinued operations?

a. $980,000
b. $1,190,000
c. $1,400,000
d. $1,700,000

**CPA-00096 Explanation**
Choice "b" is correct. Since the fair value of Alpha's facilities was $300,000 less than its carrying value, there has been an impairment loss, and that loss should be recognized in 20X2. That $300,000 impairment loss plus the $1,400,000 20X2 operating loss would be recognized in 20X2 net of tax. The total loss would be $1,700,000 $\times$ 70% (100% - 30%) or $1,190,000.

Choice "a" is incorrect. It includes the 20X2 operating loss of $1,400,000 but not the $300,000 impairment loss but does report the 20X2 operating loss net of tax.

Choice "c" is incorrect. It includes the 20X2 operating loss of $1,400,000, but not the $300,000 impairment loss, and reports the 20X2 operating loss gross of tax and not net of tax.

Choice "d" is incorrect. It reports the 20X2 loss from discontinued operations gross of tax and not net of tax.

**CPA-00097 Type1 M/C A-D Corr Ans: C PM#34 F 1-03**

47. CPA-00097 PI May 93 #58 (Adapted) Page 20

On December 31, 20X2, the Board of Directors of Maxy Manufacturing, Inc. committed to a plan to discontinue the operations of its Alpha division. Maxy estimated that Alpha's 20X3 operating loss would be $500,000 and that the fair value of Alpha's facilities was $300,000 less than their carrying amounts. The estimate for 20X3 turned out to be correct. Alpha's 20X2 operating loss was $1,400,000, and the division was actually sold for $400,000 less than its carrying amount. Maxy's effective tax rate is 30%.


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In its 20X3 income statement, what amount should Maxy report as loss from discontinued operations?

a. $350,000
b. $500,000
c. $420,000
d. $600,000

**CPA-00097 Explanation**
Choice "c" is correct. The 20X3 loss from discontinued operations would include both the 20X3 operating loss of $500,000 (which turned out to be a correct estimate) and the "additional" loss (on disposal) of $100,000, net of tax, for a total of $600,000 x .70 or $420,000.

Choice "a" is incorrect. It includes the 20X3 operating loss of $500,000 but not the $300,000 impairment loss but does report the 20X3 operating loss net of tax.

Choice "b" is incorrect. It includes the 20X3 operating loss of $500,000, but not the $100,000 loss on disposal, and reports the 20X3 operating loss gross of tax and not net of tax.

Choice "d" is incorrect. It reports the 20X3 loss from discontinued operations gross of tax and not net of tax. The 20X3 loss from discontinued operations should include both the 20X3 operating loss of $500,000 and the loss on disposal of $100,000, net of tax, for a total of $600,000 x .70 or $420,000.

**CPA-04692 Type1 M/C A-D Corr Ans: B PM#36 F 1-03**

48. CPA-04692 Released 2005 Page 29

In which of the following situations should a company report a prior-period adjustment?

a. A change in the estimated useful lives of fixed assets purchased in prior years.
b. The correction of a mathematical error in the calculation of prior years' depreciation.
c. A switch from the straight-line to double-declining balance method of depreciation.
d. The scrapping of an asset prior to the end of its expected useful life.

**CPA-04692 Explanation**
Choice "b" is correct. Prior period adjustments consist of: corrections of errors in the financial statements of prior periods, retroactive restatements required by new GAAP pronouncements, and changes from a non-GAAP method of accounting to a GAAP method of accounting (which are corrections of errors).

Choice "a" is incorrect. This change is a change in accounting estimate.

Choice "c" is incorrect. This change is a change for one GAAP method of depreciation to another GAAP method of depreciation. Under SFAS No. 154, it is treated as a change in accounting estimate effected by a change in accounting principle and is handled prospectively, and not as a prior-period adjustment.

Choice "d" is incorrect. This is a business activity ordinary in nature.

**CPA-05211 Type1 M/C A-D Corr Ans: A PM#37 F 1-03**

49. CPA-05211 Released 2006 Page 25

Mellow Co. depreciated a $12,000 asset over five years, using the straight-line method with no salvage value. At the beginning of the fifth year, it was determined that the asset will last another four years. What amount should Mellow report as depreciation expense for year 5?

a. $600
b. $900
c. $1,500
d. $2,400

**CPA-05211 Explanation**
Choice "a" is correct. Over the first 4 years, the asset would be depreciated down to $2,400. Once it was determined that the asset would last for another 4 years, $600 would be depreciated each year of that 4-


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year period. This change is a change in accounting estimate (the estimate being the life of the asset). Changes is accounting estimate are accounted for in the current year and future years if the change affects both.

Choice "b" is incorrect. This answer is the annual difference between the depreciation expense IF depreciation expense had been retroactively restated ($24,000 / 8 = $1,500) and the correct depreciation expense. Retroactive restatement is not appropriate for changes in accounting estimate.

Choice "c" is incorrect. This answer is the depreciation expense IF depreciation had been retroactively restated ($24,000 / 8 = $1,500). Retroactive restatement is not appropriate for changes in accounting estimate.

Choice "d" is incorrect. This answer is the undepreciated amount at the beginning of the fifth year or the amount of the annual depreciation expense for each of the first 4 years. Either way, it certainly is not going to be the depreciation expense for that year because the remaining cost will depreciated over the remaining period.

**CPA-05427 Type1 M/C A-D Corr Ans: A PM#38 F 1-03**

50. CPA-05427 Released 2007 Page 20

Envoy Co. manufactures and sells household products. Envoy experienced losses associated with its small appliance group. Operations and cash flows for this group can be clearly distinguished from the rest of Envoy's operations. Envoy plans to sell the small appliance group with its operations. What is the earliest point at which Envoy should report the small appliance group as a discontinued operation?

a. When Envoy classifies it as held for sale.
b. When Envoy receives an offer for the segment.
c. When Envoy first sells any of the assets of the segment.
d. When Envoy sells the majority of the assets of the segment.

**CPA-05427 Explanation**
Choice "a" is correct. The earliest period that a component of an entity can be reported in discontinued operations is when the component meets the following "held for sale" criteria:

1. Management commits to a plan to sell the component.
2. The component is available for immediate sale in its present condition.
3. An active program to locate a buyer has been initiated.
4. The sale of the component is probable and the sale is expected to be completed within one year.
5. The sale of the component is being actively marketed.
6. It is unlikely that significant change to the plan to sell will be made or that the plan will be withdrawn.

Choices "b", "c", and "d" are incorrect, per the explanation above.

**CPA-05433 Type1 M/C A-D Corr Ans: D PM#39 F 1-03**

51. CPA-05433 Released 2007 Page 26

Belle Co. determined after four years that the estimated useful life of its labeling machine should be 10 years rather than 12 years. The machine originally cost $46,000 and had an estimated salvage value of $1,000. Belle uses straight-line depreciation. What amount should Belle report as depreciation expense for the current year?

a. $3,200
b. $3,750
c. $4,500
d. $5,000


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**CPA-05433 Explanation**
Choice "d" is correct. A change in estimated useful life is a change in accounting estimate, and is therefore accounted for prospectively. The revised useful life should be used as of the beginning of the year of the change and should be applied to the current book value of the fixed asset.

The first step in determining the depreciation expense in the year of the change in estimate is to determine the book value of the labeling machine at the time of the change:

| | | |
|---|---|---|
| | Original cost | $46,000 |
| - | Accumulated depreciation | 15,000 = [(46,000 - 1,000) / 12] *4 |
| | Current book value | $31,000 |

This book value is then depreciated over the remaining life of the fixed asset based on the new estimated life. In this problem, the new estimated life is 10 years, four of which have already passed, so the asset must be depreciated over the remaining 6 years:

($31,000 - 1,000) / 6 = $5,000

Choice "a" is incorrect. This answer is incorrectly calculated by adding the salvage value to the current book value, and by using the entire 10 year revised estimated life. Salvage value should always be subtracted and the asset should only be depreciated over the remaining life of the asset.

Choice "b" is incorrect. This is the annual depreciation before the change in estimated life ($46,000 - $1,000) / 12 = $3,750]. The depreciation after the change in estimate should be calculated as described above.

Choice "c" is incorrect. This would have been the annual straight-line depreciation if the original useful life of the asset had been 10 years rather than 12 years. The change in estimated life is applied prospectively, as described above, not retrospectively.

**Comprehensive Income**

**CPA-00099 Type1 M/C A-D Corr Ans: C PM#1 F 1-04**

52. CPA-00099 FARE R03 #1 Page 31

Rock Co.'s financial statements had the following balances at December 31:

| | |
|---|---|
| Extraordinary gain | $50,000 |
| Foreign currency translation gain, net of tax | 100,000 |
| Net income | 400,000 |
| Unrealized gain on available-for-sale equity securities, net of tax | 20,000 |

What amount should Rock report as comprehensive income for the year ended December 31?

a. $400,000
b. $420,000
c. $520,000
d. $570,000

**CPA-00099 Explanation**
Choice "c" is correct. Comprehensive Income includes all items included in "Net Income" plus "Other Comprehensive Income" items. Since the $50,000 extraordinary gain is already included in Net Income, Comprehensive Income is:

| | |
|---|---|
| Net Income | $400,000 |
| "PUFE" adjustments: | |
| **F**oreign currency translation adj. | 100,000 |
| **U**nrealized gain on available-for-sale securities | 20,000 |
| | $520,000 |


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**CPA-00101 Type1 M/C A-D Corr Ans: B PM#2 F 1-04**

53. CPA-00101 FARE R98 #1 Page 31

According to the FASB conceptual framework, comprehensive income includes which of the following?

| | *Loss on discontinued operations* | *Investments by owners* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |

**CPA-00101 Explanation**
Choice "b" is correct. Comprehensive income is the change in equity of a business during a period from transactions and other events and circumstances from non-owner sources. It includes all changes in equity except those resulting from investments by owners and distributions to owners. SFAC 6 para 70.

**CPA-04696 Type1 M/C A-D Corr Ans: C PM#4 F 1-04**

54. CPA-04696 Released 2005 Page 33

Which of the following describes how comprehensive income should be reported?

a. Must be reported in a separate statement, as part of a complete set of financial statements.
b. Should **not** be reported in the financial statements but should only be disclosed in the footnotes.
c. May be reported in a separate statement, in a combined statement of income and comprehensive income, or within a statement of stockholders' equity.
d. May be reported in a combined statement of income and comprehensive income or disclosed within a statement of stockholders' equity; separate statements of comprehensive income are **not** permitted.

**CPA-04696 Explanation**
Choice "c" is correct.

Comprehensive income must be presented in one of three formats:

1. In a combined statement of income and comprehensive income;
2. In a separate statement of comprehensive income that begins with net income; or
3. In a statement of changes in equity.

Choices "a", "b", and "d" are incorrect, per the above.

**Balance Sheet and Disclosures Overview**

**CPA-00104 Type1 M/C A-D Corr Ans: A PM#2 F 1-05**

55. CPA-00104 FARE May 94 #6 Page 37

What is the purpose of information presented in notes to the financial statements?

a. To provide disclosures required by generally accepted accounting principles.
b. To correct improper presentation in the financial statements.
c. To provide recognition of amounts not included in the totals of the financial statements.
d. To present management's responses to auditor comments.

**CPA-00104 Explanation**
Choice "a" is correct. Information presented in notes to the financial statements have the purpose of providing disclosures required by generally accepted accounting principles. SFAC 5 para. 7

**CPA-05189 Type1 M/C A-D Corr Ans: A PM#3 F 1-05**


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56. CPA-05189 Released 2006 Page 37

Which of the following should be disclosed in a summary of significant accounting policies?

a. Basis of profit recognition on long-term construction contracts.
b. Future minimum lease payments in the aggregate and for each of the five succeeding fiscal years.
c. Depreciation expense.
d. Composition of sales by segment.

**CPA-05189 Explanation**
Choice "a" is correct. The summary of significant accounting policies should disclose policies. The only policy in this question is the "basis" of profit recognition on long-term construction contracts. The other disclosures are accounting details and would be disclosed in other footnotes, but not in the summary of significant accounting policies.

Choice "b" is incorrect. The future minimum lease payments should be disclosed, but not in the summary of significant accounting policies.

Choice "c" is incorrect. Depreciation expense should certainly be disclosed, but not in the summary of significant accounting policies.

Choice "d" is incorrect. The composition of sales by segment should be disclosed, but not in the summary of significant accounting policies.

**CPA-05210 Type1 M/C A-D Corr Ans: D PM#4 F 1-05**

57. CPA-05210 Released 2006 Page 37

Which of the following must be included in a company's summary of significant accounting policies in the notes to the financial statements?

a. Description of current year equity transactions.
b. Summary of long-term debt outstanding.
c. Schedule of fixed assets.
d. Revenue recognition policies.

**CPA-05210 Explanation**
Choice "d" is correct. The summary of significant accounting policies should include "policies." The only policy in the choices listed is the revenue recognition policies.

Choice "a" is incorrect. A description of current year equity transactions is not a policy. It should be disclosed somewhere in the footnotes but not in the summary of significant accounting policies.

Choice "b" is incorrect. A summary of long-term debt outstanding is not a policy. It should be disclosed somewhere in the footnotes but not in the summary of significant accounting policies.

Choice "c" is incorrect. A schedule of fixed assets is not a policy. It should be disclosed somewhere in the footnotes but not in the summary of significant accounting policies.

**CPA-05214 Type1 M/C A-D Corr Ans: B PM#5 F 1-05**

58. CPA-05214 Released 2006 Page 37

Which of the following is correct concerning financial statement disclosure of accounting policies?

a. Disclosures should be limited to principles and methods peculiar to the industry in which the company operates.
b. Disclosure of accounting policies is an integral part of the financial statements.
c. The format and location of accounting policy disclosures are fixed by generally accepted accounting principles.
d. Disclosures should duplicate details disclosed elsewhere in the financial statements.

**CPA-05214 Explanation**


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Choice "b" is correct. Disclosure of accounting policies (and all other disclosure also) is an integral part of the financial statements.

Choice "a" is incorrect. For disclosure of accounting policies, disclosure should **not** be limited to principles and methods peculiar to the industry in which the company operates. All material accounting policies should be disclosed.

Choice "c" is incorrect. For disclosure of accounting policies, the format and location of accounting policies are **not** fixed by GAAP. Accounting policy disclosures are normally Note 1, but that is a (reasonable and very general) practice and not a "rule." It does make sense to disclose the "why" before the "what."

Choice "d" is incorrect. Disclosure of accounting policies should **not** duplicate details disclosed elsewhere in the financial statements.

**Interim Financial Reporting**

**CPA-00105 Type1 M/C A-D Corr Ans: A PM#1 F 1-06**

59. CPA-00105 FARE Nov 95 #6 Page 38

Conceptually, interim financial statements can be described as emphasizing:

a. Timeliness over reliability.
b. Reliability over relevance.
c. Relevance over comparability.
d. Comparability over neutrality.

**CPA-00105 Explanation**
Choice "a" is correct. Interim financial statements emphasize timeliness (an element of relevance) by providing financial information based on actual performance to date and estimates prior to year end. Information must be available when it is needed to be useful. Reliability is impeded by the extensive use of estimates; however, the lag until verifiability is obtained detracts from usefulness. SFAC 2 para. 56

Choice "b" is incorrect. Relevance (particularly timeliness) of information in interim financial statements is emphasized more than reliability. Reliability is impeded by the extensive use of estimates in interim data.

Choice "c" is incorrect. Since comparability is a secondary quality of information, there should be no need to trade off comparability for relevance (a primary quality).

Choice "d" is incorrect. Neutrality is an element of reliability (a primary quality of information. There should be NO need for a trade-off for comparability over neutrality.

**CPA-00106 Type1 M/C A-D Corr Ans: C PM#2 F 1-06**

60. CPA-00106 FARE May 95 #3 Page 38

APB Opinion No. 28, *Interim Financial Reporting,* concluded that interim financial reporting should be viewed primarily in which of the following ways?

a. As useful only if activity is spread evenly throughout the year.
b. As if the interim period were an annual accounting period.
c. As reporting for an integral part of an annual period.
d. As reporting under a comprehensive basis of accounting other than GAAP.

**CPA-00106 Explanation**
Choice "c" is correct. Interim financial reporting should be viewed as reporting for an integral part of an annual period.

Choices "a", "b", and "d" are incorrect, per the above rule.


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**CPA-00109 Type1 M/C A-D Corr Ans: C PM#4 F 1-06**

61. CPA-00109PII May 93 #17 Page 38

During the first quarter of 1993, Tech Co. had income before taxes of $200,000, and its effective income tax rate was 15%. Tech's 1992 effective annual income tax rate was 30%, but Tech expects its 1993 effective annual income tax rate to be 25%. In its first quarter interim income statement, what amount of income tax expense should Tech report?

a. $0
b. $30,000
c. $50,000
d. $60,000

**CPA-00109 Explanation**
Choice "c" is correct. Interim period tax expense is the estimated annual effective tax rate (25% in this case) applied to the year-to-date income before taxes minus the tax expense recognized in previous interim periods. Since this question involves the first quarter, there are no previous interim periods. 25% $\times$ $200,000 = $50,000. FIN 18, para. 16

Choice "a" is incorrect. Income tax expense is reported in interim income statements.

Choice "b" is incorrect. The 1993 annual estimated tax rate, not the first quarter effective tax rate, is used to calculate income tax expense for interim statements.

Choice "d" is incorrect. The 1993 annual estimated tax rate, not the 1992 annual effective tax rate, is used to calculate income tax expense for interim statements.

**CPA-00110 Type1 M/C A-D Corr Ans: D PM#5 F 1-06**

62. CPA-00110Th May 93 #21 Page 38

Due to a decline in market price in the second quarter, Petal Co. incurred an inventory loss. The market price is expected to return to previous levels by the end of the year. At the end of the year the decline had not reversed. When should the loss be reported in Petal's interim income statements?

a. Ratably over the second, third, and forth [sic] quarters.
b. Ratably over the third and fourth quarters.
c. In the second quarter only.
d. In the fourth quarter only.

**CPA-00110 Explanation**
Choice "d" is correct. When the loss is probable and estimable, the expected loss must be recorded in full. This loss becomes such at the end of the fourth quarter. Therefore, the inventory must be valued on the year-end at the lower of cost or market, recognizing the loss at that time.

Choice "a" is incorrect. Expected losses must be recorded in full when the loss is probable and estimable and not ratably over several quarters.

Choice "b" is incorrect. Expected losses must be recorded in full when the loss is probable and estimable and not ratably over several quarters.

Choice "c" is incorrect. Since the loss is not probable at the end of the second quarter, no amount should be recognized at that time.

**CPA-04662 Type1 M/C A-D Corr Ans: D PM#6 F 1-06**

63. CPA-04662Released 2005 Page 38

In general, an enterprise preparing interim financial statements should:

a. Defer recognition of seasonal revenue.
b. Disregard permanent decreases in the market value of its inventory.


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c. Allocate revenues and expenses evenly over the quarters, regardless of when they actually occurred.
d. Use the same accounting principles followed in preparing its latest annual financial statements.

**CPA-04662 Explanation**
Choice "d" is correct. Generally accepted accounting principles that were used in the most recent annual report of an enterprise should be applied to interim financial statements of the current year, unless a change in accounting principle is adopted in the current year.

Choices "a", "b", and "c" are incorrect, per above.

**CPA-05464 Type1 M/C A-D Corr Ans: B PM#7 F 1-06**

64. CPA-05464 Released 2007 Page 38

During the first quarter of the calendar year, Worth Co. had income before taxes of $100,000, and its effective income tax rate was 15%. Worth's effective annual income tax rate for the previous year was 30%. Worth expects that its effective annual income tax rate for the current year will be 25%. The statutory tax rate for the current year is 35%. In its first quarter interim income statement, what amount of income tax expense should Worth report?

a. $15,000
b. $25,000
c. $30,000
d. $35,000

**CPA-05464 Explanation**
Choice "b" is correct. When preparing interim financial statements, income tax expense is estimated each quarter using the effective tax rate expected to apply to the entire year.

Choice "a" is incorrect. Worth should use the effective annual tax rate, not the effective tax rate for the quarter only.

Choice "c" is incorrect. Worth should use the effective annual tax rate expected to apply to the current year, not the prior year's effective tax rate.

Choice "d" is incorrect. Worth should use the effective annual tax rate, not the statutory tax rate.

**Segment Reporting**

**CPA-00122 Type1 M/C A-D Corr Ans: D PM#1 F 1-07**

65. CPA-00122 FARE Nov 95 #8 Page 41

Terra Co.'s total revenues from its three operating segments were as follows:

| *Segment* | *Sales to unaffiliated customers* | *Intersegment sales* | *Total revenues* |
|---|---|---|---|
| Lion | $ 70,000 | $ 30,000 | $ 100,000 |
| Monk | 22,000 | 4,000 | 26,000 |
| Nevi | 8,000 | 16,000 | 24,000 |
| Combined | $100,000 | $ 50,000 | $ 150,000 |
| Elimination | - | (50,000) | (50,000) |
| Consolidated | $100,000 | $ - | $ 100,000 |

Which operating segment(s) is (are) deemed to be reportable segments?

a. None.
b. Lion only.
c. Lion and Monk only.
d. Lion, Monk, and Nevi.


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**CPA-00122 Explanation**
Choice "d" is correct. A reportable operating segment is one having 10% of all revenue, including revenue from unaffiliated sales and from intersegment sales:

Lion's revenue percentage is 66.7% [$100,000/150,000].

Monk's revenue percentage is 17.3% [$26,000/150,000].

Nevi's revenue percentage is 16% [$24,000/150,000].

Thus, all three segments meet the 10% of total revenues test and are reportable as operating segments. SFAS 14 para. 10 and 15 as amended by SFAS 131

Choice "a" is incorrect. All segments with revenue percentages exceeding 10% of total revenues are reportable operating segments.

Choice "b" is incorrect. Lion is not the only segment with revenue percentages exceeding 10% of total revenues.

Choice "c" is incorrect. Nevi has a revenue percentage exceeding 10% of total revenues.

**CPA-00124 Type1 M/C A-D Corr Ans: A PM#2 F 1-07**

66. CPA-00124 Th Nov 93 #17 (Adapted) Page 62

What information should a public company present about revenues from its reporting segments?

a. Disclose separately the amount of sales to unaffiliated customers and the amount of intracompany sales.
b. Disclose as a combined amount sales to unaffiliated customers and intracompany sales between geographic areas.
c. Disclose separately the amount of sales to unaffiliated customers but not the amount of intracompany sales between geographic areas.
d. No disclosure of revenues from foreign operations need be reported.

**CPA-00124 Explanation**
Choice "a" is correct. Unaffiliated customers sales and intracompany sales must be disclosed separately.

**CPA-00125 Type1 M/C A-D Corr Ans: A PM#3 F 1-07**

67. CPA-00125 PII May 93 #12 (Adapted) Page 42

Taft Corp. discloses supplemental industry segment information. The following information is available for 1992:

| *Segment* | *Sales* | *Traceable operating expenses* |
|---|---|---|
| A | $ 20,000 | $ 12,000 |
| B | 16,000 | 10,000 |
| C | 12,000 | 7,000 |
| | $ 48,000 | $ 29,000 |

Additional 1992 expenses, not included above, are as follows:

| | |
|---|---|
| Indirect operating expenses | $7,200 |
| General corporate expenses | 4,800 |

Segment C's 1992 operating profit was:

a. $5,000
b. $3,200
c. $2,600
d. $2,000


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**CPA-00125 Explanation**
Choice "a" is correct. $5,000 operating profit for Segment C.

**Rule:** Operating profit by segments is based on the measure of profit reported to the "Chief Operating Decision Maker."

Interest expense, income taxes, and general corporate expenses are not allocated to the divisions solely for the purposes of segment disclosures; they may be allocated if that is how the segments report to the "Chief Operating Decision Maker."

| | |
|---|---|
| Segment C's sales | $12,000 |
| Less traceable operating expenses | (7,000) |
| Segment C operating profit | $ 5,000 |

**CPA-00126 Type1 M/C A-D Corr Ans: B PM#4 F 1-07**

68. CPA-00126Th May 93 #36 (Adapted) Page 60

In financial reporting of segment data, which of the following items is always used in determining a segment's operating income?

a. Income tax expense.
b. Sales to other segments.
c. General corporate expense.
d. Gain or loss on discontinued operations.

**CPA-00126 Explanation**
Choice "b" is correct. Sales to other segments would be used in determining a segment's operating income.

**Rule:** Equity in net income of another company, general corporate expenses, interest, income tax expense, and gains or losses on discontinued operations are all not included in segment profit unless they are included in the determination of segment profit reported to the "Chief Operating Decision Maker."

**CPA-04666 Type1 M/C A-D Corr Ans: A PM#6 F 1-07**

69. CPA-04666Released 2005 Page 39

Opto Co. is a publicly-traded, consolidated enterprise reporting segment information. Which of the following items is a required enterprise-wide disclosure regarding external customers?

a. The fact that transactions with a particular external customer constitute more than 10% of the total enterprise revenues.
b. The identity of any external customer providing 10% or more of a particular operating segment's revenue.
c. The identity of any external customer considered to be "major" by management.
d. Information on major customers is **not** required in segment reporting.

**CPA-04666 Explanation**
Choice "a" is correct. In order to conform to GAAP, financial statements for public business enterprises must report segment information about a company's major customers if that customer provides 10% or more of the combined revenue, internal and external, of all operating segments.

Choice "b" is incorrect. Revenue is 10% of **ALL** operating segments not "a particular" segment.

Choice "c" is incorrect. Disclosure is not at management's discretion.

Choice "d" is incorrect. Disclosure is required.

**CPA-04689 Type1 M/C A-D Corr Ans: B PM#8 F 1-07**

70. CPA-04689Released 2005 Page 40


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Which of the following qualifies as an operating segment?

a. Corporate headquarters, which oversees $1 billion in sales for the entire company.
b. North American segment, whose assets are 12% of the company's assets of all segments, and management reports to the chief operating officer.
c. South American segment, whose results of operations are reported directly to the chief operating officer, and has 5% of the company's assets, 9% of revenues, and 8% of the profits.
d. Eastern Europe segment, which reports its results directly to the manager of the European division, and has 20% of the company's assets, 12% of revenues, and 11% of profits.

**CPA-04689 Explanation**
Choice "b" is correct. Assets of the North American segment exceed 10% combined assets of all operating segments.

Choice "a" is incorrect. Corporate headquarters in not considered a segment.

Choice "c" is incorrect. The South American segment does not meet any of the 10% minimums (Revenue, P&L or Assets).

Choice "d" is incorrect. Eastern Europe segment does not report to the chief operating officer.

**CPA-05196 Type1 M/C A-D Corr Ans: A PM#9 F 1-07**

71. CPA-05196 Released 2006 Page 39

Which of the following should be disclosed for each reportable operating segment of an enterprise?

| | *Profit or loss* | *Total assets* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |

**CPA-05196 Explanation**
Choice "a" is correct. For each reportable segment of an enterprise, **both** profit or loss and total assets should be disclosed. In disclosure questions, if you are not sure, disclose the most rather than the least.

Choice "b" is incorrect. For each reportable segment of an enterprise, **both** profit or loss and total assets should be disclosed.

Choice "c" is incorrect. For each reportable segment of an enterprise, **both** profit or loss and total assets should be disclosed.

Choice "d" is incorrect. For each reportable segment of an enterprise, **both** profit or loss and total assets should be disclosed.

**CPA-05217 Type1 M/C A-D Corr Ans: A PM#10 F 1-07**

72. CPA-05217 Released 2006 Page 40

Which of the following factors determines whether an identified segment of an enterprise should be reported in the enterprise's financial statements under SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*?

I. The segment's assets constitute more than 10% of the combined assets of all operating segments.
II. The segment's liabilities constitute more than 10% of the combined liabilities of all operating segments.

a. I only.
b. II only.
c. Both I and II.
d. Neither I nor II.


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**CPA-05217 Explanation**
Choice "a" is correct. For segment reporting, if an identified segment's assets constitute more than 10% of the combined assets of all operating segments, the segment should be reported. The same rule does not apply for the segment's liabilities. The candidate does have to remember the 10% and also the 10% of "what."

Choice "b" is incorrect. For segment reporting, if an identified segment's assets constitute more than 10% of the combined assets of all operating segments, the segment should be reported. The same rule does not apply for the segment's liabilities.

Choice "c" is incorrect. For segment reporting, if an identified segment's assets constitute more than 10% of the combined assets of all operating segments, the segment should be reported. The same rule does not apply for the segment's liabilities, so the correct answer cannot be "Both."

Choice "d" is incorrect. For segment reporting, if an identified segment's assets constitute more than 10% of the combined assets of all operating segments, the segment should be reported. The correct answer cannot be "Neither."

**CPA-05439 Type1 M/C A-D Corr Ans: B PM#10 F 1-07**

73. CPA-05439 Released 2007 Page 38

Which of the following types of entities are required to report on business segments?

a. Nonpublic business enterprises.
b. Publicly-traded enterprises.
c. Not-for-profit enterprises.
d. Joint ventures.

**CPA-05439 Explanation**
Choice "b" is correct. Only publicly-traded enterprises are required to report on business segments.

Choices "a", "c", and "d" are incorrect, per the explanation above.

**CPA-05447 Type1 M/C A-D Corr Ans: A PM#11 F 1-07**

74. CPA-05447 Released 2007 Page 41

In financial reporting of segment data, which of the following must be considered in determining if an industry segment is a reportable segment?

| | *Sales to unaffiliated customers* | *Intersegment sales* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |

**CPA-05447 Explanation**
Choice "a" is correct. A segment is considered reportable if its reported revenue, including sales to unaffiliated customers and intersegment sales, is 10% or more of the combined revenue (unaffiliated and intersegment) of all operating segments.

Choices "b", "c", and "d" are incorrect, per the above explanation.

**Development-Stage Enterprises**

**CPA-00128 Type1 M/C A-D Corr Ans: A PM#1 F 1-08**


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75. CPA-00128 FARE Nov 95 #4 Page 43

A development stage enterprise should use the same generally accepted accounting principles that apply to established operating enterprises for:

| | *Revenue recognition* | *Deferral of expenses* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | No |
| d. | No | Yes |

**CPA-00128 Explanation**

Choice "a" is correct. Development stage enterprises must use all the same principles as established enterprises including those of revenue recognition and deferral of expenses. The primary difference is that development stage enterprises must provide additional disclosures not required of established operating enterprises. SFAS #7, para. 10

**CPA-00129 Type1 M/C A-D Corr Ans: D PM#2 F 1-08**

76. CPA-00129 PII May 93 #14 (Adapted) Page 43

Tanker Oil Co., a development stage enterprise, incurred the following costs during its first year of operations:

| | |
|---|---|
| Legal fees for incorporation and other related matters | 55,000 |
| Underwriters' fees for initial stock offering | 40,000 |
| Exploration costs and purchases of mineral rights | 60,000 |

Tanker had no revenue during its first year of operation. What amount may Tanker capitalize as organizational costs?

a. $115,000
b. $95,000
c. $55,000
d. $0

**CPA-00129 Explanation**

| | *Capitalize as organizational costs* |
|---|---|
| Legal fees for incorporation and other related matters should be expensed as start-up costs | - |
| Underwriting fees for initial stock offering should be recorded as a reduction of contributed capital | - |
| Exploration costs should be expensed as research & development | - |
| Purchases of mineral rights should be capitalized as fixed assets | - |
| Capitalize as organizational costs | 0 |

Choice "d" is correct. $0.

All organizational costs (start-up costs) should be expensed when incurred (per SOP 98-5).

**Fair Value Measurements**

**CPA-05407 Type1 M/C A-D Corr Ans: D PM#1 F 1-09**

77. CPA-05407 Page 44


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Which of the following statements regarding fair value is/are correct?

I. The fair value of an asset or liability is specific to the entity making the fair value measurement.
II. Fair value is the price to acquire an asset or assume a liability.
III. Fair value includes transportation costs, but not transaction costs.
IV. The price in the principal market for an asset or liability will be the fair value measurement.

a. I & II
b. I & IV
c. II & III
d. III & IV

**CPA-05407 Explanation**
Choice "d" is correct. Statements III and IV are correct. Statement I is incorrect because fair value is a market-specific measure, not an entity-specific measure. Statement II is incorrect because fair value is an exit price (the price to sell an asset or transfer a liability), not an entrance price.

Choices "a", "b" and "c" are incorrect, per the above explanation.

**CPA-05408 Type1 M/C A-D Corr Ans: B PM#2 F 1-09**

78. CPA-05408 Page 46

Which of the following is not a valuation technique that can be used to measure the fair value of an asset or liability?

a. The market approach.
b. The impairment approach.
c. The income approach.
d. The cost approach.

**CPA-05408 Explanation**
Choice "b" is correct. The impairment approach is not used to measure the fair value of an asset or liability. Instead, when an entity is determining whether an asset has been impaired, the entity will use the market approach, the income approach or the cost approach to determine the fair value of the asset.

Choice "a" is incorrect. The market approach is an accepted method of fair value measurement in which price and other market information from identical or comparable assets or liabilities is used to measure fair value.

Choice "c" is incorrect. The income approach is an accepted method of fair value measurement in which future cash flows or earnings are discounted to determine fair value.

Choice "d" is incorrect. The cost approach is an accepted method of fair value measurement in which current replacement cost is used to determine the fair value of an asset.

**CPA-05409 Type1 M/C A-D Corr Ans: C PM#3 F 1-09**

79. CPA-05409 Page 46

Which of the following statements is incorrect regarding the inputs that can be used to measure fair value?

I. Level I inputs are the most reliable fair value measurements and Level III inputs are the least reliable.
II. Level I measurements are quoted prices in active markets for identical or similar assets or liabilities.
III. A fair value measurement based on management assumptions only (no market data) would not be acceptable per GAAP.
IV. The level in the fair value hierarchy of a fair value measurement is determined by the level of the highest level significant input.

a. I only.
b. I, II, IV.


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c. II, III, IV.
d. I, II, III, IV.

**CPA-05409 Explanation**
Choice "c" is correct. Statement I is correct and statements II, III, and IV are incorrect. Statement II is incorrect because Level I measurements are quoted prices in active markets for *identical* assets or liabilities only. Quoted prices in active markets for similar assets or liabilities are Level II inputs. Statement III is incorrect because a fair value measurement based on management assumptions only is a Level III measurement and is acceptable when there are no Level I or Level II inputs or when undo cost or effort is required to obtain Level I or Level II inputs. Statement IV is incorrect because the level in the fair value hierarchy of a fair value measurement is determined by the level of the *lowest* level significant input.

**CPA-05410 Type1 M/C A-D Corr Ans: C PM#4 F 1-09**

80. CPA-05410 Page 45

There are multiple active markets for a financial asset with different observable market prices:

| Market | Quoted Price | Transaction Costs |
|---|---|---|
| A | $76 | $5 |
| B | $74 | $2 |

There is no principal market for the financial asset. What is the fair value of the asset?

a. $71
b. $72
c. $74
d. $76

**CPA-05410 Explanation**
Choice "c" is correct. When there is no principal market, the price in the most advantageous market is the fair value measurement. Although transaction costs are not included in the fair value measurement, they are used to determine the most advantageous market, as follows:

Market A: Net Price = Quoted Price - Transaction Costs = $76 - 5 = $71

Market B: Net Price = Quoted Price - Transaction Costs = $74 - 2 = $72

Because the net price in Market B is higher than the net price in Market A, Market B is the most advantageous market and the quoted price in Market B ($74) is the fair value of the asset.

Choice "a" is incorrect. This is the net price in Market A. Fair value does not include transaction costs.

Choice "b" is incorrect. This is the net price in Market B. This net price indicates that Market B is the most advantageous market, but the net price is not the fair value because fair value does not include transaction costs.

Choice "d" is incorrect. If Market A were the principal market for the asset, then this would be the fair value of the asset. However, because there is no principal market, the price in the most advantageous market (Market B) is the price of the asset.

**CPA-05411 Type1 M/C A-D Corr Ans: A PM#5 F 1-09**

81. CPA-05411 Page 46

A change from the cost approach to the market approach of measuring fair value is considered to be what type of accounting change?


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a. Change in accounting estimate.
b. Change in accounting principle.
c. Change in valuation technique.
d. Error correction.

**CPA-05411 Explanation**
Choice "a" is correct. A change in the valuation technique used to measure fair value is a change in accounting estimate.

Choice "b" is incorrect. Per SFAS No. 157, a change in valuation technique is a change in accounting estimate, not a change in accounting principal.

Choice "c" is incorrect. Although a change from the cost approach to the market approach is a change in valuation technique, a change in valuation technique is not defined as a type of accounting change, but instead falls into the category of changes in accounting estimate.

Choice "d" is incorrect. Both the market approach and the cost approach are acceptable methods of measuring fair value per SFAS No. 157; therefore, switching between these methods is not the correction of an error. Additionally, an error correction is not a type of accounting change.

**Supplemental Questions**

**CPA-00187 Type1 M/C A-D Corr Ans: D PM#1 F 1-99**

82. CPA-00187 Th Nov 93 #5 Page 6

According to the FASB conceptual framework, the objectives of financial reporting for business enterprises are based on:

a. The need for conservatism.
b. Reporting on management's stewardship.
c. Generally accepted accounting principles.
d. The needs of the users of the information.

**CPA-00187 Explanation**
Choice "d" is correct. The FASB conceptual framework states that the objectives of financial reporting stem from the informational needs of the external users of the information. SFAC 1 para. 28

Choice "a" is incorrect. Conservatism is an underlying concept for financial accounting but is not the basis for the objectives. SFAC 2 para. 91-97

Choice "b" is incorrect. Information concerning management's stewardship is only one aspect of the information financial statements are intended to provide. SFAC 1 para. 50

Choice "c" is incorrect. Generally accepted accounting principles (GAAP) are derived from and based on the objectives of financial reporting, not the other way around.

**CPA-00189 Type1 M/C A-D Corr Ans: D PM#2 F 1-99**

83. CPA-00189 May 90 #1 Page 7

According to the FASB conceptual framework, predictive value is an ingredient of:

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

**CPA-00189 Explanation**
Choice "d" is correct. Yes - No. Predictive value is an ingredient of relevance but not of reliability.


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Memorize:
Bud's relevance to "PFT."
Bud's reliability to "VRN."

**CPA-00190 Type1 M/C A-D Corr Ans: A PM#3 F 1-99**

84. CPA-00190 Nov 90 #1 Page 10

According to the FASB's conceptual framework, the process of reporting an item in the financial statements of an entity is:

a. Recognition.
b. Realization.
c. Allocation.
d. Matching.

**CPA-00190 Explanation**
Choice "a" is correct. Recognition.

According to the FASB's conceptual framework, the process of reporting an item in the financial statements of an entity is recognition.

**CPA-00191 Type1 M/C A-D Corr Ans: A PM#4 F 1-99**

85. CPA-00191 May 91 #1 Page 31

Under FASB Statement of Financial Accounting Concepts #5, which of the following items would cause earnings to differ from comprehensive income for an enterprise in an industry not having specialized accounting principles?

a. Unrealized loss on investments in noncurrent marketable equity securities available for sale.
b. Unrealized loss on investments in current marketable equity securities held for trading.
c. Loss on exchange of nonmonetary assets without commercial substance.
d. Loss on exchange of nonmonetary assets with commercial substance.

**CPA-00191 Explanation**
Choice "a" is correct. Unrealized loss on investments in marketable equity securities available for sale would cause earnings to differ from comprehensive income for an enterprise in an industry not having specialized accounting principles.

**Rule:** FAC 5 defines "earnings" for a period to exclude certain cumulative accounting adjustments and other non-owner changes in equity (such as changes in market value of marketable securities available for sale) that are included in comprehensive income for a period.

**CPA-00192 Type1 M/C A-D Corr Ans: C PM#5 F 1-99**

86. CPA-00192 Nov 91 #1 Page 11

FASB's conceptual framework explains both financial and physical capital maintenance concepts. Which capital maintenance concept is applied to currently reported net income, and which is applied to comprehensive income?

| | *Currently reported net income* | *Comprehensive income* |
|---|---|---|
| a. | Financial capital | Physical capital |
| b. | Physical capital | Physical capital |
| c. | Financial capital | Financial capital |
| d. | Physical capital | Financial capital |

**CPA-00192 Explanation**


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Choice "c" is correct. Financial capital - Financial capital.

Financial capital maintenance is considered to be an element of both "currently reported net income" and "comprehensive income." This was a rare instance in which this type of information was asked on the exam.

**CPA-00193 Type1 M/C A-D Corr Ans: D PM#6 F 1-99**

87. CPA-00193 May 92 #2 Page 11

According to the FASB conceptual framework, which of the following is an essential characteristic of an asset?

a. The claims to an asset's benefits are legally enforceable.
b. An asset is tangible.
c. An asset is obtained at a cost.
d. An asset provides future benefits.

**CPA-00193 Explanation**
Choice "d" is correct. An asset provides future benefits.

**Rule:** According to the FASB conceptual framework, assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.

**CPA-00194 Type1 M/C A-D Corr Ans: D PM#7 F 1-99**

88. CPA-00194 Nov 92 #3 Page 11

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

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

**CPA-00194 Explanation**
**Rule:** Revenues are inflows or other enhancements of assets and/or settlements (decreases) in liabilities resulting from the entity's ongoing major operations, **not** from "incidental" operations.

Choice "d" is correct. An entity's revenue may result from a decrease in a liability from primary operations.

**CPA-00195 Type1 M/C A-D Corr Ans: C PM#8 F 1-99**

89. CPA-00195 May 90 #30 Page 37

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

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

**CPA-00195 Explanation**
Choice "c" is correct. Yes - No.

Yes - "Depreciation methods" should be disclosed in the "summary of significant accounting policies."

No - Composition of fixed assets (or any other account) should **not** be disclosed in the "summary of significant accounting policies."


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**CPA-00196 Type1 M/C A-D Corr Ans: A PM#9 F 1-99**

90. CPA-00196 Nov 90 I #40 Page 18

Brock Corp. reports operating expenses in two categories: (1) selling and (2) general and administrative. The adjusted trial balance at December 31, 1989 included the following expense and loss accounts:

| | |
|---|---|
| Accounting and legal fees | $120,000 |
| Advertising | 150,000 |
| Freight out | 80,000 |
| Interest | 70,000 |
| Loss on sale of long-term investment | 30,000 |
| Officers' salaries | 225,000 |
| Rent for office space | 220,000 |
| Sales salaries and commissions | 140,000 |

One-half of the rented premises is occupied by the sales department. Brock's total selling expenses for 1989 are:

a. $480,000
b. $400,000
c. $370,000
d. $360,000

**CPA-00196 Explanation**

| | |
|---|---|
| Advertising | $150,000 |
| Freight out | 80,000 |
| Office space | 110,000 (1/2 × $220,000) |
| Sales salaries and commissions | 140,000 |
| Total selling expenses | $480,000 |

**Note:** Only one-half of rent for office space was used for sales office.

Choice "a" is correct. $480,000.

**CPA-00197 Type1 M/C A-D Corr Ans: A PM#10 F 1-99**

91. CPA-00197 Nov 90 II #10 Page 18

The following items were among those that were reported on Lee Co.'s income statement for the year ended December 31, 1989:

| | |
|---|---|
| Legal and audit fees | $170,000 |
| Rent for office space | 240,000 |
| Interest on inventory floorplan | 210,000 |
| Loss on abandoned data processing equipment used in operations | 35,000 |

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

a. $290,000
b. $325,000
c. $410,000
d. $500,000

**CPA-00197 Explanation**

| | |
|---|---|
| Legal and audit fees | $170,000 |
| Rent for admin office (1/2 × $240,000) | 120,000 |
| Total general and administrative expenses | $290,000 |


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**Note:** 1/2 of the office space of $240,000 was used by the sales department, which should be allocated to "selling expenses" (not general and administrative).

Choice "a" is correct. $290,000.

**CPA-00198 Type1 M/C A-D Corr Ans: D PM#11 F 1-99**

92. CPA-00198 May 91 I #3 (Adapted) Page 17

In Baer Food Co.'s 1990 single-step income statement, the section titled "Revenues" consisted of the following:

| | | |
|---|---|---|
| Net sales revenue | | $187,000 |
| Results from discontinued operations: | | |
| Loss from operations of component (net of $1,200 tax effect) | $(2,400) | |
| Gain on disposal of component (net of $7,200 tax effect) | 14,400 | 12,000 |
| Interest revenue | | 10,200 |
| Gain on sale of equipment | | 4,700 |
| Total revenues | | $213,900 |

In the revenues section of its 1990 income statement, Baer Food should have reported total revenues of:

a. $216,300
b. $215,400
c. $203,700
d. $201,900

**CPA-00198 Explanation**
Choice "d" is correct. $201,900.

Revenues (in a single step income statement) include:

| | |
|---|---|
| Net sales revenue (of goods & services) | $187,000 |
| Interest revenue (and dividends earned) | 10,200 |
| Gain on sale of equipment | 4,700 |
| Total revenues | 201,900 |

The various amounts from discontinued operations should be included in discontinued operations, not in revenues.

**CPA-00199 Type1 M/C A-D Corr Ans: D PM#12 F 1-99**

93. CPA-00199 May 92 #1 Page 4

FASB Interpretations of Statements of Financial Accounting Standards have the same authority as the FASB:

a. Statements of Financial Accounting Concepts.
b. Emerging Issues Task Force Consensus.
c. Technical Bulletins.
d. Statements of Financial Accounting Standards.

**CPA-00199 Explanation**
Choice "d" is correct. FASB interpretations of the "statements of financial accounting standards" (SFAS) have the same authority as the FASB statements of financial accounting standards (SFAS), which by themselves determine GAAP.


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Choice "a" is incorrect. Statements of financial accounting concepts (FAC's) have much less authority (fifth floor) and do not by themselves determine GAAP as is the case with SFASs and interpretations of SFASs.

Choice "b" is incorrect. Emerging issues task force (EITF) consensus is in the nature of a "third floor" authority. The EITF was established in 1984 to aid the FASB in identifying and implementing emerging issues before they become widespread and ultimately require action by the FASB. After discussing the issues and the relevant accounting pronouncements, the group can sometimes reach a consensus on an issue, in which case no action by the FASB is usually needed.

Choice "c" is incorrect. Technical bulletins of the FASB (second floor) do not by themselves determine GAAP.

**CPA-00200 Type1 M/C A-D Corr Ans: B PM#13 F 1-99**

94. CPA-00200 May 92 #17 Page 18

On January 1, 1991, Brecon Co. installed cabinets to display its merchandise in customers' stores. Brecon expects to use these cabinets for five years. Brecon's 1991 multi-step income statement should include:

a. One-fifth of the cabinet costs in cost of goods sold.
b. One-fifth of the cabinet costs in selling, general, and administrative expenses.
c. All of the cabinet costs in cost of goods sold.
d. All of the cabinet costs in selling, general, and administrative expenses.

**CPA-00200 Explanation**
Choice "b" is correct. One-fifth of the cabinet costs (depreciation expense) should be included in selling, general, and administrative expenses for 1991.

Choice "a" is incorrect. Merchandise display cabinets in stores relate to selling activities, not to the purchase cost of goods sold.

Choices "c" and "d" are incorrect. Merchandise display cabinets are fixed assets whose cost should be allocated systematically over their five-year useful life.

**CPA-00201 Type1 M/C A-D Corr Ans: C PM#14 F 1-99**

95. CPA-00201 Nov 92 #1 Page 4

Which of the following accounting pronouncements is the most authoritative?

a. FASB Statement of Financial Accounting Concepts.
b. FASB Technical Bulletin.
c. AICPA Accounting Principles Board Opinion.
d. AICPA Statement of Position.

**CPA-00201 Explanation**
Choice "c" is correct. The AICPA accounting principal board opinion (APBO) is a first floor (category A) of established accounting principle pronouncements.

Choice "a" is incorrect. FASB statement of financial accounting concepts (SFAC or FACs) is a fifth floor (other accounting literature) category.

Choice "b" is incorrect. FASB technical bulletins are a second floor (category B) accounting pronouncement.

Choice "d" is incorrect. AICPA statement of position is a second floor (category B) accounting pronouncement.

**CPA-00202 Type1 M/C A-D Corr Ans: C PM#15 F 1-99**


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96. CPA-00202 Nov 92 #37 Page 37

Which of the following should be disclosed in a summary of significant accounting policies?

I. Management's intention to maintain or vary the dividend payout ratio.
II. Criteria for determining which investments are treated as cash equivalents.
III. Composition of the sales order backlog by segment.

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

**CPA-00202 Explanation**
Choice "c" is correct. II only.

The criteria for determining which investments are treated as "cash equivalents" is a method of accounting policies that needs to be disclosed in the summary of significant accounting policies.

Choice "a" is incorrect. Management's intention to maintain or vary the "dividend payout ratio" is not an "accounting policy."

Choices "b" and "d" are incorrect. Composition of the sales order backlog by segment is **not** an "accounting policy."

**CPA-00203 Type1 M/C A-D Corr Ans: D PM#16 F 1-99**

97. CPA-00203 May 93 T #31 Page 35

The summary of significant accounting policies should disclose the:

a. Maturity dates of noncurrent debts.
b. Terms for convertible debt to be exchanged for common stock.
c. Concentration of credit risk of all financial instruments by geographical region.
d. Criteria for determining which investments are treated as cash equivalents.

**CPA-00203 Explanation**
Choice "d" is correct. The criteria for determining which investments are treated as cash equivalents would be part of the summary of significant accounting policies.

Choice "a" is incorrect. The maturity dates of noncurrent debts are required disclosures, but are not a part of the summary of significant accounting policies.

Choice "b" is incorrect. The terms for convertible debt to be exchanged for common stock are not accounting policies; they would be disclosed separately.

Choice "c" is incorrect. The concentration of credit risk of all financial instruments by geographic region may be a required segment disclosure, especially for financial institutions. However, it would **not** be a part of the summary of significant accounting policies.

**CPA-00204 Type1 M/C A-D Corr Ans: A PM#17 F 1-99**

98. CPA-00204 Nov 93 I #52 Page 18

The following costs were incurred by Griff Co., a manufacturer, during 1992:

| | |
|---|---|
| Accounting and legal fees | $25,000 |
| Freight-in | 175,000 |
| Freight-out | 160,000 |
| Officers salaries | 150,000 |
| Insurance | 85,000 |
| Sales representatives salaries | 215,000 |

What amount of these costs should be reported as general and administrative expenses for 1992?


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a. $260,000
b. $550,000
c. $635,000
d. $810,000

**CPA-00204 Explanation**
Choice "a" is correct. $260,000.

General and administrative

| | |
|---|---|
| Accounting and legal fees | $ 25,000 |
| Officers salaries | 150,000 |
| Insurance | 85,000 |
| Total "general and admin" expenses | $260,000 **A** |

"Freight-in" is part of "cost of goods sold."
"Freight-out" is a "selling" expense.
Sales representative salaries is a selling expense.

**CPA-00205 Type1 M/C A-D Corr Ans: A PM#18 F 1-99**

99. CPA-00205 Nov 93 T #19 (Adapted) Page 38

Which of the following information should be included in Melay, Inc.'s 1992 summary of significant accounting policies?

a. Property, plant, and equipment is recorded at cost with depreciation computed principally by the straight-line method.
b. During 1992, the Delay component was sold.
c. Business segment 1992 sales are Alay $1M, Belay $2M, and Celay $3M.
d. Future common share dividends are expected to approximate 60% of earnings.

**CPA-00205 Explanation**
Choice "a" is correct. Computing depreciation principally by the straight-line method is a GAAP method of depreciation that should be described in the "summary of significant accounting policies."

Choice "b" is incorrect. Disclosing the sale of a component of a business is required (and is covered in the lecture on "discontinued operations" in the F1 class) but is not a "significant accounting policy."

Choice "c" is incorrect. Disclosing "sales" of segments is required, but is not a "significant accounting policy."

Choice "d" is incorrect. "Estimates of future common share dividends" are not appropriate disclosures for the financial statements. They might be appropriate for the "presidents letter to shareholders."

**CPA-00206 Type1 M/C A-D Corr Ans: A PM#19 F 1-99**

100. CPA-00206 Nov 93 A #52 Page 4

Several sources of GAAP consulted by an auditor are in conflict as to the application of an accounting principle. Which of the following should the auditor consider the most authoritative?

a. FASB Technical Bulletins.
b. AICPA Accounting Interpretations.
c. FASB Statements of Financial Accounting Concepts.
d. AICPA Technical Practice Aids.

**CPA-00206 Explanation**
Choice "a" is correct. The most authoritative pronouncements (first floor) are FASB Statements, FASB Staff Positions, FASB Statement 133 Implementation Issues, FASB Interpretations, AICPA APB opinions, and AICPA Accounting Research Bulletins. When these pronouncements do not provide appropriate


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guidance, the next level of pronouncements (second floor) are AICPA Industry Audit and Accounting Guides, AICPA Statements of Position, and FASB Technical Bulletins.

Choice "b" is incorrect. AICPA Accounting Interpretations are not as authoritative as FASB Technical Bulletins, since they are on the fourth floor.

Choices "c" and "d" are incorrect. FASB Concepts Statements and AICPA Technical Practice Aids are among the least authoritative of accounting literature (fifth floor).

**CPA-00207 Type1 M/C A-D Corr Ans: D PM#20 F 1-99**

101. CPA-00207 Nov 89 I #1 (Adapted) Page 18

Coffey Corp.'s trial balance of Income Statement Accounts for the year ended December 31, 1988 as follows:

| | *Debit* | *Credit* |
|---|---|---|
| Net sales | | $1,600,000 |
| Cost of goods sold | $ 960,000 | |
| Selling expenses | 235,000 | |
| Administrative expenses | 150,000 | |
| Interest expense | 25,000 | |
| Gain on debt extinguishment | | 10,000 |
| Totals | $1,370,000 | $1,610,000 |

Coffey's income tax rate is 30%. The gain on debt extinguishment is considered a usual and recurring part of Coffey's operations. Coffey prepares a multiple-step income statement for 1988.

Income from operations before income tax is:

a. $190,000
b. $200,000
c. $230,000
d. $240,000

**CPA-00207 Explanation**
Choice "d" is correct. $240,000

The gain on debt extinguishment does not meet the unusual and infrequent criteria of APB 30 to be treated as an extraordinary item (per SFAS No. 145, extinguishments of debt are no longer automatically extraordinary), so it is included as part of income from continuing operations.

**CPA-00208 Type1 M/C A-D Corr Ans: A PM#21 F 1-99**

102. CPA-00208 Nov 89 I #2 (Adapted) Page 18

Coffey Corp.'s trial balance of Income Statement Accounts for the year ended December 31, 1988 as follows:

| | *Debit* | *Credit* |
|---|---|---|
| Net sales | | $1,600,000 |
| Cost of goods sold | $960,000 | |
| Selling expenses | 235,000 | |
| Administrative expenses | 150,000 | |
| Interest expense | 25,000 | |
| Hurricane damage | 40,000 | |
| Gain on debt extinguishment | | 10,000 |
| Totals | $1,410,000 | $1,610,000 |

Coffey's income tax rate is 30%. The gain on debt extinguishment is considered a usual and recurring part of Coffey's operations. The hurricane is considered an unusual and infrequent event. Coffey prepares a multiple-step income statement for 1988.


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Net income is:

a. $140,000
b. $161,000
c. $168,000
d. $200,000

**CPA-00208 Explanation**
Choice "a" is correct. $140,000.

Net income is the "bottom line" amount after all has been considered on the income statement. Without showing all the line items as required for the income statement, the "bottom line" amount of $140,000 is derived as follows:

| | |
|---|---|
| Income from continuing operations | $240,000 |
| Less: Income taxes (30%) | (72,000) |
| Extraordinary item - Hurricane damage (net of tax) | (28,000) |
| Net Income | $140,000 |

**CPA-00209 Type1 M/C A-D Corr Ans: B PM#22 F 1-99**

103. CPA-00209 Nov 90 #37 Page 15

Gown, Inc. sold a warehouse and used the proceeds to acquire a new warehouse. The excess of the proceeds over the carrying amount of the warehouse sold should be reported as a(an):

a. Extraordinary gain, net of income taxes.
b. Part of continuing operations.
c. Gain from discontinued operations, net of income taxes.
d. Reduction of the cost of the new warehouse.

**CPA-00209 Explanation**
Choice "b" is correct. Part of continuing operations.

**Rule:** When a fixed asset is sold, gain or loss is recognized as part of income from continuing operations. The amount of the gain or loss is equal to the difference between the proceeds from the sale and the carrying amount (FMV) of the fixed asset sold.

Choice "a" is incorrect. The gain is **not** extraordinary and is shown gross - not net of tax.

Choice "c" is incorrect. The gain is part of continuing operations - not discontinued operations.

Choice "d" is incorrect. The gain is not reported as a reduction of the cost of the new warehouse.

**CPA-00210 Type1 M/C A-D Corr Ans: B PM#23 F 1-99**

104. CPA-00210 Nov 90 I #39 (Adapted) Page 22

Adam Corp. had the following infrequent transactions during 1989:

- A $190,000 gain on reacquisition and retirement of bonds. This material event is also considered unusual for Adam Corp.
- A $260,000 gain on the disposal of a component of a business. Adam continues similar operations at another location.
- A $90,000 loss on the abandonment of equipment.

In its 1989 income statement, what amount should Adam report as total infrequent net gains that are **not** considered extraordinary?

a. $100,000
b. $170,000


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c. $360,000
d. $450,000

**CPA-00210 Explanation**
Infrequent net gains not considered extraordinary include:

| | |
|---|---|
| Gain on disposal of a component of a business | $260,000 |
| Loss on abandonment of equipment | (90,000) |
| Total | $170,000 |

Choice "b" is correct. $170,000.

**CPA-00211 Type1 M/C A-D Corr Ans: D PM#24 F 1-99**

105. CPA-00211 May 91 I #5 Page 15

Thorpe Co.'s income statement for the year ended December 31, 1990, reported net income of $74,100. The auditor raised questions about the following amounts that had been included in net income:

| | |
|---|---|
| Unrealized loss on decline in market value of available-for-sale investments in stock | $(5,400) |
| Gain on early retirement of bonds payable (net of $11,000 tax effect) | 22,000 |
| Adjustment to profits of prior years for errors in depreciation (net of $3,750 tax effect) | (7,500) |
| Loss from fire (net of $7,000 tax effect) | (14,000) |

The loss from the fire was an infrequent but not unusual occurrence in Thorpe's line of business. Thorpe's December 31, 1990, income statement should report net income of:

a. $65,000
b. $66,100
c. $81,600
d. $87,000

**CPA-00211 Explanation**

| | |
|---|---|
| Net income before adjustments | $74,100 |
| Add: Unrealized loss in market value of available-for-sale investments in stock which should not have affected net income | 5,400 |
| Add: Correction of error of prior period which should not have affected net income | 7,500 |
| Net income after adjustments | $87,000 |

**Rule:** Unrealized losses (or gains) resulting from changes in market value of available-for-sale investments should be reported as a component of other comprehensive income in shareholders' equity. Unrealized gains and losses on investments held for trading would be included in net income.

Correction of errors of prior periods should be reported as an adjustment to beginning retained earnings, not as an item of net income.

Choice "d" is correct. $87,000.

**CPA-00212 Type1 M/C A-D Corr Ans: D PM#25 F 1-99**

106. CPA-00212 May 91 #25 Page 15

A transaction that is unusual, but **not** infrequent, should be reported separately as a(an):

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

**CPA-00212 Explanation**
Choice "d" is correct. A transaction that is unusual, but not "infrequent" should be reported separately as a component of continuing operations, (gross) but not net of applicable income taxes.


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Choices "a" and "b" are incorrect. An extraordinary item has to be both "unusual" and "infrequent."

Choice "c" is incorrect, per "d" above.

**CPA-00213 Type1 M/C A-D Corr Ans: B PM#26 F 1-99**

107. CPA-00213 Nov 91 I #50 (Adapted) Page 22

During 1990, Fuqua Steel Co. had the following unusual financial events occur:

- Bonds payable were retired five years before their scheduled maturity, resulting in a $260,000 gain. Fuqua has frequently retired bonds early when interest rates declined significantly.
- A steel forming segment suffered $255,000 in losses due to hurricane damage. This was the fourth similar loss sustained in a 5-year period at that location.
- A component of Fuqua's operations, steel transportation, was sold at a net loss of $350,000. This was Fuqua's first divestiture of one of its operating segments.

Before income taxes, what amount of gain (loss) should be reported separately as a component of income from continuing operations in 1990?

a. $260,000
b. $5,000
c. $(255,000)
d. $(350,000)

**CPA-00213 Explanation**
Choice "b" is correct. $5,000.

The steel forming segment's hurricane damage (4th in 5 years) of $255,000 is only "unusual in nature" and does not occur infrequently, therefore, it is not an "extraordinary item," and should be reported separately as a component of "income from continuing operations."

The retirement of debt, although unusual, is not infrequent for the company; therefore, the gain does not qualify for classification as an extraordinary item per APBO No. 30 (and SFAS No. 145).

**CPA-00214 Type1 M/C A-D Corr Ans: A PM#27 F 1-99**

108. CPA-00214 Nov 91 I #51 (Adapted) Page 22

During 1990, Fuqua Steel Co. had the following unusual financial events occur:

- Bonds payable were retired five years before their scheduled maturity, resulting in a $260,000 gain. Fuqua has frequently retired bonds early when interest rates declined significantly.
- A steel forming segment suffered $255,000 in losses due to hurricane damage. This was the fourth similar loss sustained in a 5-year period at that location.
- A component of Fuqua's operations, steel transportation, was sold at a net loss of $350,000. This was Fuqua's first divestiture of one of its operating segments.

Before income taxes, what amount should be disclosed as the gain (loss) from extraordinary items in 1990?

a. $0
b. $5,000
c. $(90,000)
d. $(350,000)

**CPA-00214 Explanation**
Choice "a" is correct. $0.

Note: The sale of the steel transportation component resulted in a loss from discontinued operations and is reported after "income from continuing operations." The steel forming segment's hurricane damage


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(4th in 5 years) of $255,000 is only "unusual in nature" and does not occur infrequently, therefore, it is not an "extraordinary item," and should be reported separately as a component of "income from continuing operations." The retirement of debt, although unusual, is not infrequent for the company; therefore, the gain does not qualify for classification as an extraordinary item per APBO No. 30 (and SFAS No. 145).

**CPA-00215 Type1 M/C A-D Corr Ans: C PM#28 F 1-99**

109. CPA-00215 Nov 91 #23 Page 22

In 1990, Teller Co. incurred losses arising from its guilty plea in its first antitrust action, and from a substantial increase in production costs caused when a major supplier's workers went on strike. Which of these losses should be reported as an extraordinary item?

| | *Antitrust action* | *Production costs* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | No |
| d. | Yes | Yes |

**CPA-00215 Explanation**
Choice "c" is correct. Yes - No.

**Rule:** Losses arising from a company's first (and probably "last") "anti-trust" action are unusual and extraordinary and should be reported as an extraordinary item. Losses resulting from additional costs caused by a strike at a major supplier or even at one's own company are not extraordinary and should be disclosed as a separate component of "income from continuing operations."

**CPA-00216 Type1 M/C A-D Corr Ans: C PM#29 F 1-99**

110. CPA-00216 May 92 I #46 Page 15

Ocean Corp.'s comprehensive insurance policy allows its assets to be replaced at current value. The policy has a $50,000 deductible clause. One of Ocean's waterfront warehouses was destroyed in a winter storm. Such storms occur approximately every four years. Ocean incurred $20,000 of costs in dismantling the warehouse and plans to replace it. The tax rate is 30%. The following data relate to the warehouse:

| | |
|---|---|
| Current carrying amount | $ 300,000 |
| Replacement cost | 1,100,000 |

What amount of gain should Ocean report as a separate component of income before extraordinary items?

a. $1,030,000
b. $780,000
c. $730,000
d. $0

**CPA-00216 Explanation**
Choice "c" is correct. $730,000 gain reported as a separate component of income before extraordinary items.

| | |
|---|---|
| Replacement cost | $1,100,000 |
| Less: Deductible clause | (50,000) |
| Subtotal - insurance proceeds | 1,050,000 |
| Less: Costs to dismantle old warehouse | (20,000) |
| Subtotal | 1,030,000 |
| Less: Current carrying amount | (300,000) |
| Gain on insurance settlement of casualty | $ 730,000 |


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**CPA-00217 Type1 M/C A-D Corr Ans: B PM#30 F 1-99**

111. CPA-00217 Nov 90 #36 Page 29

Which of the following should be reported as a prior period adjustment?

| | *Change in estimated lives of depreciable assets* | *Change from unaccepted principle to accepted principle* |
|---|---|---|
| a. | Yes | Yes |
| b. | No | Yes |
| c. | Yes | No |
| d. | No | No |

**CPA-00217 Explanation**
Choice "b" is correct. No - Yes

Change in estimated lives of depreciable assets is a "change in estimate." They affect only current and future periods (not "prior periods," not retained earnings).

Change from unaccepted principle to accepted principle is an example of an error of a prior period that should be reported as a "prior period adjustment."

**CPA-00218 Type1 M/C A-D Corr Ans: D PM#31 F 1-99**

112. CPA-00218 May 91 I #60 Page 26

On January 1, 20X1, Pell Corp. purchased a machine having an estimated useful life of 10 years and no salvage. The machine was depreciated by the double declining balance method for both financial statement and income tax reporting. On January 1, 20X6, Pell changed to the straight-line method for financial statement reporting but not for income tax reporting. Accumulated depreciation at December 31, 20X5, was $560,000. If the straight-line method had been used, the accumulated depreciation at December 31, 20X5, would have been $420,000. Pell's enacted income tax rate for 20X6 and thereafter is 30%. The amount shown in the 20X6 income statement for the cumulative effect of changing to the straight-line method should be:

a. $98,000 debit.
b. $98,000 credit.
c. $140,000 credit.
d. $0.

**CPA-00218 Explanation**
Choice "d" is correct. A change in the method of depreciation is now considered to be both a change in method and a change in estimate. These changes should be accounted for as changes in estimate and handled prospectively. The new depreciation method should be used as of the beginning of the year of change and should start with the current book value of the underlying asset. No retroactive or retrospective calculations should be made, and no adjustment should be made to retained earnings. And, certainly, the cumulative effect should not be reflected on the income statement any more.

Choices "a", "b", and "c" are incorrect, per the above explanation.

**CPA-00219 Type1 M/C A-D Corr Ans: B PM#32 F 1-99**

113. CPA-00219 May 91 #34 Page 26

Is the cumulative effect of an inventory pricing change on prior years earnings reported on the financial statements for

| | *LIFO to weighted average?* | *Weighed average to LIFO?* |
|---|---|---|
| a. | Yes | Yes |


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| | | |
|---|---|---|
| b. | Yes | No |
| c. | No | No |
| d. | No | Yes |

**CPA-00219 Explanation**
Choice "b" is correct. The cumulative effect of a change in accounting principle is now reported as an adjustment to beginning retained earnings when it is considered practicable to calculate the cumulative effect. When making a change to LIFO, it is generally considered impracticable to calculate the cumulative effect of the change (in most cases, data on the historical LIFO layers in not available). In a change to LIFO, the beginning inventory dollar amount becomes the first LIFO layer. No cumulative effect adjustment is made. The change is accounted for prospectively.

A change from LIFO to weighted average, there is no such impracticability. The cumulative effect is computed and the change is handled retrospectively.

Choices "a", "c", and "d" are incorrect, per the above explanation.

**CPA-00220 Type1 M/C A-D Corr Ans: A PM#33 F 1-99**

114. CPA-00220 Nov 91 I #56 Page 25

Goddard has used the FIFO method of inventory valuation since it began operations in 1987. Goddard decided to change to the weighted-average method for determining inventory costs at the beginning of 1990. The following schedule shows year-end inventory balances under the FIFO and weighted-average methods:

| *Year* | *FIFO* | *Weighted-average* |
|---|---|---|
| 1987 | $45,000 | $54,000 |
| 1988 | 78,000 | 71,000 |
| 1989 | 83,000 | 78,000 |

What amount, before income taxes, should be reported in the 1990 retained earnings statement as the cumulative effect of the change in accounting principle?

a. $5,000 decrease.
b. $3,000 decrease.
c. $2,000 increase.
d. $0.

**CPA-00220 Explanation**
Choice "a" is correct. $5,000 decrease.

The cumulative effect of change in accounting principle is determined as of the beginning of the year of change if comparative financial statements are not presented. In this case, the year of change is 1990, so the cumulative effect is the difference in inventory as of the end of 1989. [Note that inventory is a balance sheet item, so the change is based on the balances at the end of the last year the prior method was used. Had this question shown annual income statement amounts of cost of goods sold, we would have had to look at all the past years in the aggregate.] This will allow us to arrive at the adjustment to obtain the amount of retained earnings that would have been reported at the beginning of the period of change if the new accounting principle had been used for all prior periods.

| | *1989* |
|---|---|
| FIFO (current method) | $83,000 |
| Weighted average - new method | (78,000) |
| Decrease in 1990 retained earnings | $ 5,000 |

**CPA-00221 Type1 M/C A-D Corr Ans: C PM#34 F 1-99**

115. CPA-00221 Nov 91 II #2 Page 27

During 20X5, Dale Corp. made the following accounting changes:


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| Method used in 20X4 | Method used in 20X5 | After-tax effect |
|---|---|---|
| Sum-of-the-years' digits depreciation | Straight-line depreciation | $30,000 |
| Last-in, first-out for inventory valuation | First-in, first-out for inventory valuation | 98,000 |

What amount should be shown in the 20X5 retained earnings statement as an adjustment to the beginning balance?
a. $0
b. $30,000
c. $98,000
d. $128,000

**CPA-00221 Explanation**
Choice "c" is correct. $98,000.

The cumulative effect of a change in accounting principle is now shown on the retained earnings statement as an adjustment to the beginning balance of retained earnings, assuming that the cumulative effect can be calculated. A change from LIFO to FIFO for inventory valuation (costing) is a change in accounting principle.

An exception is made however, for a change in depreciation method, since a change in depreciation method is no longer considered to be a change in accounting principle. A change in depreciation method is now considered to be both a change in principle and a change in estimate. These changes should now be accounted for as a change in estimate and handled prospectively. The new depreciation method should be used as of the beginning of the year of change and should start with the current book value of the underlying asset. No retroactive or retrospective calculations should be made, and no adjustment should be made to retained earnings.

Choices "a", "b", and "d" are incorrect, per the above explanation.

**CPA-00222 Type1 M/C A-D Corr Ans: B PM#35 F 1-99**

116. CPA-00222 Nov 91 #16 Page 27

Earnings per share data should be reported on the income statement for:

| | *Extraordinary items* | *Income before extraordinary items* |
|---|---|---|
| a. | Yes | No |
| b. | Yes | Yes |
| c. | No | Yes |
| d. | No | No |

**CPA-00222 Explanation**
Choice "b" is correct. Yes - Yes.

Both the "extraordinary items" and "income before extraordinary items" should be shown with an earnings per share number on the income statement.

**CPA-00223 Type1 M/C A-D Corr Ans: C PM#36 F 1-99**

117. CPA-00223 Nov 91 #24 Page 24

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

a. By restating the financial statements of all prior periods presented.
b. As a correction of an error.


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

**CPA-00223 Explanation**
Choice "c" is correct. A change in accounting principle that is inseparable from a change in accounting estimate should now be reported as a change in estimate and thus as a component of income from continuing operations, in the period of change and future periods if the change affects both.

Distinguishing between a change in accounting principle and a change in accounting estimate is sometimes difficult. For example, a company may change from deferring and amortizing a cost to recording it as an expense when incurred because future benefits of the cost have become doubtful. The new accounting method is adopted, therefore, in partial or complete recognition of the change in estimated future benefits. The effect of the change in principle is inseparable from the effect of the change in estimate. Changes of this type are often related to the continuing process of obtaining additional information and revising estimates and are therefore considered as changes in estimates.

Choice "a" is incorrect. Restating the financial statements of all prior periods would be done in the case of prior period adjustments (corrections of errors), changes in accounting principle (retrospective application), and changes in accounting entity (retrospective application).

Choice "b" is incorrect. Correction of an error would be treated as a prior period adjustment.

Choice "d" is incorrect. Separate disclosure after income from continuing operations would be done in the case of extraordinary items or discontinued operations. However, this disclosure would not be made "in the period of change and future periods if the change affects both" but only in the period of the extraordinary item or discontinued operation.

**CPA-00224 Type1 M/C A-D Corr Ans: B PM#37 F 1-99**

118. CPA-00224 Nov 91 #25 Page 29

In single period statements, which of the following should not be reflected as an adjustment to the opening balance of retained earnings?

a. Effect of a failure to provide for uncollectible accounts in the previous period.
b. Effect of a decrease in the estimated useful life of depreciable equipment.
c. Cumulative effect of a change from the percentage of completion to the completed contract method of accounting for long-term construction projects.
d. Cumulative effect of a change from LIFO to FIFO in valuing merchandise inventory.

**CPA-00224 Explanation**
Choice "b" is correct. A change in the estimated useful life of a depreciable asset is a change in estimate handled prospectively. No adjustment to retained earnings is necessary.

Choice "a" is incorrect. The correction of a failure to provide for uncollectible accounts is considered to be a correction of an error. The opening balance of retained earnings would be adjusted to correct the error.

Choice "c" is incorrect. This change is a change in accounting principle and is handled retrospectively. With retrospective application, the opening balance of retained earnings would be adjusted to reflect the cumulative effect of the changes.

Choice "d" is incorrect. This change is a change in accounting principle and is handled retrospectively. With retrospective application, the opening balance of retained earnings would be adjusted to reflect the cumulative effect of the changes.

**CPA-00225 Type1 M/C A-D Corr Ans: A PM#38 F 1-99**

119. CPA-00225 Nov 91 #26 Page 27


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In 1990, Brighton Co. changed from the individual item approach to the aggregate approach in applying the lower of FIFO cost or market to inventories. The cumulative effect of this change should be reported in Brighton's financial statements as a:

a. Retrospective adjustment on the retained earnings statement, with separate disclosure.
b. Component of income from continuing operations, with separate disclosure.
c. Component of income from continuing operations, without separate disclosure.
d. Component of income after continuing operations, with separate disclosure.

**CPA-00225 Explanation**

Choice "a" is correct. A change in the composition of the elements of cost such as changing from the individual item approach to the aggregate approach in applying the lower of FIFO cost or market to inventories (LCM is covered in F4) is an example of a change in accounting principle. The cumulative effect of the change in accounting principle should now be shown on the retained earnings statement as an adjustment to the beginning balance of retained earnings, in what is called retrospective application.

Choices "b", "c", and "d" are incorrect. The cumulative effect of a change in accounting principle is now reported on the retained earnings statement, not the income statement. Most of these types of changes (changes in accounting principle) used to be reported on the income statement. SFAS No. 154 changed that.

**CPA-00226 Type1 M/C A-D Corr Ans: C PM#39 F 1-99**

120. CPA-00226 May 92 II #2 Page 28

While preparing its 1991 financial statements, Dek Corp. discovered computational errors in its 1990 and 1989 depreciation expense. These errors resulted in overstatement of each year's income by $25,000, net of income taxes. The following amounts were reported in the previously issued financial statements:

| | *1990* | *1989* |
|---|---|---|
| Retained earnings, 1/1 | $700,000 | $500,000 |
| Net income | $150,000 | $200,000 |
| Retained earnings, 12/31 | $850,000 | $700,000 |

Dek's 1991 net income is correctly reported at $180,000. Which of the following amounts should be reported as prior period adjustments and net income in Dek's 1991 and 1990 comparative financial statements?

| | *Year* | *Prior Period Adjustment* | *Net Income* |
|---|---|---|---|
| a. | 1990 | - | $150,000 |
| | 1991 | ($50,000) | $180,000 |
| b. | 1990 | ($50,000) | $150,000 |
| | 1991 | - | $180,000 |
| c. | 1990 | ($25,000) | $125,000 |
| | 1991 | - | $180,000 |
| d. | 1990 | - | $125,000 |
| | 1991 | - | $180,000 |

**CPA-00226 Explanation**

| | | | |
|---|---|---|---|
| Choice "c" is correct. | 1990 | ($25,000) | $125,000 |
| | 1991 | -- | 180,000 |

Because these are comparative financial statements, prior period adjustments require retroactive treatment for the years presented. Because 1989 is not presented, the 1989 correction is shown as a prior period adjustment of $25,000 to retained earnings statement of 1990.

**CPA-00227 Type1 M/C A-D Corr Ans: B PM#40 F 1-99**

121. CPA-00227 Nov 92 I #8 Page 29


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Tack, Inc. reported a retained earnings balance of $150,000 at December 31,1990. In June 1991, Tack discovered that merchandise costing $40,000 had not been included in inventory in its 1990 financial statements. Tack has a 30% tax rate. What amount should Tack report as adjusted beginning retained earnings in its statement of retained earnings at December 31, 1991?

a. $190,000
b. $178,000
c. $150,000
d. $122,000

**CPA-00227 Explanation**

| | | |
|---|---|---|
| Retained earnings as previously reported 12-31-90 | | $150,000 |
| Add: Adjustment for inventory not recorded | $40,000 | |
| Less applicable tax (30% × 40,000) | (12,000) | 28,000 |
| As restated | | $178,000 **B** |

Choice "b" is correct. $178,000.

**CPA-00228 Type1 M/C A-D Corr Ans: B PM#41 F 1-99**

122. CPA-00228 Nov 92 II #46 Page 29

On January 2, 1991, Air, Inc. agreed to pay its former president $300,000 under a deferred compensation arrangement. Air should have recorded this expense in 1990 but did not do so. Air's reported income tax expense would have been $70,000 lower in 1990 had it properly accrued this deferred compensation in its December 31,1991, financial statements, Air should adjust the beginning balance of its retained earnings by a:

a. $230,000 credit.
b. $230,000 debit.
c. $300,000 credit.
d. $370,000 debit.

**CPA-00228 Explanation**

| | |
|---|---|
| Less adjustments (shown "net of tax"): | |
| Deferred compensation | $ 300,000 |
| Less: Applicable tax | (70,000) |
| Debit to subtract | $ 230,000 **B** |

Choice "b" is correct. $230,000 debit.

**CPA-00229 Type1 M/C A-D Corr Ans: A PM#42 F 1-99**

123. CPA-00229 May 93 T #20 Page 25

On August 31, 1992, Harvey Co. decided to change from the FIFO periodic inventory system to the weighted average periodic inventory system. Harvey is on a calendar year basis. The cumulative effect of the change is determined:

a. As of January 1, 1992.
b. As of August 31, 1992.
c. During the eight months ending August 31, 1992, by a weighted average of the purchases.
d. During 1992 by a weighted average of the purchases.

**CPA-00229 Explanation**

**Rule:** The cumulative effect of a change in accounting principle equals the difference between retained earnings at the beginning of period of the change and what retained earnings would have been if the change was applied to all affected prior periods.


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Choice "a" is correct. As of January 1, 1992, the beginning of the year. This assumes that the company is not presenting comparative financial statements. If comparative financial statements are presented, then the adjustment is made to the beginning retained earnings of the earliest year presented.

Choice "b" is incorrect. The cumulative effect of the change is not determined as of the date the decision is made.

Choices "c" and "d" are incorrect. The cumulative effect of the change is not determined by a weighted average. (A far out distractor.)

**CPA-00230 Type1 M/C A-D Corr Ans: B PM#43 F 1-99**

124. CPA-00230 Nov 93 I #10 Page 29

Conn Co. reported a retained earnings balance of $400,000 at December 31, 1991. In August 1992, Conn determined that insurance premiums of $60,000 for the three-year period beginning January 1, 1991, had been paid and fully expensed in 1991. Conn has a 30% income tax rate. What amount should Conn report as adjusted beginning retained earnings in its 1992 statement of retained earnings?

a. $420,000
b. $428,000
c. $440,000
d. $442,000

**CPA-00230 Explanation**

| | |
|---|---|
| Beginning balance - RE 12-31-91 | $400,000 |
| Add: Prior period adjustment - Net of tax: | |
| $60,000 3-year insurance policy 1-1-91 to 1-1-94 | |
| Expensed in 1991. 2/3 prepaid at | |
| 1-1-92. ($60,000 × 2/3 = $40,000 × 70% net of tax) | 28,000 |
| Adjusted balance – RE 1-1-92 | $428,000 |

**B**

Choice "b" is correct. $428,000 net of tax.

**CPA-00232 Type1 M/C A-D Corr Ans: C PM#44 F 1-99**

125. CPA-00232 Dec 97 C #1 Page 33

Which of the following is true regarding the presentation of "comprehensive income."

| | *Must be shown on the face of the income statement* | *Related tax effects for components must be disclosed* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |

**CPA-00232 Explanation**

Choice "c" is correct. No - Yes.

Comprehensive income may be shown on the face of a combined "statement of income and comprehensive income" a separate section below net income, or in:

1. Separate "statement of comprehensive income," or as a
2. Component of the "statement of changes of owners' equity."

The income tax expense or benefit allocated to components must be disclosed, either on the face of the statement or in notes to the statement.


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Choices "a", "b", and "d" are incorrect, per the above rules.

**CPA-00233 Type1 M/C A-D Corr Ans: C PM#45 F 1-99**

126. CPA-00233 Dec 97 C #2 Page 35

Reclassification adjustments must be shown in the financial statement that discloses comprehensive income:

a. To show what portion of comprehensive income is from the realization of current assets.
b. To show the tax effect of items of comprehensive income.
c. To avoid double counting in comprehensive income items, which are currently displayed in net income.
d. To avoid including transactions with shareholders in items of comprehensive income.

**CPA-00233 Explanation**
Choice "c" is correct. Reclassification entries may be necessary to avoid double counting an item previously reported as comprehensive income (i.e., unrealized gain), which are now reported as part of net income (i.e., realized gain).

Choice "a" is incorrect. The classification of assets as current or non-current has no bearing on reporting comprehensive income.

Choice "b" is incorrect. All items of comprehensive income must be shown net of the related tax effects, but it is not done with reclassification adjustments.

Choice "d" is incorrect. Transactions with shareholders such as paying dividends and issuing capital stock are not included in comprehensive income, thus, reclassification adjustments are not necessary to exclude them.

**CPA-00234 Type1 M/C A-D Corr Ans: C PM#46 F 1-99**

127. CPA-00234 Nov 90 I #53 Page 37

Dean Co. acquired 100% of Morey Corp. prior to 1989. During 1989, the individual companies included in their financial statements the following:

| | *Dean* | *Morey* |
|---|---|---|
| Officers' salaries | $ 75,000 | $ 50,000 |
| Officers' expenses | 20,000 | 10,000 |
| Loans to officers | 125,000 | 50,000 |
| Intercompany Sales | 150,000 | -- |

What amount should be reported as related party disclosures in the notes to Dean's 1989 consolidated financial statements?

a. $150,000
b. $155,000
c. $175,000
d. $330,000

**CPA-00234 Explanation**
Choice "c" is correct. The only related party transaction that would require disclosure (assuming that all amounts are material to the financial statements) would be the loans to officers since they are outside of the ordinary course of business.

Choices "a", "b", and "d" are incorrect. Officers' salaries, officers' expenses and intercompany sales (between entities included in a consolidated set of financial statements) are all transactions in the ordinary course of business and generally would not require disclosure.

**CPA-00236 Type1 M/C A-D Corr Ans: A PM#47 F 1-99**


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128. CPA-00236 FARE R99 #18 Page 63

Wilson Corp. experienced a $50,000 decline in the market value of its inventory in the first quarter of its fiscal year. Wilson had expected this decline to reverse in the third quarter, and in fact, the third quarter recovery exceeded the previous decline by $10,000. Wilson's inventory did not experience any other declines in market value during the fiscal year. What amounts of loss and/or gain should Wilson report in its interim financial statements for the first and third quarters?

| | *First quarter* | *Third quarter* |
|---|---|---|
| a. | $0 | $0 |
| b. | $0 | $10,000 gain |
| c. | $50,000 loss | $50,000 gain |
| d. | $50,000 loss | $60,000 gain |

**CPA-00236 Explanation**
Choice "a" is correct. Temporary market declines in inventory need not be recognized at interim when a turn-around can reasonably be expected to occur before the end of the fiscal year.

**CPA-00237 Type1 M/C A-D Corr Ans: A PM#48 F 1-99**

129. CPA-00237 Nov 88 I #46 Page 37

During the second quarter of 1988, Buzz Company sold a piece of equipment at a $12,000 gain. What portion of the gain should Buzz report in its income statement for the second quarter of 1988?

a. $12,000
b. $6,000
c. $4,000
d. $0

**CPA-00237 Explanation**
Choice "a" is correct. $12,000.

**Rule:** The entire amount of an "extraordinary gain or loss" or an "unusual or infrequently occurring item," e.g., a gain or loss from sale of fixed assets, should be reported during the period (quarter) incurred.

Choices "b", "c", and "d" are incorrect. The full gain should be reported in the second quarter when it occurred.

**CPA-00238 Type1 M/C A-D Corr Ans: D PM#49 F 1-99**

130. CPA-00238 Nov 89 #35 Page 38

For interim financial reporting, the computation of a company's second quarter provision for income taxes uses an effective tax rate expected to be applicable for the full fiscal year. The effective tax rate should reflect anticipated:

| | *Foreign tax rates* | *Available tax planning alternatives* |
|---|---|---|
| a. | No | Yes |
| b. | No | No |
| c. | Yes | No |
| d. | Yes | Yes |

**CPA-00238 Explanation**
Choice "d" is correct. Yes - Yes.

The effective income tax rates for operations for the full year should reflect anticipated foreign tax rates and available tax planning alternatives. In addition, the effect of other anticipated tax credits, capital gains rates, and foreign tax credits should be included.


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**CPA-00239 Type1 M/C A-D Corr Ans: D PM#50 F 1-99**

131. CPA-00239 May 90 II #43 Page 63

An inventory loss from a permanent market decline of $360,000 occurred in May 1989. Cox Co. appropriately recorded this loss in May 1989 after its March 31, 1989 quarterly report was issued. What amount of inventory loss should be reported in Cox's quarterly income statement for the three months ended June 30, 1989?

a. $0
b. $90,000
c. $180,000
d. $360,000

**CPA-00239 Explanation**
Choice "d" is correct. $360,000 inventory loss reported for the quarter ended 6-30-89.

**Rule:** Inventory losses from "permanent market declines" are recognized in the interim period, incurred and later, if they "turn-around," are recognized as gains in a subsequent interim period only to the extent of previously reported losses.

**Rule:** "Temporary" market declines need not be recognized at interim when a "turn-around" can reasonably be expected to occur before the end of the fiscal year.

Facts: This $360,000 inventory decline is permanent and the entire loss would be recognized in the quarter interim period incurred (6-30-89).

**CPA-00240 Type1 M/C A-D Corr Ans: B PM#51 F 1-99**

132. CPA-00240 May 90 #34 Page 38

Advertising costs may be accrued or deferred to provide an appropriate expense in each period for:

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

**CPA-00240 Explanation**
Choice "b" is correct. Yes - Yes.

Advertising costs may be accrued or deferred to provide an appropriate expense in each period for both "interim" and "year-end" financial reporting.

**CPA-00241 Type1 M/C A-D Corr Ans: D PM#52 F 1-99**

133. CPA-00241 May 91 #36 Page 63

A planned volume variance in the first quarter, which is expected to be absorbed by the end of the fiscal period, ordinarily should be deferred at the end of the first quarter if it is:

| | *Favorable* | *Unfavorable* |
|---|---|---|
| a. | Yes | No |
| b. | No | Yes |
| c. | No | No |
| d. | Yes | Yes |

**CPA-00241 Explanation**
Choice "d" is correct. Yes - Yes.


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**Rule:** Volume variances that are planned or expected to be absorbed by the end of the year should be deferred at interim whether favorable or unfavorable.

**CPA-00242 Type1 M/C A-D Corr Ans: A PM#53 F 1-99**

134. CPA-00242 Nov 91 II #13 Page 63

Kell Corp.'s $95,000 net income for the quarter ended September 30, 1990, included the following after-tax items:

- A $60,000 extraordinary gain, realized on April 30, 1990, was allocated equally to the second, third, and fourth quarters of 1990.
- A $16,000 cumulative-effect loss resulting from a change in inventory valuation method was recognized on August 2, 1990.

In addition, Kell paid $48,000 on February 1, 1990, for 1990 calendar-year property taxes. Of this amount, $12,000 was allocated to the third quarter of 1990.

For the quarter ended September 30, 1990, Kell should report net income of:

a. $91,000
b. $103,000
c. $111,000
d. $115,000

**CPA-00242 Explanation**
Choice "a" is correct. $91,000 net income for the third quarter ended 9-30-90.

**Rules:** The entire amount of an "extraordinary" item should be reported during the period incurred.

A "cumulative effect" type accounting change is not included in the net income of the period of change; instead, the beginning of the year retained earnings is restated.

Expenses, which benefit more than one interim period, such as property taxes, are allocated among the periods benefited.

| | |
|---|---|
| Third quarter income as originally calculated | $95,000 |
| Less: 1/3 of second quarter extraordinary gain | (20,000) |
| Subtotal | $75,000 |
| Plus: Cumulative effect of accounting change | 16,000 |
| Corrected third quarter net income | $91,000 |

**CPA-00243 Type1 M/C A-D Corr Ans: B PM#54 F 1-99**

135. CPA-00243 May 92 II #12 (Adapted) Page 64

On June 30, 1991, Mill Corp. incurred a $100,000 net loss from disposal of a component of a business. Also, on June 30, 1991, Mill paid $40,000 for property taxes assessed for the calendar year 1991. What amount of the foregoing items should be included in the determination of Mill's net income or loss for the six-month interim period ended June 30, 1991?

a. $140,000
b. $120,000
c. $90,000
d. $70,000

**CPA-00243 Explanation**
Choice "b" is correct. $120,000 expense included in the determination of net income or loss for the six-month interim period ended June 30, 1991.

**Rules:**
The net loss on disposal of a component is recorded in the interim period incurred $100,000


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| | |
|---|---|
| Property taxes should be allocated over the periods ($40,000 ÷ 2) | 20,000 |
| Expenses for six-month interim period | $120,000 |

**CPA-00244 Type1 M/C A-D Corr Ans: C PM#55 F 1-99**

136. CPA-00244 Nov 92 II #52 Page 38

On March 15, 1992, Krol Co. paid property taxes of $90,000 on its office building for the calendar year 1992. On April 1, 1992, Krol paid $150,000 for unanticipated repairs to its office equipment. The repairs will benefit operations for the remainder of 1992. What is the total amount of these expenses that Krol should include in its quarterly income statement for the three months ended June 30, 1992?

a. $172,500
b. $97,500
c. $72,500
d. $37,500

**CPA-00244 Explanation**
**Rule:** Actual and estimated expenditures benefiting all interim periods equally should be expensed ratably throughout the year.

| | | Quarterly |
|---|---|---|
| Annual property taxes | $90,000 ÷ 4 = | $22,500 |
| Repairs which will benefit operations for 3 quarters remaining in year | 150,000 ÷ 3 = | 50,000 |
| | | $72,500 **C** |

Choice "c" is correct. $72,500 total expense for the three months ended June 30, 1992.

**CPA-00245 Type1 M/C A-D Corr Ans: A PM#56 F 1-99**

137. CPA-00245 Nov 92 #16 Page 63

An inventory loss from a market price decline occurred in the first quarter, and the decline was not expected to reverse during the fiscal year. However, in the third quarter the inventory's market price recovery exceeded the market decline that occurred in the first quarter. For interim financial reporting, the dollar amount of net inventory should:

a. Decrease in the first quarter by the amount of the market price decline and increase in the third quarter by the amount of the decrease in the first quarter.
b. Decrease in the first quarter by the amount of the market price decline and increase in the third quarter by the amount of the market price recovery.
c. Decrease in the first quarter by the amount of the market price decline and not be affected in the third quarter.
d. Not be affected in either the first quarter or the third quarter.

**CPA-00245 Explanation**
Choice "a" is correct. Market price declines should be recognized in the interim period in which decline is judged permanent and later, if they "turn around," are recognized as gains in subsequent periods only to the extent of previously reported losses.

Choice "b" is incorrect. Recovery should not cause an increase in inventory value above original cost.

Choice "c" is incorrect. The recovery should be recognized to the extent of the first quarter write down.

Choice "d" is incorrect.

**CPA-00247 Type1 M/C A-D Corr Ans: B PM#58 F 1-99**

138. CPA-00247 May 89 II #20 Page 41


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The following information pertains to Aria Corp. and its divisions for the year ended December 31, 1988:

| | |
|---|---|
| Sales to unaffiliated customers | $2,000,000 |
| Intersegment sales of products similar to those sold to unaffiliated customers | 600,000 |
| Interest earned on loans to other industry segments | 40,000 |

Aria and all of its divisions are engaged solely in manufacturing operations. Aria has a reportable segment if that segment's revenue exceeds:

a. $264,000
b. $260,000
c. $204,000
d. $200,000

**CPA-00247 Explanation**
Choice "b" is correct. $260,000 represents a reportable segment (10% of total sales):

| | |
|---|---|
| Including unaffiliated sales | $2,000,000 |
| and intersegment sales | 600,000 |
| Total combined sales | 2,600,000 |
| | × 10% |
| | $ 260,000 |

**Rule:** To be significant enough to report on, a segment must be at least 10% of:

1. Combined revenues (whether intersegment or unaffiliated customers), or
2. Operating income, or
3. Identifiable assets.

**CPA-00248 Type1 M/C A-D Corr Ans: D PM#59 F 1-99**

139. CPA-00248 May 90 II #54 Page 42

Hyde Corp. has three manufacturing divisions, each of which has been determined to be a reportable segment. In 1989, Clay division had sales of $3,000,000, which was 25% of Hyde's total sales, and had operating costs of $1,900,000, as reported to the CFO. In 1989, Hyde incurred operating costs of $500,000 that were not directly traceable to any of the divisions. In addition, Hyde incurred corporate interest expense of $300,000 in 1989. In reporting segment information, what amount should be shown as Clay's operating profit for 1989?

a. $875,000
b. $900,000
c. $975,000
d. $1,100,000

**CPA-00248 Explanation**
Choice "d" is correct. $1,100,000 operating profit for clay.

**Rule:** Operating profit by segments is based on the measure of profit reported to the "chief operating decision maker."

Allocations for general operating costs and interest, etc., should not be made solely for purposes of segment disclosures.

| | |
|---|---|
| Sales | $3,000,000 |
| Less operating costs | (1,900,000) |
| Sub total | $1,100,000 |

**CPA-00249 Type1 M/C A-D Corr Ans: C PM#60 F 1-99**

140. CPA-00249 May 90 #36 Page 41


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YIV, Inc. is a multidivisional corporation, which has both intersegment sales and sales to unaffiliated customers. YIV should report segment financial information for each division meeting which of the following criteria?

a. Segment operating profit or loss is 10% or more of consolidated profit or loss.
b. Segment operating profit or loss is 10% or more of combined operating profit or loss of all company segments.
c. Segment revenue is 10% or more of combined revenue of all the company segments.
d. Segment revenue is 10% or more of consolidated revenue.

**CPA-00249 Explanation**
Choice "c" is correct. Segment revenue is 10% or more of combined revenue of all the company segments.

**Rule:** To be significant enough to report on, a segment must be at least 10% of:

1. Combined revenues (whether intersegment or affiliated customers) or
2. Operating profit (of all segments not having an operating loss), or
3. Identifiable assets.

Choice "a" is incorrect. Rule is 10% of "operating profit," not "consolidated profit."

Choice "b" is incorrect. Segments with "operating losses" are not combined with those having "operating profits" in determining a segment.

Choice "d" is incorrect. "Consolidated revenue" would not include "intersegment revenue." Rule is "combined revenue," not "consolidated revenue."

**CPA-00250 Type1 M/C A-D Corr Ans: D PM#61 F 1-99**

141. CPA-00250 Nov 92 II #54 Page 41

Grum Corp., a publicly-owned corporation, is subject to the requirements for segment reporting. In its income statement for the year ended December 31, 1991, Grum reported revenues of $50,000,000, operating expenses of $47,000,000, and net income of $3,000,000. Operating expenses include payroll costs of $ 15,000,000. Grum's combined identifiable assets of all industry segments at December 31, 1991, were $40,000,000.

In its 1991 financial statements, Grum should disclose major customer data if sales to any single customer amount to at least:

a. $300,000
b. $1,500,000
c. $4,000,000
d. $5,000,000

**CPA-00250 Explanation**
Choice "d" is correct. $5,000,000 (10% x $50,000,000 revenue). If revenue from a single external customer is 10% or more of total revenue, then the company should disclose this fact, the total amount of revenue from the customer, and the segment or segments reporting the revenues. The identity of the customer need not be disclosed.

**CPA-00251 Type1 M/C A-D Corr Ans: D PM#62 F 1-99**

142. CPA-00251 Nov 92 #36 Page 41

Grum Corp., a publicly-owned corporation, is subject to the requirements for segment reporting. In its income statement for the year ended December 31, 1991, Grum reported revenues of $50,000,000, operating expenses of $47,000,000, and net income of $3,000,000. Operating expenses include payroll costs of $ 15,000,000. Grum's combined identifiable assets of all industry segments at December 31, 1991, were $40,000,000.


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Cott Co.'s four business segments have revenues and identifiable assets expressed as percentages of Cott's total revenues and total assets as follows:

| | *Revenues* | *Assets* |
|---|---|---|
| Ebon | 64% | 66% |
| Fair | 14% | 18% |
| Gel | 14% | 4% |
| Hak | 8% | 12% |
| | 100% | 100% |

Which of these business segments are deemed to be reportable segments?

a. Ebon only.
b. Ebon and Fair only.
c. Ebon, Fair, and Gel only.
d. Ebon, Fair, Gel, and Hak.

**CPA-00251 Explanation**
**Rule:** A segment must be at least 10% of:

1. Combined revenues (whether intersegment or unaffiliated customers), or
2. Operating income (of all segments not having an operating loss), or
3. Identifiable assets.

Choice "d" is correct. Ebon, Fair, Gel, and Hak, since all four companies meet at least one of the criteria.

**CPA-00252 Type1 M/C A-D Corr Ans: D PM#63 F 1-99**

143. CPA-00252 Nov 89 I #4 Page 43

Chester Corp. was a development stage enterprise from its inception on September 1, 1987 to December 31, 1988. The following information was taken from Chester's accounting records for the above period:

| | |
|---|---|
| Net sales | $1,350,000 |
| Cost of sales | 1,000,000 |
| Selling, general, and administrative expenses | 400,000 |
| Research and development costs | 300,000 |
| Interest expense | 100,000 |

For the period September 1, 1987 to December 31, 1988, what amount should Chester report as net loss?

a. $ 50,000
b. $150,000
c. $350,000
d. $450,000

**CPA-00252 Explanation**
Choice "d" is correct. $450,000 net loss for the period Sept. 1, 1987 to Dec. 31, 1988.

**Rule:** "Development stage enterprises" present their FS in accordance with GAAP and make additional disclosures such as: cumulative net losses, cumulative deficit, cumulative sales and expenses.

| | |
|---|---|
| Net sales | $1,350,000 |
| Cost of sales | (1,000,000) |
| Selling, general and administrative exp. | (400,000) |
| Research & development costs (100% expense) | (300,000) |
| Interest expense | (100,000) |
| Net loss (9/1/87 to 12/31/88) | (450,000) |

**CPA-00253 Type1 M/C A-D Corr Ans: B PM#64 F 1-99**


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144. CPA-00253 Nov 90 #8 Page 43

Deficits accumulated during the development stage of a company should be:

a. Reported as organization costs.
b. Reported as a part of stockholders' equity.
c. Capitalized and written off in the first year of principal operations.
d. Capitalized and amortized over a five year period beginning when principal operations commence.

**CPA-00253 Explanation**
Choice "b" is correct. Deficits accumulated during the development stage of a company should be reported as a part of stockholders' equity.

**Rule:** Development stage enterprises should present FS in accordance with GAAP and make additional disclosures such as: cumulative net losses, cumulative deficit (as part of equity), cumulative sales & expenses (part of I/S), cumulative statement of cash flows and supplementary "shareholders equity."

Choices "a", "c", and "d" are incorrect, per the rule above.

**CPA-00254 Type1 M/C A-D Corr Ans: A PM#65 F 1-99**

145. CPA-00254 May 92 #49 Page 43

Financial reporting by a development stage enterprise differs from financial reporting for an established operating enterprise in regard to footnote disclosures:

a. Only.
b. And expense recognition principles only.
c. And revenue recognition principles only.
d. And revenue and expense recognition principles.

**CPA-00254 Explanation**
Choice "a" is correct. Financial reporting by a development stage enterprise differs from financial reporting for an established operating enterprise in regard to (more extensive) footnote disclosures only.

Choices "b", "c", and "d" are incorrect. Revenue and expense recognition principles are the same.

**Rule:** Development stage enterprises should present financial statements in accordance with GAAP and make additional disclosures such as: cumulative net losses, cumulative deficit (as part of equity), cumulative sales and expenses (as part of the income statement), cumulative statement of cash flows and supplementary "shareholders equity."

**CPA-00255 Type1 M/C A-D Corr Ans: A PM#66 F 1-99**

146. CPA-00255 Nov 92 #44 Page 43

A statement of cash flows for a development stage enterprise:

a. Is the same as that of an established operating enterprise and, in addition, shows cumulative amounts from the enterprise's inception.
b. Shows only cumulative amounts from the enterprise's inception.
c. Is the same as that of an established operating enterprise, but does not show cumulative amounts from the enterprise's inception.
d. Is not presented.

**CPA-00255 Explanation**
**Rule:** Development stage enterprises should present financial statements in accordance with GAAP and make additional disclosures such as cumulative amounts from inception for: net losses, deficits, sales, expenses, and cash flows and supplementary data.

Choice "a" is correct, per the rule shown above.

Choice "b" is incorrect. Current amounts are shown as well as cumulative amounts.


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Choice "c" is incorrect. Cumulative amounts from inception are shown.

Choice "d" is incorrect. A statement of cash flows is required.

**CPA-04554 Type1 M/C A-D Corr Ans: A PM#67 F 1-99**

147. CPA-04554 May 94 No. 2 1A Page 3

On January 2, 1993, Quo, Inc. hired Reed to be its controller. During the year, Reed, working closely with Quo's president and outside accountants, made changes in accounting policies, corrected several errors dating from 1992 and before, and instituted new accounting policies.

Quo's 1993 financial statements will be presented in comparative form with its 1992 financial statements.

This question represents one of Quo's transactions. List A represents possible clarifications of these transactions as: a change in accounting principle, a change in accounting estimate, a correction of an error in previously presented financial statements, or neither an accounting change nor an accounting error.

**Item to Be Answered**
Quo manufactures heavy equipment to customer specifications on a contract basis. On the basis that it is preferable, accounting for these long-term contracts was switched from the completed-contract method to the percentage-of-completion method.

*List A (Select one)*

a. Change in accounting principal.
b. Change in accounting estimate.
c. Correction of an error in previously presented financial statements.
d. Neither an accounting change nor an accounting error.

**CPA-04554 Explanation**
Choice "a" is correct. Switching from the completed-contract method of accounting to the percentage-of-completion method is a "**change in accounting principle**."

**CPA-04555 Type1 M/C X,Y,Z Corr Ans: Y PM#68 F 1-99**

148. CPA-04555 May 94 No. 2 1B Page 25

On January 2, 1993, Quo, Inc. hired Reed to be its controller. During the year, Reed, working closely with Quo's president and outside accountants, made changes in accounting policies, corrected several errors dating from 1992 and before, and instituted new accounting policies.

Quo's 1993 financial statements will be presented in comparative form with its 1992 financial statements.

This question represents one of Quo's transactions. List B represents the general accounting treatment required for these transactions. These treatments are:

- Cumulative effect approach - Include the cumulative effect of the adjustment resulting from the accounting change or error correction in the 1993 financial statements, and do **not** restate the 1992 financial statements.
- Retroactive or retrospective restatement approach - Restate the 1992 financial statements and adjust 1992 beginning retained earnings if the error or change affects a period prior to 1992.
- Prospective approach - Report 1993 and future financial statements on the new basis but do **not** restate 1992 financial statements.

**Item to Be Answered**
Quo manufactures heavy equipment to customer specifications on a contract basis. On the basis that it is preferable, accounting for these long-term contracts was switched from the completed-contract method to the percentage-of-completion method.

*List B (Select one)*

X. Cumulative effect approach.


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Y. Retroactive or retrospective restatement approach.
Z. Prospective approach.

**CPA-04555 Explanation**
Choice "Y" is correct. Changes in accounting principle are handled "retrospectively." Beginning retained earnings of the earliest year presented is adjusted for the cumulative effect of the change and all prior year financial statements are restated.

**CPA-04556 Type1 M/C A-D Corr Ans: B PM#69 F 1-99**

149. CPA-04556 May 94 No. 2 2A Page 26

On January 2, 1993, Quo, Inc. hired Reed to be its controller. During the year, Reed, working closely with Quo's president and outside accountants, made changes in accounting policies, corrected several errors dating from 1992 and before, and instituted new accounting policies.

Quo's 1993 financial statements will be presented in comparative form with its 1992 financial statements.

This question represents one of Quo's transactions. List A represents possible clarifications of these transactions as: a change in accounting principle, a change in accounting estimate, a correction of an error in previously presented financial statements, or neither an accounting change nor an accounting error.

**Item to Be Answered**
As a result of a production breakthrough, Quo determined that manufacturing equipment previously depreciated over 15 years should be depreciated over 20 years.

*List A (Select one)*
a. Change in accounting principal.
b. Change in accounting estimate.
c. Correction of an error in previously presented financial statements.
d. Neither an accounting change nor an accounting error.

**CPA-04556 Explanation**
Choice "b" is correct. Change in lives of fixed assets is a **change in accounting estimate.**

**CPA-04557 Type1 M/C X,Y,Z Corr Ans: Z PM#70 F 1-99**

150. CPA-04557 May 94 No. 2 2B Page 26

On January 2, 1993, Quo, Inc. hired Reed to be its controller. During the year, Reed, working closely with Quo's president and outside accountants, made changes in accounting policies, corrected several errors dating from 1992 and before, and instituted new accounting policies.

Quo's 1993 financial statements will be presented in comparative form with its 1992 financial statements.

This question represents one of Quo's transactions. List B represents the general accounting treatment required for these transactions. These treatments are:

- Cumulative effect approach - Include the cumulative effect of the adjustment resulting from the accounting change or error correction in the 1993 financial statements, and do **not** restate the 1992 financial statements.
- Retroactive or retrospective restatement approach - Restate the 1992 financial statements and adjust 1992 beginning retained earnings if the error or change affects a period prior to 1992.
- Prospective approach - Report 1993 and future financial statements on the new basis but do **not** restate 1992 financial statements.

**Item to Be Answered**
As a result of a production breakthrough, Quo determined that manufacturing equipment previously depreciated over 15 years should be depreciated over 20 years.

*List B (Select one)*


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X. Cumulative effect approach.
Y. Retroactive or retrospective restatement approach.
Z. Prospective approach.

**CPA-04557 Explanation**
Choice "Z" is correct. This affects only the **prospective (current and subsequent) periods** - not prior periods, not retained earnings.

**CPA-04558 Type1 M/C A-D Corr Ans: B PM#71 F 1-99**

151. CPA-04558 May 94 No. 2 3A Page 24

On January 2, 1993, Quo, Inc. hired Reed to be its controller. During the year, Reed, working closely with Quo's president and outside accountants, made changes in accounting policies, corrected several errors dating from 1992 and before, and instituted new accounting policies.

Quo's 1993 financial statements will be presented in comparative form with its 1992 financial statements.

This question represents one of Quo's transactions. List A represents possible clarifications of these transactions as: a change in accounting principle, a change in accounting estimate, a correction of an error in previously presented financial statements, or neither an accounting change nor an accounting error.

**Item to Be Answered**
The equipment that Quo manufactures is sold with a five-year warranty. Because of a production breakthrough, Quo reduced its computation of warranty costs from 3% of sales to 1% of sales.

*List A (Select one)*
a. Change in accounting principal.
b. Change in accounting estimate.
c. Correction of an error in previously presented financial statements.
d. Neither an accounting change nor an accounting error.

**CPA-04558 Explanation**
Choice "b" is correct. Change in the computation of warranty costs from 3% of sales to 1% of sales is a **change in accounting estimate.**

**CPA-04559 Type1 M/C X,Y,Z Corr Ans: Z PM#72 F 1-99**

152. CPA-04559 May 94 No. 2 3B Page 24

On January 2, 1993, Quo, Inc. hired Reed to be its controller. During the year, Reed, working closely with Quo's president and outside accountants, made changes in accounting policies, corrected several errors dating from 1992 and before, and instituted new accounting policies.

Quo's 1993 financial statements will be presented in comparative form with its 1992 financial statements.

This question represents one of Quo's transactions. List B represents the general accounting treatment required for these transactions. These treatments are:

- Cumulative effect approach - Include the cumulative effect of the adjustment resulting from the accounting change or error correction in the 1993 financial statements, and do **not** restate the 1992 financial statements.
- Retroactive or retrospective restatement approach - Restate the 1992 financial statements and adjust 1992 beginning retained earnings if the error or change affects a period prior to 1992.
- Prospective approach - Report 1993 and future financial statements on the new basis but do **not** restate 1992 financial statements.

**Item to Be Answered**
The equipment that Quo manufactures is sold with a five-year warranty. Because of a production breakthrough, Quo reduced its computation of warranty costs from 3% of sales to 1% of sales.


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*List B (Select one)*

X. Cumulative effect approach.
Y. Retroactive or retrospective restatement approach.
Z. Prospective approach.

**CPA-04559 Explanation**

Choice "Z" is correct. This affects only the **prospective (current and subsequent) periods** - not prior periods, not retained earnings.

**CPA-04560 Type1 M/C A-D Corr Ans: A PM#73 F 1-99**

153. CPA-04560 May 94 No. 2 4A Page 26

On January 2, 1993, Quo, Inc. hired Reed to be its controller. During the year, Reed, working closely with Quo's president and outside accountants, made changes in accounting policies, corrected several errors dating from 1992 and before, and instituted new accounting policies.

Quo's 1993 financial statements will be presented in comparative form with its 1992 financial statements.

This question represents one of Quo's transactions. List A represents possible clarifications of these transactions as: a change in accounting principle, a change in accounting estimate, a correction of an error in previously presented financial statements, or neither an accounting change nor an accounting error.

**Item to Be Answered**

Quo changed from LIFO to FIFO to account for its finished goods inventory.

*List A (Select one)*

a. Change in accounting principal.
b. Change in accounting estimate.
c. Correction of an error in previously presented financial statements.
d. Neither an accounting change nor an accounting error.

**CPA-04560 Explanation**

Choice "a" is correct. Change from **LIFO** to FIFO is a **change in accounting principle.**

**CPA-04561 Type1 M/C X,Y,Z Corr Ans: Y PM#74 F 1-99**

154. CPA-04561 May 94 No. 2 4B Page 26

On January 2, 1993, Quo, Inc. hired Reed to be its controller. During the year, Reed, working closely with Quo's president and outside accountants, made changes in accounting policies, corrected several errors dating from 1992 and before, and instituted new accounting policies.

Quo's 1993 financial statements will be presented in comparative form with its 1992 financial statements.

This question represents one of Quo's transactions. List B represents the general accounting treatment required for these transactions. These treatments are:

- Cumulative effect approach - Include the cumulative effect of the adjustment resulting from the accounting change or error correction in the 1993 financial statements, and do **not** restate the 1992 financial statements.
- Retroactive or retrospective restatement approach - Restate the 1992 financial statements and adjust 1992 beginning retained earnings if the error or change affects a period prior to 1992.
- Prospective approach - Report 1993 and future financial statements on the new basis but do **not** restate 1992 financial statements.

**Item to Be Answered**

Quo changed from LIFO to FIFO to account for its finished goods inventory.

***List B (Select one)***


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X. Cumulative effect approach.
Y. Retroactive or retrospective restatement approach.
Z. Prospective approach.

**CPA-04561 Explanation**
Choice "Y" is correct. A change in accounting principle should be shown in the retained earnings statement of the earliest year presented as an adjustment of the beginning balance. All prior year financial statements are recast.

**CPA-04562 Type1 M/C A-D Corr Ans: A PM#75 F 1-99**

155. CPA-04562 May 94 No. 2 5A Page 26

On January 2, 1993, Quo, Inc. hired Reed to be its controller. During the year, Reed, working closely with Quo's president and outside accountants, made changes in accounting policies, corrected several errors dating from 1992 and before, and instituted new accounting policies.

Quo's 1993 financial statements will be presented in comparative form with its 1992 financial statements.

This question represents one of Quo's transactions. List A represents possible clarifications of these transactions as: a change in accounting principle, a change in accounting estimate, a correction of an error in previously presented financial statements, or neither an accounting change nor an accounting error.

**Item to Be Answered**
Quo changed from FIFO to average cost to account for its raw materials and work in process inventories.

*List A (Select one)*
a. Change in accounting principal.
b. Change in accounting estimate.
c. Correction of an error in previously presented financial statements.
d. Neither an accounting change nor an accounting error.

**CPA-04562 Explanation**
Choice "a" is correct. Change in inventory pricing method from FIFO to average cost is a **change in accounting principle.**

**CPA-04563 Type1 M/C X,Y,Z Corr Ans: Y PM#76 F 1-99**

156. CPA-04563 May 94 No. 2 5B Page 26

On January 2, 1993, Quo, Inc. hired Reed to be its controller. During the year, Reed, working closely with Quo's president and outside accountants, made changes in accounting policies, corrected several errors dating from 1992 and before, and instituted new accounting policies.

Quo's 1993 financial statements will be presented in comparative form with its 1992 financial statements.

This question represents one of Quo's transactions. List B represents the general accounting treatment required for these transactions. These treatments are:

- Cumulative effect approach - Include the cumulative effect of the adjustment resulting from the accounting change or error correction in the 1993 financial statements, and do **not** restate the 1992 financial statements.
- Retroactive or retrospective restatement approach - Restate the 1992 financial statements and adjust 1992 beginning retained earnings if the error or change affects a period prior to 1992.
- Prospective approach - Report 1993 and future financial statements on the new basis but do **not** restate 1992 financial statements.

**Item to Be Answered**
Quo changed from FIFO to average cost to account for its raw materials and work in process inventories.

*List B (Select one)*


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X. Cumulative effect approach.
Y. Retroactive or retrospective restatement approach.
Z. Prospective approach.

**CPA-04563 Explanation**
Choice "Y" is correct. A change in accounting principle should be shown in the retained earnings statement of the earliest year presented as an adjustment of the beginning balance. All prior year financial statements are recast.

**CPA-04564 Type1 M/C A-D Corr Ans: C PM#77 F 1-99**

157. CPA-04564 May 94 No. 2 6A Page 29

On January 2, 1993, Quo, Inc. hired Reed to be its controller. During the year, Reed, working closely with Quo's president and outside accountants, made changes in accounting policies, corrected several errors dating from 1992 and before, and instituted new accounting policies.

Quo's 1993 financial statements will be presented in comparative form with its 1992 financial statements.

This question represents one of Quo's transactions. List A represents possible clarifications of these transactions as: a change in accounting principle, a change in accounting estimate, a correction of an error in previously presented financial statements, or neither an accounting change nor an accounting error.

**Item to Be Answered**
Quo sells extended service contracts on its products. Because related services are performed over several years, in 1993 Quo changed from the cash method to the accrual method of recognizing income from these service contracts.

*List A (Select one)*
a. Change in accounting principal.
b. Change in accounting estimate.
c. Correction of an error in previously presented financial statements.
d. Neither an accounting change nor an accounting error.

**CPA-04564 Explanation**
Choice "c" is correct. Change from the cash method to the accrual method is a **correction of an error in previously presented financial statements.**

**CPA-04565 Type1 M/C X,Y,Z Corr Ans: Y PM#78 F 1-99**

158. CPA-04565 May 94 No. 2 6B Page 29

On January 2, 1993, Quo, Inc. hired Reed to be its controller. During the year, Reed, working closely with Quo's president and outside accountants, made changes in accounting policies, corrected several errors dating from 1992 and before, and instituted new accounting policies.

Quo's 1993 financial statements will be presented in comparative form with its 1992 financial statements.

This question represents one of Quo's transactions. List B represents the general accounting treatment required for these transactions. These treatments are:

- Cumulative effect approach - Include the cumulative effect of the adjustment resulting from the accounting change or error correction in the 1993 financial statements, and do **not** restate the 1992 financial statements.
- Retroactive or retrospective restatement approach - Restate the 1992 financial statements and adjust 1992 beginning retained earnings if the error or change affects a period prior to 1992.
- Prospective approach - Report 1993 and future financial statements on the new basis but do **not** restate 1992 financial statements.


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**Item to Be Answered**
Quo sells extended service contracts on its products. Because related services are performed over several years, in 1993 Quo changed from the cash method to the accrual method of recognizing income from these service contracts.

*List B (Select one)*
X. Cumulative effect approach.
Y. Retroactive or retrospective restatement approach.
Z. Prospective approach.

**CPA-04565 Explanation**
Choice "Y" is correct. If comparative FS are issued, **restate prior year's FS.** If comparative FS are **not** issued, **restate prior year-end's retained earnings account** by "adjusting" **(net of tax)** the opening balance of the current retained earnings statement. Note that when an error is corrected, retroactive restatement is used, and when there is a change in accounting principle, retrospective restatement is done. However, this is only a difference in terminology.

**CPA-04566 Type1 M/C A-D Corr Ans: C PM#79 F 1-99**

159. CPA-04566 May 94 No. 2 7A Page 29

On January 2, 1993, Quo, Inc. hired Reed to be its controller. During the year, Reed, working closely with Quo's president and outside accountants, made changes in accounting policies, corrected several errors dating from 1992 and before, and instituted new accounting policies.

Quo's 1993 financial statements will be presented in comparative form with its 1992 financial statements.

This question represents one of Quo's transactions. List A represents possible clarifications of these transactions as: a change in accounting principle, a change in accounting estimate, a correction of an error in previously presented financial statements, or neither an accounting change nor an accounting error.

**Item to Be Answered**
During 1993, Quo determined that an insurance premium paid and entirely expensed in 1992 was for the period January 1, 1992, through January 1, 1994.

*List A (Select one)*
a. Change in accounting principal.
b. Change in accounting estimate.
c. Correction of an error in previously presented financial statements.
d. Neither an accounting change nor an accounting error.

**CPA-04566 Explanation**
Choice "c" is correct. Expensing insurance premiums when paid (rather than allocating them to the periods benefited) is a **correction of an error** in previously presented financial statements.

**CPA-04567 Type1 M/C X,Y,Z Corr Ans: Y PM#80 F 1-99**

160. CPA-04567 May 94 No. 2 7B Page 29

On January 2, 1993, Quo, Inc. hired Reed to be its controller. During the year, Reed, working closely with Quo's president and outside accountants, made changes in accounting policies, corrected several errors dating from 1992 and before, and instituted new accounting policies.

Quo's 1993 financial statements will be presented in comparative form with its 1992 financial statements.

This question represents one of Quo's transactions. List B represents the general accounting treatment required for these transactions. These treatments are:

- Cumulative effect approach - Include the cumulative effect of the adjustment resulting from the accounting change or error correction in the 1993 financial statements, and do **not** restate the 1992 financial statements.


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- Retroactive or retrospective restatement approach - Restate the 1992 financial statements and adjust 1992 beginning retained earnings if the error or change affects a period prior to 1992.
- Prospective approach - Report 1993 and future financial statements on the new basis but do **not** restate 1992 financial statements.

**Item to Be Answered**
During 1993, Quo determined that an insurance premium paid and entirely expensed in 1992 was for the period January 1, 1992, through January 1, 1994.

*List B (Select one)*
X. Cumulative effect approach.
Y. Retroactive or retrospective restatement approach.
Z. Prospective approach.

**CPA-04567 Explanation**
Choice "Y" is correct. If comparative FS are issued, **restate prior year's FS.** If comparative FS are **not** issued, **restate prior year-end's retained earnings account** by "adjusting" **(net of tax)** the opening balance of the current retained earnings statement.

**CPA-04572 Type1 M/C A-D Corr Ans: D PM#81 F 1-99**

161. CPA-04572 May 94 No. 2 10A Page 25

On January 2, 1993, Quo, Inc. hired Reed to be its controller. During the year, Reed, working closely with Quo's president and outside accountants, made changes in accounting policies, corrected several errors dating from 1992 and before, and instituted new accounting policies.

Quo's 1993 financial statements will be presented in comparative form with its 1992 financial statements.

This question represents one of Quo's transactions. List A represents possible clarifications of these transactions as: a change in accounting principle, a change in accounting estimate, a correction of an error in previously presented financial statements, or neither an accounting change nor an accounting error.

During 1993, Quo increased its investment in Worth, Inc. from a 10% interest, purchased in 1992, to 30%, and acquired a seat on Worth's board of directors. As a result of its increased investment, Quo changed its method of accounting for investment in Worth, Inc. from the cost method to the equity method.

***List A***
a. Change in accounting principle.
b. Change in accounting estimate.
c. Correction of an error in previously presented financial statements.
d. Neither an accounting change nor an accounting error.

**CPA-04572 Explanation**
Choice "d" is correct. A change from the cost method (less than 20% ownership) to the equity method (20% or more ownership or a Board seat or other significant influence) of accounting for investment in an investee is neither an accounting change nor an accounting error. If it is not an accounting change, it cannot be a change in accounting principle or a change in accounting estimate since those two types of changes are both accounting changes.

There is a considerable amount of controversy on this particular answer. Some people think that this change is a change in accounting principle (something certainly changed, but was it the accounting principle?), and others think it is a change in accounting entity (which is not one of the available answers; anyway, did the accounting entity actually change or is it the same entity accounted for differently?). Under SFAS No. 154, a change in accounting principle is treated retrospectively and a change in accounting entity is treated retrospectively.

This kind of change (cost to equity) has never been specifically identified in any accounting literature as either a change in accounting principle or a change in accounting entity. The words "cost method" were never mentioned in APB 20 (other than the full cost method for oil & gas companies, which is an entirely


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different subject), nor was it mentioned in SFAS No. 154. It was, however, discussed in APB 18 (the pronouncement for the equity method) in Paragraph 19m (bold added):

> *"An investment in common stock of an investee that was previously accounted for on other than the equity method* ***may become qualified for use of the equity method by an increase in the level of ownership*** *described in paragraph 17 (i.e., acquisition of additional voting stock by the investor, acquisition or retirement of voting stock by the investee, or other transactions). When an investment qualifies for use of the equity method, the investor* ***should adopt the equity method of accounting****. The investment, results of operations (current and prior periods presented), and retained earnings of the investor should be* ***adjusted retroactively*** *in a manner consistent with the accounting for a step-by-step acquisition of a subsidiary."*

What does all this mean? It means that, when there is a change in the percentage of ownership that changes accounting from the cost method to the equity method, the change is treated retroactively (just like changes in accounting entity used to be treated, although they are now treated retrospectively). It does not say that the change is a change in accounting principle or anything else. Nothing in SFAS No. 154 changed this treatment. So all this still makes Choice "d" correct.

This whole issue might easily be considered to be splitting hairs, at the very least. Some questions on the CPA exam are just that way. Most are not.

**CPA-04573 Type1 M/C X,Y,Z Corr Ans: Y PM#82 F 1-99**

162. CPA-04573 May 94 No. 2 10B Page 3

On January 2, 1993, Quo, Inc. hired Reed to be its controller. During the year, Reed, working closely with Quo's president and outside accountants, made changes in accounting policies, corrected several errors dating from 1992 and before, and instituted new accounting policies.

Quo's 1993 financial statements will be presented in comparative form with its 1992 financial statements.

This question represents one of Quo's transactions. List B represents the general accounting treatment required for these transactions. These treatments are:

- Cumulative effect approach - Include the cumulative effect of the adjustment resulting from the accounting change or error correction in the 1993 financial statements, and do **not** restate the 1992 financial statements.
- Retroactive or retrospective restatement approach - Restate the 1992 financial statements and adjust 1992 beginning retained earnings if the error or change affects a period prior to 1992.
- Prospective approach - Report 1993 and future financial statements on the new basis but do **not** restate 1992 financial statements.

During 1993, Quo increased its investment in Worth, Inc. from a 10% interest, purchased in 1992, to 30%, and acquired a seat on Worth's board of directors. As a result of its increased investment, Quo changed its method of accounting for investment in Worth, Inc. from the cost method to the equity method.

***List B***

X. Cumulative effect approach.
Y. Retroactive or retrospective restatement approach.
Z. Prospective approach.

**CPA-04573 Explanation**

Choice "Y" is correct. The equity method of accounting is applied retroactively when the investor has acquired 20% ownership. Prior to acquiring the ability to influence the investee, the cost method is proper. The retroactive restatement approach does not mean that this change is the correction of an error (which is now treated retroactively), a change in accounting principle (which is now treated


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retrospectively), or a change in accounting entity (which is now treated retrospectively). It just means that retroactive restatement is the proper treatment.

**CPA-04770 Type1 M/C A-D Corr Ans: D PM#83 F 1-99**

163. CPA-04770 Released 2005 Page 8

According to the FASB conceptual framework, what does the concept of reliability in financial reporting include?

a. Effectiveness.
b. Certainty.
c. Precision.
d. Neutrality.

**CPA-04770 Explanation**
Choice "d" is correct. The concept of reliability in financial reporting includes; neutrality, representational faithfulness and verifiability.

Choices "a", "b", and "c" are incorrect, per the above.


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# CPA PassMaster Questions–Financial 2
# Export Date: 10/30/08


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**Timing Issues**

**CPA-00536 Type1 M/C A-D Corr Ans: B PM#1 F 2-01**

1. CPA-00536 FARE R03 #9 Page 18

Miller Co. incurred the following computer software costs for the development and sale of software programs during the current year:

| | |
|---|---|
| Planning costs | $ 50,000 |
| Design of the software | 150,000 |
| Substantial testing of the project's initial stages | 75,000 |
| Production and packaging costs for the first month's sales | 500,000 |
| Costs of producing product masters after technology feasibility was established | 200,000 |

The project was not under any contractual arrangement when these expenditures were incurred. What amount should Miller report as research and development expense for the current year?

a. $200,000
b. $275,000
c. $500,000
d. $975,000

**CPA-00536 Explanation**
Choice "b" is correct. Before technological feasibility is established computer software development costs are expensed as research and development. Miller Co.'s research and development costs are:

| | |
|---|---|
| Planning costs | $ 50,000 |
| Design of the software | 150,000 |
| Substantial testing of the project's initial stages | 75,000 |
| | $275,000 |

**CPA-00538 Type1 M/C A-D Corr Ans: A PM#3 F 2-01**

2. CPA-00538 FARE R97 #6 Page 5

Troop Co. frequently borrows from the bank to maintain sufficient operating cash. The following loans were at a 12% interest rate, with interest payable at maturity. Troop repaid each loan on its scheduled maturity date.

| *Date of Loan* | *Amount* | *Maturity Date* | *Term of Loan* |
|---|---|---|---|
| 11/1/95 | $10,000 | 10/31/96 | 1 year |
| 2/1/96 | 30,000 | 7/31/96 | 6 months |
| 5/1/96 | 16,000 | 1/31/97 | 9 months |

Troop records interest expense when the loans are repaid. Accordingly, interest expense of $3,000 was recorded in 1996. If no correction is made, by what amount would 1996 interest expense be understated?

a. $1,080
b. $1,240
c. $1,280
d. $1,440

**CPA-00538 Explanation**
Choice "a" is correct. $1,080 understated interest expense.

Actual interest expense:

| Date | | Amount | | Rate | | Time | | |
|---|---|---|---|---|---|---|---|---|
| 11/1/95 | Loan | $10,000 | × | 12% | × | 10/12 mos | = | $1,000 |


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| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| 2/1/96 | Loan | 30,000 | × | 12% | × | 6/12 mos | = | 1,800 |
| 5/1/96 | Loan | 16,000 | × | 12% | × | 8/12 mos | = | 1,280 |
| | | | | | | | | 4,080 |
| Stated interest expense on the cash basis. | | | | | | | | 3,000 |
| Understated interest expense | | | | | | | | $1,080 |

**CPA-00539 Type1 M/C A-D Corr Ans: D PM#4 F 2-01**

3. CPA-00539 FARE Nov 95 #13 Page 5

Lime Co.'s payroll for the month ended January 31, 1995, is summarized as follows:

| | |
|---|---|
| Total wages | $10,000 |
| Federal income tax withheld | 1,200 |

All wages paid were subject to FICA. FICA tax rates were 7% each for employee and employer. Lime remits payroll taxes on the 15th of the following month. In its financial statements for the month ended January 31, 1995, what amounts should Lime report as total payroll tax liability and as payroll tax expense?

| | *Liability* | *Expense* |
|---|---|---|
| a. | $1,200 | $1,400 |
| b. | $1,900 | $1,400 |
| c. | $1,900 | $700 |
| d. | $2,600 | $700 |

**CPA-00539 Explanation**
Choice "d" is correct, $2,600 total payroll tax liability; $700 payroll tax expense:

| | |
|---|---|
| Total wages | $10,000 |
| FICA tax rate | 7% |
| FICA tax withheld (employee portion) | 700 |
| Federal income tax withheld | 1,200 |
| Total tax withheld | 1,900 |
| Employer FICA tax expense and liability | 700 |
| Total payroll tax liability at Jan. 31, 1995 | $ 2,600 |

| Journal entry | Dr | Cr |
|---|---|---|
| Wage expense | 10,000 | |
| Employer FICA tax expense | 700 | |
| FIT withheld | | 1,200 |
| FICA tax withheld (employee portion) | | 700 |
| Employer FICA tax liability | | 700 |
| Accrued payroll liability | | 8,100 |

**CPA-00540 Type1 M/C A-D Corr Ans: D PM#5 F 2-01**

4. CPA-00540 FARE Nov 95 #16 Page 5

On March 1, 1993, Fine Co. borrowed $10,000 and signed a two-year note bearing interest at 12% per annum compounded annually. Interest is payable in full at maturity on February 28, 1995. What amount should Fine report as a liability for accrued interest at December 31, 1994?

a. $0
b. $1,000
c. $1,200
d. $2,320

**CPA-00540 Explanation**
Choice "d" is correct.


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| | |
|---|---|
| 12%, 2-yr note payable | $10,000 |
| 1993 interest expense [12% × $10,000 × 10/12] | 1,000 |
| 1993 net liability | $11,000 |
| 1994 interest expense = [12% × $11,000] | $ 1,320 |

Accrued interest payable at 12/31/94 equals $2,320 [$1,000 + $1,320]

Choice "a" is incorrect. Accrued interest must be recognized and recorded during the term of the note.

Choice "b" is incorrect. 1993 accrued interest equals $1,000 [$10,000 × 12% × 10/12].

Choice "c" is incorrect. This is simple interest on the original note [12% × $10,000] for one year and is not the accrued interest payable balance.

**CPA-00541 Type1 M/C A-D Corr Ans: C PM#6 F 2-01**

5. CPA-00541 FARE Nov 95 #30 Page 7

Rill Co. owns a 20% royalty interest in an oil well. Rill receives royalty payments on January 31 for the oil sold between the previous June 1 and November 30, and on July 31 for oil sold between the previous December 1 and May 31. Production reports show the following oil sales:

| | |
|---|---|
| June 1, 1993-November 30, 1993 | $300,000 |
| December 1, 1993-December 31, 1993 | 50,000 |
| December 1, 1993-May 31, 1994 | 400,000 |
| June 1, 1994-November 30, 1994 | 325,000 |
| December 1, 1994-December 31, 1994 | 70,000 |

What amount should Rill report as royalty revenue for 1994?

a. $140,000
b. $144,000
c. $149,000
d. $159,000

**CPA-00541 Explanation**

Choice "c" is correct. Royalty revenue accrued for 1994 is based on 20% of production in 1994.

| | |
|---|---|
| Production, Jan. 1 thru May 31 [$400,000 – $50,000] | $350,000 |
| June 1 through November 30 production | 325,000 |
| Production for December | 70,000 |
| Total 1994 production | $745,000 |

Royalty revenue on this production equals $149,000 [20% × $745,000].

**CPA-00543 Type1 M/C A-D Corr Ans: A PM#8 F 2-01**

6. CPA-00543 FARE May 95 #13 Page 11

During 1994, Jase Co. incurred research and development costs of $136,000 in its laboratories relating to a patent that was granted on July 1, 1994. Costs of registering the patent equaled $34,000. The patent's legal life is 17 years, and its estimated economic life is 10 years. In its December 31, 1994, balance sheet, what amount should Jase report as patent, net of accumulated amortization?

a. $32,300
b. $33,000
c. $161,500
d. $165,000

**CPA-00543 Explanation**


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Choice "a" is correct. The research and development costs should be expensed. The patent will be capitalized and amortized over 10 years (the lesser of legal life or economic life). 1994 amortization equals $1,700 ($34,000/10 × 6/12). The patent balance at year-end is $32,300 ($34,000 – $1,700). SFAS 2 para. 12 APB 17 para. 9

Choice "b" is incorrect. The amortization should be calculated based on the lesser of legal life or economic life. APB 17 para. 9

Choice "c" is incorrect. The research and development costs should not be capitalized as part of the cost of the patent. SFAS 2 para. 12

Choice "d" is incorrect. The research and development costs should not be capitalized as part of the cost of the patent. SFAS 2 para. 12

**CPA-00546 Type1 M/C A-D Corr Ans: B PM#11 F 2-01**

7. CPA-00546 FARE May 95 #38 Page 5

Under a royalty agreement with another company, Wand Co. will pay royalties for the assignment of a patent for three years. The royalties paid should be reported as expense:

a. In the period paid.
b. In the period incurred.
c. At the date the royalty agreement began.
d. At the date the royalty agreement expired.

**CPA-00546 Explanation**
Choice "b" is correct. Royalties paid should be reported as expense in the period incurred.

Choice "a" is incorrect. Reporting the royalties paid in the period in which they are paid would be the correct treatment under the cash basis of accounting, not accrual.

Choices "c" and "d" are incorrect. Both of these answers do not necessarily match the expense with the related revenue over an appropriate period.

**CPA-00547 Type1 M/C A-D Corr Ans: C PM#12 F 2-01**

8. CPA-00547 FARE Nov 94 #9 Page 5

The following trial balance of Trey Co. at December 31, 1993, has been adjusted except for income tax expense.

| | *Dr.* | *Cr.* |
|---|---|---|
| Cash | $ 550,000 | |
| Accounts receivable, net | 1,650,000 | |
| Prepaid taxes | 300,000 | |
| Accounts payable | | $120,000 |
| Common stock | | 500,000 |
| Additional paid-in capital | | 680,000 |
| Retained earnings | | 630,000 |
| Foreign currency translation adjustment | 430,000 | |
| Revenues | | 3,600,000 |
| Expenses | 2,600,000 | |
| | $5,530,000 | $5,530,000 |

*Additional information*

- During 1993, estimated tax payments of $300,000 were charged to prepaid taxes. Trey has not yet recorded income tax expense. There were no differences between financial statement and income tax income, and Trey's tax rate is 30%.
- Included in accounts receivable is $500,000 due from a customer. Special terms granted to this customer require payment in equal semiannual installments of $125,000 every April 1 and October 1.


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In Trey's December 31, 1993, balance sheet, what amount should be reported as total retained earnings?

a. $1,029,000
b. $1,200,000
c. $1,330,000
d. $1,630,000

**CPA-00547 Explanation**
Choice "c" is correct. $1,330,000.

| | |
|---|---|
| Revenue | $3,600 |
| Expenses | (2,600) |
| Pre-tax income | 1,000 |
| Tax expense – 30% | (300) |
| Net income | 700 |
| Beginning retained earnings | 630 |
| Ending retained earnings | $1,330 |

Notes:
1. The estimated tax payments do not affect the expense.
2. For GAAP purposes, 100% of the profit on an installment sale is recorded at time of sale unless there is doubt as to collectibility.

**CPA-00549 Type1 M/C A-D Corr Ans: D PM#14 F 2-01**

9. CPA-00549 FARE Nov 94 #21 Page 9

For $50 a month, Rawl Co. visits its customers' premises and performs insect control services. If customers experience problems between regularly scheduled visits, Rawl makes service calls at no additional charge. Instead of paying monthly, customers may pay an annual fee of $540 in advance. For a customer who pays the annual fee in advance, Rawl should recognize the related revenue:

a. When the cash is collected.
b. At the end of the fiscal year.
c. At the end of the contract year after all of the services have been performed.
d. Evenly over the contract year as the services are performed.

**CPA-00549 Explanation**
Choice "d" is correct. For a customer who pays the $540 annual fee in advance, the related revenue should be recognized evenly over the contract year as the services are performed (GAAP-accrual basis of accounting).

Choice "a" is incorrect. Under the cash basis of accounting, revenue is recognized when the cash is collected.

Choice "b" is incorrect. Revenue should not be recognized at the end of the fiscal year; it should be recognized evenly over the contract year.

Choice "c" is incorrect. Revenue should not be recognized at the end of the contract year after all of the services have been performed; it should be recognized evenly over the contract year.

**CPA-00550 Type1 M/C A-D Corr Ans: C PM#15 F 2-01**

10. CPA-00550 FARE Nov 94 #23 Page 5

House Publishers offered a contest in which the winner would receive $1,000,000, payable over 20 years. On December 31, 1993, House announced the winner of the contest and signed a note payable to the winner for $1,000,000, payable in $50,000 installments every January 2. Also on December 31, 1993, House purchased an annuity for $418,250 to provide the $950,000 prize monies remaining after the first $50,000 installment, which was paid on January 2, 1994.

In its 1993 income statement, what should House report as contest prize expense?


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a. $0
b. $418,250
c. $468,250
d. $1,000,000

**CPA-00550 Explanation**
Choice "c" is correct. $468,250 contest prize expense.

| | |
|---|---|
| First payment on 1/2/94 | $ 50,000 |
| Present value of 19 subsequent payments | 418,250 |
| Contest prize expense in 1993 income statement | $468,250 |

**CPA-00551 Type1 M/C A-D Corr Ans: A PM#16 F 2-01**

11. CPA-00551 FARE Nov 94 #40 Page 7

Wren Corp.'s trademark was licensed to Mont Co. for royalties of 15% of sales of the trademarked items. Royalties are payable semiannually on March 15 for sales in July through December of the prior year, and on September 15 for sales in January through June of the same year. Wren received the following royalties from Mont:

| | *March 15* | *September 15* |
|---|---|---|
| 1992 | $10,000 | $15,000 |
| 1993 | 12,000 | 17,000 |

Mont estimated that sales of the trademarked items would total $60,000 for July through December 1993.

In Wren's 1993 income statement, the royalty revenue should be:

a. $26,000
b. $29,000
c. $38,000
d. $41,000

**CPA-00551 Explanation**
Choice "a" is correct. Royalties to be received on March 15 reflect earnings from the latter half of the prior year. Royalties to be received on September 15 reflect earnings from the first half of the current year. Earnings for the latter half of 1993 equal $9,000 (15% $\times$ $60,000). 1993 earnings equal first half earnings of $17,000 plus second half earnings of $9,000 for a total of $26,000. Note: 1992 earnings equal $27,000 ($12,000 plus $15,000); 1991 earnings equal $10,000. SFAC 5 para. 83

**CPA-00553 Type1 M/C A-D Corr Ans: D PM#17 F 2-01**

12. CPA-00553 FARE Nov 94 #44 Page 16

During 1993, Orr Co. incurred the following costs:

| | |
|---|---|
| Research and development services performed by Key Corp. for Orr | $150,000 |
| Design, construction, and testing of preproduction prototypes and models | 200,000 |
| Testing in search for new products or process alternatives | 175,000 |

In its 1993 income statement, what should Orr report as research and development expense?

a. $150,000
b. $200,000
c. $350,000
d. $525,000

**CPA-00553 Explanation**
Choice "d" is correct. R&D contracted out to a third party, preproduction prototypes and models costs, and, costs for searching for new products or new process alternatives are reported as R&D expense.


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Choice "a" is incorrect. R&D expense should include the preproduction prototypes and models costs and the costs of searching for new products or new process alternatives.

Choice "b" is incorrect. R&D expense should include the costs incurred through contracting with a third party for the R&D work to be done and the costs of searching for new product or new process alternatives.

Choice "c" is incorrect. R&D expense should include the costs for searching for new products or new process alternatives.

**CPA-00554 Type1 M/C A-D Corr Ans: C PM#18 F 2-01**

13. CPA-00554 FARE May 94 #20 Page 14

On January 2, 1993, Rafa Co. purchased a franchise with a useful life of ten years for $50,000. An additional franchise fee of 3% of franchise operation revenues must be paid each year to the franchisor. Revenues from franchise operations amounted to $400,000 during 1993. In its December 31, 1993, balance sheet, what amount should Rafa report as an intangible asset franchise?

a. $33,000
b. $43,800
c. $45,000
d. $50,000

**CPA-00554 Explanation**

Choice "c" is correct. The $50,000 franchise cost will be amortized on a straight-line basis over 10 years ($5,000 per year). The balance in the franchise account will be $50,000 – $5,000 = $45,000. The 3% of franchise operation revenue is an operating expense, unrelated to the intangible asset balance.

**CPA-00557 Type1 M/C A-D Corr Ans: D PM#20 F 2-01**

14. CPA-00557 FARE May 94 #42 Page 5

Compared to the accrual basis of accounting, the cash basis of accounting understates income by the net decrease during the accounting period of:

| | *Accounts Receivable* | *Accrued Expenses* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | No |
| d. | No | Yes |

**CPA-00557 Explanation**

| | Accrual Basis | Adjustments Accrual to Cash | Cash Basis | |
|---|---|---|---|---|
| Sales | 1,000 | 300 | 1,300 | AR - No |
| Expenses | 600 | 100 | 700 | AP - Yes |
| Net income | 400 | 200 | 600 | |

| | Accounts Receivable | | Accrued Expenses Payable | | Net Income |
|---|---|---|---|---|---|
| Beginning balance | 300 | | 100 | | |
| Add: Sales accrued | 1,000 | -Add Accrued Exps. | 600 | = | 400 |
| Subtotal | 1,300 | | 700 | | |
| Less: Cash collections | <1,300> | -Less Payments | <700> | = | 600 |
| Ending balance | 0 | | 0 | | |
| | No | | Yes | | |


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Choice "d" is correct. No - Accounts receivable

Yes - Accrued expenses payable

**CPA-00563 Type1 M/C A-D Corr Ans: B PM#21 F 2-01**

15. CPA-00563Th Nov 93 #10 (Adapted) Page 16

Which of the following costs of goodwill should be capitalized?

| | *Maintaining goodwill* | *Developing goodwill* |
|---|---|---|
| a. | Yes | No |
| b. | No | No |
| c. | Yes | Yes |
| d. | No | Yes |

**CPA-00563 Explanation**
Choice "b" is correct. Goodwill is capitalized only when incurred in the purchase of another entity. Costs incurred for maintaining or developing goodwill are expensed. APB 17 para. 9

**CPA-00564 Type1 M/C A-D Corr Ans: C PM#22 F 2-01**

16. CPA-00564PI Nov 93 #17 Page 6

Frame Co. has an 8% note receivable dated June 30, 1991, in the original amount of $150,000. Payments of $50,000 in principal plus accrued interest are due annually on July 1, 1992, 1993, and 1994. In its June 30, 1993, balance sheet, what amount should Frame report as a current asset for interest on the note receivable?

a. $0
b. $4,000
c. $8,000
d. $12,000

**CPA-00564 Explanation**
Choice "c" is correct. The current asset for interest receivable on June 30, 1993, is the interest to be received within one year. Interest to be received on July 1, 1993 is:

$$\$100{,}000 \text{ balance of note} \times 8\% = \underline{\$8{,}000}$$

ARB 43 Ch 3A para. 4

Choice "a" is incorrect. The current asset for interest receivable on June 30, 1993, is the interest to be received within one year.

Choice "b" is incorrect. The current asset for interest receivable on June 30, 1993, is the interest to be received within one year.

Choice "d" is incorrect. The current asset for interest receivable on June 30, 1993, is the interest to be received within one year.

**CPA-00573 Type1 M/C A-D Corr Ans: C PM#23 F 2-01**

17. CPA-00573PI Nov 93 #25 (Adapted) Page 11

On January 2, 2002, Judd Co. bought a trademark from Krug Co. for $500,000. Judd retained an independent consultant, who estimated the trademark's remaining life to be 50 years. Its unamortized cost on Krug's accounting records was $380,000. In Judd's December 31, 2002, balance sheet, what amount should be reported as accumulated amortization?

a. $7,600


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b. $9,500
c. $10,000
d. $12,500

**CPA-00573 Explanation**
Choice "c" is correct. The cost of a trademark is amortized over its economic life.

$$\$500{,}000 \div 50 = \underline{\$10{,}000}$$

Choice "a" is incorrect. The cost to Judd is used as the basis, not the seller's basis.

Choice "b" is incorrect. The cost to Judd is used as the basis, not the seller's basis, and 40 years is no longer the upper limit over which an intangible asset may be amortized.

Choice "d" is incorrect. 40 years is no longer used as a maximum amortization period.

**CPA-00575 Type1 M/C A-D Corr Ans: A PM#24 F 2-01**

18. CPA-00575 PI Nov 93 #30 Page 5

Lyle, Inc. is preparing its financial statements for the year ended December 31, 1992. Accounts payable amounted to $360,000 before any necessary year-end adjustment related to the following:

- At December 31, 1992, Lyle has a $50,000 debit balance in its accounts payable to Ross, a supplier, resulting from a $50,000 advance payment for goods to be manufactured to Lyle's specifications.
- Checks in the amount of $100,000 were written to vendors and recorded on December 29, 1992. The checks were mailed on January 5, 1993.

What amount should Lyle report as accounts payable in its December 31, 1992, balance sheet?

a. $510,000
b. $410,000
c. $310,000
d. $210,000

**CPA-00575 Explanation**
Choice "a" is correct, $510,000.

| | |
|---|---|
| Unadjusted accounts payable at 12/31/92 | $360,000 |
| Reverse debit balance and record as a prepaid (asset) | 50,000 |
| Reverse unmailed checks: | 100,000 |
| Adjusted accounts payable at 12/31/92 | $510,000 |

**CPA-00577 Type1 M/C A-D Corr Ans: B PM#25 F 2-01**

19. CPA-00577 PI Nov 93 #38 Page 7

Dunne Co. sells equipment service contracts that cover a two-year period. The sales price of each contract is $600. Dunne's past experience is that, of the total dollars spent for repairs on service contracts, 40% is incurred evenly during the first contract year and 60% evenly during the second contract year. Dunne sold 1,000 contracts evenly throughout 1992. In its December 31, 1992, balance sheet, what amount should Dunne report as deferred service contract revenue?

a. $540,000
b. $480,000
c. $360,000
d. $300,000

**CPA-00577 Explanation**


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Choice "b" is correct. When service contracts are sold, the entire proceeds are reported as deferred revenue. Revenue is recognized, and deferral reduced as the service is performed. Since repairs are made evenly (July 1 is average date), only ½ of the 40% of repairs will be in 1992.

| | |
|---|---|
| 1992 deferral ($600 × 1,000) | $600,000 |
| Earned in 1992 (600,000 × 40% × 1/2) | (120,000) |
| Deferral 12-31-92 | $480,000 |

Choice "a" is incorrect. When service contracts are sold, the entire proceeds are reported as deferred revenue. Revenue is recognized, and deferral reduced as the service is performed. Since repairs are made evenly, (July 1 is average date) only ½ of the 40% of repairs will be in 1992.

Choice "c" is incorrect. Since repairs are incurred evenly during the first year (July 1 is average date) only ½ of 40% will be earned in 1992.

Choice "d" is incorrect. Revenue is recognized, and deferral reduced, as the service is performed.

**CPA-00578 Type1 M/C A-D Corr Ans: C PM#26 F 2-01**

20. CPA-00578 Th Nov 93 #40 Page 5

Compared to its 1992 cash basis net income, Potoma Co.'s 1992 accrual basis net income increased when it:

a. Declared a cash dividend in 1991 that it paid in 1992.
b. Wrote off more accounts receivable balances than it reported as uncollectible accounts expense in 1992.
c. Had lower accrued expenses on December 31, 1992, than on January 1, 1992.
d. Sold used equipment for cash at a gain in 1992.

**CPA-00578 Explanation**
Choice "c" is correct, compared to its 1992 cash basis net income, Potoma Co.'s 1992 accrual basis net income increased when it had lower accrued expenses on Dec. 31, 1992, than on Jan. 1, 1992.

| *Assumed amounts:* | *Accrued expense liability* | *Net accrual basis* | *Income cash basis* |
|---|---|---|---|
| Begin balance, Jan. 1, 1992 | 10,000 | | |
| Add: accrued expenses | 6,000 | 6,000 | |
| Subtotal | 16,000 | | |
| Less: cash paid | (16,000) | | 16,000 |
| End balance, Dec. 31, 1992 | 0 | | |

Choice "a" is incorrect. Dividends declared (accrual) and/or paid (cash) affect balance sheet only.

Choice "b" is incorrect. Writeoffs do not affect cash or net income, but uncollectible accounts expense reduces accrual basis net income.

Choice "d" is incorrect. Sale of used equipment for cash at a gain would have the same effect on net income-whether accrual basis or cash basis.

**CPA-00582 Type1 M/C A-D Corr Ans: D PM#27 F 2-01**

21. CPA-00582 PI Nov 93 #43 Page 5

On April 1, 1993, Ivy began operating a service proprietorship with an initial cash investment of $1,000. The proprietorship provided $3,200 of services in April and received full payment in May. The proprietorship incurred expenses of $1,500 in April, which were paid in June. During May, Ivy drew $500 against her capital account.

What was the proprietorship's income for the two months ended May 31, 1993, under the following methods of accounting?

*Cash-Basis* *Accrual-Basis*


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a. $1,200 $1,200
b. $1,700 $1,700
c. $2,700 $1,200
d. $3,200 $1,700

**CPA-00582 Explanation**

| | Cash | Accrual Adjustments | | Accrual |
|---|---|---|---|---|
| Stmts of rev/exp or income | Basis | Dr | Cr | Basis |
| Service billings | 3,200 | | | 3,200 |
| Expenses incurred | – | 1,500 | | 1,500 |
| Income - 2 mos. 5-31-93 | 3,200 | | | 1,700 |
| Balance Sheet | | | | |
| Accrued expenses payable | | | 1,500 | |

Choice "d" is correct. $3,200 cash-basis income $1,700 accrual-basis income.

**CPA-00588 Type1 M/C A-D Corr Ans: D PM#28 F 2-01**

22. CPA-00588 PI Nov 93 #56 Page 19

Brill Co. made the following expenditures during 1992:

| | |
|---|---|
| Costs to develop computer software for use in Brill's general management information system | $100,000 |
| Costs of market research activities | 75,000 |

What amount of these expenditures should Brill report in its 1992 income statement as research and development expenses?

a. $175,000
b. $100,000
c. $75,000
d. $0

**CPA-00588 Explanation**

Choice "d" is correct. Research and development includes costs incurred prior to technological feasibility for developed software that is to be sold, leased, or marketed. This software is for internal use, unrelated to production and is not considered research and development. Market research is also not research and development because it is not aimed at discovery of new knowledge to develop a new product or service. SFAS #2, SFAS #86

Choice "a" is incorrect. This software is for internal use, unrelated to production and is not considered research and development. Market research is also not research and development because it is not aimed at discovery of new knowledge to develop a new product or service.

Choice "b" is incorrect. This software is for internal use, unrelated to production and is not considered research and development.

Choice "c" is incorrect. Market research is also not research and development because it is not aimed at discovery of new knowledge to develop a new product or service.

**CPA-00589 Type1 M/C A-D Corr Ans: B PM#29 F 2-01**

23. CPA-00589 PI May 93 #23 Page 11

During 1992, Lyle Co. incurred $400,000 of research and development costs in its laboratory to develop a product for which a patent was granted on July 1, 1992. Legal fees and other costs associated with the patent totaled $82,000. The estimated economic life of the patent is 10 years. What amount should Lyle capitalize for the patent on July 1, 1992?


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a. $0
b. $82,000
c. $400,000
d. $482,000

**CPA-00589 Explanation**
Choice "b" is correct. Legal fees and other costs associated with registering a patent are capitalized. Research and development costs are expensed. SFAS 2 para. 9,10

Choice "a" is incorrect. Legal fees and other costs associated with registering a patent are capitalized.

Choice "c" is incorrect. Research and development costs are expensed.

Choice "d" is incorrect. Research and development costs are expensed.

**CPA-00591 Type1 M/C A-D Corr Ans: A PM#31 F 2-01**

24. CPA-00591Th May 93 #25 Page 11

Which of the following statements concerning patents is correct?

a. Legal costs incurred to successfully defend an internally developed patent should be capitalized and amortized over the patent's remaining economic life.
b. Legal fees and other direct costs incurred in registering a patent should be capitalized and amortized on a straight-line basis over a five-year period.
c. Research and development contract services purchased from others and used to develop a patented manufacturing process should be capitalized and amortized over the patent's economic life.
d. Research and development costs incurred to develop a patented item should be capitalized and amortized on a straight-line basis over 17 years.

**CPA-00591 Explanation**
Choice "a" is correct. Once the patent is established, legal costs to successfully defend the patent should be capitalized and amortized over the lesser of the patent's useful economic life or its legal life.

Choice "b" is incorrect. Amortization should be on a straight-line basis over the lesser of the patent's useful economic life or its legal life.

Choice "c" is incorrect. Research and development costs are expensed whether they are incurred internally or by contract with outside firms.

Choice "d" is incorrect. Research and development costs are expensed when incurred.

**CPA-00592 Type1 M/C A-D Corr Ans: D PM#32 F 2-01**

25. CPA-00592PI May 93 #40 Page 5

Class Corp. maintains its accounting records on the cash basis but restates its financial statements to the accrual method of accounting. Class had $60,000 in cash-basis pretax income for 1992. The following information pertains to Class's operations for the years ended December 31, 1992 and 1991:

| | *1992* | *1991* |
|---|---|---|
| Accounts receivable | $40,000 | $20,000 |
| Accounts payable | 15,000 | 30,000 |

Under the accrual method, what amount of income before taxes should Class report in its December 31, 1992, income statement?

a. $25,000
b. $55,000
c. $65,000
d. $95,000

**CPA-00592 Explanation**


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Choice "d" is correct. $95,000 accrual income before taxes in the December 31, 1992, income statement.

| | |
|---|---|
| Cash-basis pretax income for 1992 | $60,000 |
| Increase in accts rec. ($40,000 – $20,000) (Cash not received for amounts "receivable") | 20,000 |
| Reduction in accts pay. ($30,000 – $15,000) (Cash used to pay down prior payables) | 15,000 |
| Accrual-basis pretax income for 1992 | $95,000 |

**CPA-00593 Type1 M/C A-D Corr Ans: B PM#33 F 2-01**

26. CPA-00593Th May 93 #40 Page 7

Delect Co. provides repair services for the AZ195 TV set. Customers prepay the fee on the standard one-year service contract. The 1991 and 1992 contracts were identical, and the number of contracts outstanding was substantially the same at the end of each year. However, Delect's December 31, 1992, deferred revenues' balance on unperformed service contracts was significantly less than the balance at December 31, 1991. Which of the following situations might account for this reduction in the deferred revenue balance?

a. Most 1992 contracts were signed later in the calendar year than were the 1991 contracts.
b. Most 1992 contracts were signed earlier in the calendar year than were the 1991 contracts.
c. The 1992 contract contribution margin was greater than the 1991 contract contribution margin.
d. The 1992 contribution margin was less than the 1991 contract contribution margin.

**CPA-00593 Explanation**

Choice "b" is correct. If 1992 contracts were signed earlier in the year than before, more warranty work would have been performed by year-end, thus reducing the deferred revenue balance more than in prior years.

Choice "a" is incorrect. Contracts signed later in the year than before would create fewer opportunities for warranty work to be done. Thus, the balance in the deferred revenue account would be greater than before.

Choice "c" is incorrect. None of the facts indicate that contribution margin would be any different between the contracts written in two separate years.

Choice "d" is incorrect. None of the facts indicate that contribution margin would be any different between the contracts written in two separate years.

**CPA-00594 Type1 M/C A-D Corr Ans: D PM#34 F 2-01**

27. CPA-00594PI May 93 #44 Page 7

In 1990, Super Comics Corp. sold a comic strip to Fantasy, Inc. and will receive royalties of 20% of future revenues associated with the comic strip. At December 31, 1991, Super reported royalties receivable of $75,000 from Fantasy. During 1992, Super received royalty payments of $200,000. Fantasy reported revenues of $1,500,000 in 1992 from the comic strip. In its 1992 income statement, what amount should Super report as royalty revenue?

a. $125,000
b. $175,000
c. $200,000
d. $300,000

**CPA-00594 Explanation**

Choice "d" is correct. Royalties earned by Super are 20% of Fantasy's 1992 revenue of $1,500,000 or $300,000 for 1992. SFAC 5 para. 84

Choice "a" is incorrect. Royalty revenue for 1992 should not be based on collections, but rather on 20% of earnings of Fantasy.


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Choice "b" is incorrect. Royalty revenue for 1992 should include what was earned in 1992.

Choice "c" is incorrect. Royalty revenue includes Super's share of Fantasy's earnings in 1992, not collections.

**CPA-00596 Type1 M/C A-D Corr Ans: C PM#35 F 2-01**

28. CPA-00596 PI May 93 #50 Page 5

On February 12, 1992, VIP Publishing, Inc. purchased the copyright to a book for $15,000 and agreed to pay royalties equal to 10% of book sales, with a guaranteed minimum royalty of $60,000. VIP had book sales of $800,000 in 1992. In its 1992 income statement, what amount should VIP report as royalty expense?

a. $60,000
b. $75,000
c. $80,000
d. $95,000

**CPA-00596 Explanation**
Choice "c" is correct. Royalty expense is the larger of minimum royalties of $60,000, or 10% of $800,000 sales, $80,000.

Choice "a" is incorrect. The minimum royalty would be the expense if actual royalties were less than $60,000.

Choice "b" is incorrect. The minimum royalty would be the expense if actual royalties were less than $60,000. The copyright should be recorded as an intangible asset, not royalty expense.

Choice "d" is incorrect. The copyright should be recorded as an intangible asset, not as royalty expense.

**CPA-00597 Type1 M/C A-D Corr Ans: A PM#36 F 2-01**

29. CPA-00597 PI May 93 #52 Page 5

Dana Co.'s officers' compensation expense account had a balance of $224,000 at December 31, 1992, before any appropriate year-end adjustment relating to the following:

- No salary accrual was made for December 30-31, 1992. Salaries for the two-day period totaled $3,500.
- 1992 officers' bonuses of $62,500 were paid on January 31, 1993.

In its 1992 income statement, what amount should Dana report as officers' compensation expense?

a. $290,000
b. $286,500
c. $227,500
d. $224,000

**CPA-00597 Explanation**
Choice "a" is correct. $290,000 compensation expense for 1992.

| | Compensation Expense |
|---|---|
| Compensation exp before year-end adjustments | 224,000 |
| Add: Salary accrual for Dec. 30-31, 1992 | 3,500 |
| Add: 1992 bonuses not paid until Jan. 31, 1993 | 62,500 |
| Compensation exp after year-end adjustments | 290,000 |

**CPA-00598 Type1 M/C A-D Corr Ans: C PM#37 F 2-01**


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30. CPA-00598 PI May 92 #20 Page 15

Hy Corp. bought Patent A for $40,000 and Patent B for $60,000. Hy also paid acquisition costs of $5,000 for Patent A and $7,000 for Patent B. Both patents were challenged in legal actions. Hy paid $20,000 in legal fees for a successful defense of Patent A and $30,000 in legal fees for an unsuccessful defense of Patent B. What amount should Hy capitalize for patents?

a. $162,000
b. $112,000
c. $65,000
d. $45,000

**CPA-00598 Explanation**
Choice "c" is correct. $65,000 capitalized cost for Patent A successfully defended.

| | A Successful Defense | B Unsuccessful Defense |
|---|---|---|
| Purchase price | $40,000 | $60,000 |
| Acquisition costs | 5,000 | 7,000 |
| Legal fees | 20,000 | 30,000 |
| Total costs | 65,000 | 97,000 |
| Capitalize successful Patent A | 65,000 | |
| Expense unsuccessful Patent B | | 97,000 |

**CPA-00599 Type1 M/C A-D Corr Ans: B PM#38 F 2-01**

31. CPA-00599 PI May 92 #48 Page 5

Pak Co.'s professional fees expense account had a balance of $82,000 at December 31, 1991, before considering year-end adjustments relating to the following:

- Consultants were hired for a special project at a total fee not to exceed $65,000. Pak has recorded $55,000 of this fee based on billings for work performed in 1991.
- The attorney's letter requested by the auditors dated January 28, 1992, indicated that legal fees of $6,000 were billed on January 15, 1992, for work performed in November 1991, and unbilled fees for December 1991 were $7,000.

What amount should Pak report for professional fees expense for the year ended December 31, 1991?

a. $105,000
b. $95,000
c. $88,000
d. $82,000

**CPA-00599 Explanation**
Choice "b" is correct. $95,000 professional fees expense for 1991.

| | Professional Fees Exp. |
|---|---|
| Unadjusted balance at Dec. 31, 1991 | $82,000 |
| Special project fee of $55,000 billed and recorded for work performed in 1991 requires no adjustment in 1991. Additional $10,000 will be billed and recorded next year (1992) for completion of project. | 0 |
| Legal fees billed on Jan. 15, 1992 for work performed in Nov. 1991 should be accrued. | 6,000 |
| Unbilled fees for Dec. 1991 should be accrued. | 7,000 |
| Professional fees expense for 1991 | $95,000 |


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**CPA-00600 Type1 M/C A-D Corr Ans: B PM#39 F 2-01**

32. CPA-00600 PI Nov 91 #26 Page 5

On the first day of each month, Bell Mortgage Co. receives from Kent Corp. an escrow deposit of $2,500 for real estate taxes. Bell records the $2,500 in an escrow account. Kent's 1990 real estate tax is $28,000, payable in equal installments on the first day of each calendar quarter. On December 31, 1989, the balance in the escrow account was $3,000. On September 30, 1990, what amount should Bell show as an escrow liability to Kent?

a. $1,500
b. $4,500
c. $8,500
d. $11,500

**CPA-00600 Explanation**
Choice "b" is correct. $4,500 escrow liability at September 30, 1990.

| | Escrow Liability |
|---|---|
| Begin balance 12/31/89 | $ 3,000 |
| Add deposits ($2,500 × 9 months) | 22,500 |
| Subtotal | 25,500 |
| Deduct payments ($28,000/4 qtrs × 3 payments) | (21,000) |
| Ending balance 9/30/89 | $ 4,500 |

**CPA-00601 Type1 M/C A-D Corr Ans: A PM#40 F 2-01**

33. CPA-00601 PI Nov 91 #42 Page 5

Cap Corp. reported accrued investment interest receivable of $38,000 and $46,500 at January 1 and December 31, 1990, respectively. During 1990, cash collections from the investments included the following:

| | |
|---|---|
| Capital gains distributions | $145,000 |
| Interest | 152,000 |

What amount should Cap report as interest revenue from investments for 1990?

a. $160,500
b. $153,500
c. $152,000
d. $143,500

**CPA-00601 Explanation**
Choice "a" is correct. $160,500 interest revenue from investments for 1990.

| | |
|---|---|
| Begin balance (1-1-90) | 38,000 |
| Add: Accrued interest revenue | 160,500 |
| Subtotal | 198,500 |
| Less collections of interest | (152,000) |
| Ending balance (12-31-90) | 46,500 |

**Note:** Capital gains distributions of $145,000 is a distractor.

**CPA-00602 Type1 M/C A-D Corr Ans: D PM#41 F 2-01**

34. CPA-00602 PI May 91 #28 (Adapted) Page 16

On June 30, 2001, Union, Inc. purchased goodwill of $125,000 when it acquired the net assets of Apex Corp. During 2001, Union incurred additional costs of developing goodwill, by training Apex employees


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($50,000) and hiring additional Apex employees ($25,000). Union's December 31, 2001, balance sheet should report goodwill of:

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

**CPA-00602 Explanation**
Choice "d" is correct. $125,000 purchased goodwill.

**Rule:** Goodwill acquired in an arms-length transaction is capitalized, but internally created goodwill is expensed because an objective measure of its value is difficult to obtain.

**CPA-00605 Type1 M/C A-D Corr Ans: D PM#42 F 2-01**

35. CPA-00605 PI May 91 #30 Page 6

Under East Co.'s accounting system, all insurance premiums paid are debited to prepaid insurance. For interim financial reports, East makes monthly estimated charges to insurance expense with credits to prepaid insurance. Additional information for the year ended December 31, 1990, is as follows:

| | |
|---|---|
| Prepaid insurance at December 31, 1989 | $105,000 |
| Charges to insurance expense during 1990 (including a year-end adjustment of $17,500) | 437,500 |
| Prepaid insurance at December 31, 1990 | 122,500 |

What was the total amount of insurance premiums paid by East during 1990?

a. $332,500
b. $420,000
c. $437,500
d. $455,000

**CPA-00605 Explanation**
Choice "d" is correct. $455,000 insurance premiums paid during 1990.

| | Prepaid Insurance |
|---|---|
| Begin balance at 12/31/89 | $105,000 |
| Add payments | 455,000 |
| Subtotal | 560,000 |
| Less expense | (437,500) |
| Ending balance at 12/31/90 | $122,500 |

**CPA-00613 Type1 M/C A-D Corr Ans: D PM#43 F 2-01**

36. CPA-00613 PI May 91 #37 Page 5

Kemp Co. must determine the December 31, 1990, year-end accruals for advertising and rent expenses. A $500 advertising bill was received January 7, 1991, comprising costs of $375 for advertisements in December 1990 issues, and $125 for advertisements in January 1991 issues of the newspaper.

A store lease, effective December 16, 1989, calls for fixed rent of $1,200 per month, payable one month from the effective date and monthly thereafter. In addition, rent equal to 5% of net sales over $300,000 per calendar year is payable on January 31 of the following year. Net sales for 1990 were $550,000.

In its December 31, 1990, balance sheet, Kemp should report accrued liabilities of:

a. $12,875
b. $13,000
c. $13,100
d. $13,475


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**CPA-00613 Explanation**
Choice "d" is correct. $13,475 accrued liabilities at 12/31/90.

| | | Accrued Liabilities 12/31/90 |
|---|---|---|
| Advertising for December 1990 issues ($125 for Jan 1991 issues pertain to 1991) | | 375 |
| Store lease fixed rent ($1,200 × 1/2 month) | | 600 |
| Actual net sales | $550,000 | |
| Less base sales | (300,000) | |
| Excess | 250,000 | |
| Percentage | × 5% | |
| Percentage rent | | 12,500 |
| Total | | $13,475 |

**CPA-00615 Type1 M/C A-D Corr Ans: D PM#44 F 2-01**

37. CPA-00615 PI May 91 #48 Page 7

Marr Corp. reported rental revenue of $2,210,000 in its cash basis federal income tax return for the year ended November 30, 1990. Additional information is as follows:

| | |
|---|---|
| Rents receivable - November 30, 1990 | $1,060,000 |
| Rents receivable - November 30, 1989 | 800,000 |
| Uncollectible rents written off during the fiscal year | 30,000 |

Under the accrual basis, Marr should report rental revenue of:

a. $1,920,000
b. $1,980,000
c. $2,440,000
d. $2,500,000

**CPA-00615 Explanation**
Choice "d" is correct. $2,500,000 rental revenue under the accrual basis.

| | |
|---|---|
| Rents receivable at begin 11/30/89 | $ 800,000 |
| Add: Billings accrued | 2,500,000 |
| Subtotal | 3,300,000 |
| Less: Cash collections | (2,210,000) |
| Write-offs | (30,000) |
| Rents receivable at end 11/30/90 | $1,060,000 |

**CPA-00616 Type1 M/C A-D Corr Ans: A PM#45 F 2-01**

38. CPA-00616 PI May 91 #53 Page 7

Tara Co. owns an office building and leases the offices under a variety of rental agreements involving rent paid in advance monthly or annually. Not all tenants make timely payments of their rent. Tara's balance sheets contained the following data:

| | *1989* | *1990* |
|---|---|---|
| Rentals receivable | $9,600 | $12,400 |
| Unearned rentals | 32,000 | 24,000 |

During 1990, Tara received $80,000 cash from tenants. What amount of rental revenue should Tara record for 1990?

a. $90,800


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b. $85,200
c. $74,800
d. $69,200

**CPA-00616 Explanation**
Choice "a" is correct. $90,800 rental revenue earned for 1990.

| | Asset Rentals Receivable | | Liability Unearned Rentals | | Net Unearned Rentals | |
|---|---|---|---|---|---|---|
| Begin balance at end of 1989 | 9,600 | – | 32,000 | = | 22,400 | |
| Add cash collections | | | | | 80,000 | |
| Subtotal | | | | | 102,400 | |
| Less rental revenue earned | | | | | (90,800) ← | **SQZ** |
| Ending balance at end of 1990 | 12,400 | – | 24,000 | = | 11,600 | |

**CPA-00617 Type1 M/C A-D Corr Ans: B PM#46 F 2-01**

39. CPA-00617PI Nov 90 #10 Page 5

Black Corp.'s accounts payable at December 31, 1989, totaled $900,000 before any necessary year-end adjustments relating to the following transactions:

- On December 27, 1989, Black wrote and recorded checks to creditors totaling $400,000 causing an overdraft of $100,000 in Black's bank account at December 31, 1989. The checks were mailed out on January 10, 1990.
- On December 28, 1989, Black purchased and received goods for $153,061, terms 2/10, n/30. Black records purchases and accounts payable at net amounts. The invoice was recorded and paid January 3, 1990.
- Goods shipped F.O.B. destination on December 20, 1989 from a vendor to Black were received January 2, 1990. The invoice cost was $65,000.

At December 31, 1989, what amount should Black report as total accounts payable?

a. $1,515,000
b. $1,450,000
c. $1,153,061
d. $1,053,061

**CPA-00617 Explanation**
Choice "b" is correct. $1,450,000 accounts payable at 12/31/89.

| | Accounts Payable |
|---|---|
| Balance per books before y/e adjustments | $ 900,000 |
| Add: Checks written on 12/27/89 (which educed A/P) but not mailed until 1/10/90. | 400,000 |
| Add: Goods received 12/28/89 but not recorded until 1/3/90 at amount net of 2% discount ($153,061 × 98%). | 150,000 |
| No entry for goods shipped FOB destination on 12/20/89 but not received until 1/2/90. | 0 |
| Total accounts payable at 12/31/89 | $1,450,000 |

**CPA-00618 Type1 M/C A-D Corr Ans: C PM#47 F 2-01**

40. CPA-00618Th May 90 #7 Page 5


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On December 31, 1989, special insurance costs, incurred but unpaid, were not recorded. If these insurance costs were related to work-in-process, what is the effect of the omission on accrued liabilities and retained earnings in the December 31, 1989 balance sheet?

| | *Accrued liabilities* | *Retained earnings* |
|---|---|---|
| a. | No effect | No effect |
| b. | No effect | Overstated |
| c. | Understated | No effect |
| d. | Understated | Overstated |

**CPA-00618 Explanation**
Choice "c" is correct. Understated. No effect. Since the unrecorded liability affects work-in-process inventory (rather than cost of sales/retained earnings), there is no effect on retained earnings, but accrued liabilities (and inventory) are understated.

**CPA-00619 Type1 M/C A-D Corr Ans: C PM#48 F 2-01**

41. CPA-00619 PI May 90 #22 Page 5

Rice Co. salaried employees are paid biweekly. Advances made to employees are paid back by payroll deductions. Information relating to salaries follows:

| | *12/31/88* | *12/31/89* |
|---|---|---|
| Employee advances | $24,000 | $36,000 |
| Accrued salaries payable | 40,000 | ? |
| Salaries expense during the year | | 420,000 |
| Salaries paid during the year (gross) | | 390,000 |

In Rice's December 31, 1989 balance sheet, accrued salaries payable was:

a. $94,000
b. $82,000
c. $70,000
d. $30,000

**CPA-00619 Explanation**
Choice "c" is correct. $70,000 accrued salaries payable at Dec 31, 1989.

| | Accrued Salaries Payable |
|---|---|
| Beg balance 12/31/88 | $40,000 |
| Add: Salaries exp during the year | 420,000 |
| Subtotal | 460,000 |
| Less: Salaries paid during the year (gross) | (390,000) |
| End balance 12/31/89 | $70,000 |

**CPA-00620 Type1 M/C A-D Corr Ans: D PM#49 F 2-01**

42. CPA-00620 PI May 90 #23 Page 5

At December 31, 1988, a $1,200,000 note payable was included in Cobb Corp.'s liability account balances. The note is dated October 1, 1988, bears interest at 15%, and is payable in three equal annual payments of $400,000. The first interest and principal payment was made on October 1, 1989. In its December 31, 1989 balance sheet, what amount should Cobb report as accrued interest payable for this note?

a. $135,000
b. $90,000
c. $45,000


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d. $30,000

**CPA-00620 Explanation**
Choice "d" is correct. $30,000 accrued interest payable at Dec. 31, 1989.

| | Note Payable |
|---|---|
| Note payable balance at Dec. 31, 1988 | $1,200,000 |
| Less: First payment made Oct. 1, 1989 | (400,000) |
| Note payable balance at Oct. 1, 1989 | 800,000 |
| Annual interest rate | 15% |
| Annual interest | 120,000 |
| Adjustment factor for 3 mos. From 10-1-89 to 12-31-89 | × 3/12 |
| Accrued interest payable at Dec. 31, 1989 | $ 30,000 |

**CPA-00623 Type1 M/C A-D Corr Ans: C PM#51 F 2-01**

43. CPA-00623 PI Nov 89 #16 Page 5

Fay Corp. pays its outside salespersons fixed monthly salaries and commissions on net sales. Sales commissions are computed and paid on a monthly basis (in the month following the month of sale), and the fixed salaries are treated as advances against commissions. However, if the fixed salaries for salespersons exceed their sales commissions earned for a month, such excess is not charged back to them. Pertinent data for the month of March 1988 for the three salespersons are as follows:

| *Salesperson* | *Fixed Salary* | *Net Sales* | *Commission Rate* |
|---|---|---|---|
| A | $10,000 | $ 200,000 | 4% |
| B | 14,000 | 400,000 | 6% |
| C | 18,000 | 600,000 | 6% |
| Totals | $42,000 | $1,200,000 | |

What amount should Fay accrue for sales commissions payable at March 31, 1988?

a. $70,000
b. $68,000
c. $28,000
d. $26,000

**CPA-00623 Explanation**
Choice "c" is correct. $28,000 sales commissions payable at March 31, 1988.

| | Sales Persons A | B | C | Total |
|---|---|---|---|---|
| Net sales | $200,000 | $400,000 | $600,000 | |
| Commission rate | × 4% | × 6% | × 6% | |
| Commissions earned | 8,000 | 24,000 | 36,000 | |
| Adjust "A" to fixed salary minimum | 2,000 | 0 | 0 | |
| Commission accrual | 10,000 | 24,000 | 36,000 | $70,000 |
| Less fixed | | | | |
| Salary advances | (10,000) | (14,000) | (18,000) | (42,000) |
| Sales commissions payable | 0 | 10,000 | 18,000 | 28,000 |

**CPA-00624 Type1 M/C A-D Corr Ans: D PM#52 F 2-01**

44. CPA-00624 PI Nov 89 #19 Page 5

A state requires quarterly sales tax returns to be filed with the sales tax bureau by the 20th day following the end of the calendar quarter. However, the state further requires that sales taxes collected be remitted to the sales tax bureau by the 20th day of the month following any month such collections exceed $500. These payments can be taken as credits on the quarterly sales tax return.


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Taft Corp. operates a retail hardware store. All items are sold subject to a 6% state sales tax, which Taft collects and records as sales revenue. The sales taxes paid by Taft are charged against sales revenue. Taft pays the sales taxes when they are due.

Following is a monthly summary appearing in Taft's first quarter 1989 sales revenue account:

| | *Debit* | *Credit* |
|---|---|---|
| January | $ - | $10,600 |
| February | 600 | 7,420 |
| March | - | 9,540 |
| | $600 | $27,560 |

In its financial statements for the quarter ended March 31, 1989, Taft's sales revenue and sales taxes payable would be:

| | *Sales revenue* | *Sales taxes payable* |
|---|---|---|
| a. | $27,560 | $1,560 |
| b. | $26,960 | $600 |
| c. | $26,000 | $1,560 |
| d. | $26,000 | $960 |

**CPA-00624 Explanation**

Choice "d" is correct. $26,000 – $960.

$$\frac{\text{Credits to sales revenue}}{\text{Sales tax rate plus one}} = \frac{\$27,560}{1.06} = \$26,000 \text{ sales revenue}$$

| | |
|---|---|
| Sales tax rate | × .06 |
| Sales tax collected | 1,560 |
| Less advance payments | 600 |
| Sales tax payable | $ 960 |

**CPA-04677 Type1 M/C A-D Corr Ans: D PM#53 F 2-01**

45. CPA-04677 Released 2005 Page 10

Macklin Co. entered into a franchise agreement with Heath Co. for an initial fee of $50,000. Macklin received $10,000 when the agreement was signed. The balance was to be paid at a rate of $10,000 per year, starting the next year. All services were performed by Macklin and the refund period had expired. Operations started in the current year. What amount should Macklin recognize as revenue in the current year?

a. $0
b. $10,000
c. $20,000
d. $50,000

**CPA-04677 Explanation**

Choice "d" is correct. The franchisor should report revenue from initial franchise fees when all material conditions of the sale have been "substantially performed." Macklin Co. will recognize the entire initial fee in the current year.

Choices "a", "b", and "c" are incorrect per above.

**CPA-04694 Type1 M/C A-D Corr Ans: C PM#54 F 2-01**

46. CPA-04694 Released 2005 Page 17

Which of the following is an example of activities that would typically be excluded in research and development costs?


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a. Design, construction, and testing of preproduction prototypes and modes.
b. Laboratory research aimed at discovery of new knowledge.
c. Quality control during commercial production, including routine testing of products.
d. Testing in search for, or evaluation of, product or process alternatives.

**CPA-04694 Explanation**
Choice "c" is correct. Research is the planned efforts of a company to discover new information that will help either create or improve a new product, service, process, or technique or one in current use. Items not considered research and development include: Routine periodic design changes to old products or troubleshooting in production stage, marketing research, quality control testing and reformulation of a chemical compound.

**CPA-05112 Type1 M/C A-D Corr Ans: A PM#65 F 2-01**

47. CPA-05112 Financial Online Quiz Page 49

During a period of rising prices, a company that uses current cost/constant dollar accounting and holds both monetary and non-monetary assets likely experiences:

| | *Purchasing Power Gain/Loss* | *Appreciation* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |

**CPA-05112 Explanation**
Choice "a" is correct. Purchasing power measures the impact of inflation through index adjusted constant dollar accounting. As the monetary unit decreases in value constant dollar accounting will measure purchasing power gains and losses. Monetary assets, assets fixed in monetary value, will experience a purchasing power loss. Appreciation is measured by evaluating replacement costs using current dollar accounting. In a period of rising prices, we would anticipate that non-monetary assets would appreciate in value.

Choice "b" is incorrect. Constant dollar accounting would measure purchasing power gains and losses. Monetary assets would likely produce a purchasing power loss in a period of rising prices and we would most likely anticipate that non-monetary asset values would appreciate as well.

Choice "c" is incorrect. Constant dollar accounting would measure purchasing power gains and losses. Monetary assets normally produce a purchasing power loss in a period of rising prices while non-monetary assets reflect appreciation.

Choice "d" is incorrect. Constant dollar accounting would measure purchasing power gains and losses. Monetary assets would normally display a purchasing power loss and non-monetary assets would reflect appreciation.

**CPA-05114 Type1 M/C A-D Corr Ans: D PM#66 F 2-01**

48. CPA-05114 Financial Online Quiz Page 54

Chang Import/Export has numerous international subsidiaries throughout Asia that rely upon both the U.S. dollar and local currencies to sustain their operations. For the year ended December 31, 20X2, Chang experienced a remeasurement loss of $40,000 and a translation gain of $25,000. As a result of these conversions, accumulated other comprehensive income would display:

a. $0.
b. $15,000 loss.
c. $40,000 loss.
d. $25,000 gain.


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**CPA-05114 Explanation**
Choice "d" is correct. Conversion adjustments associated with translation of financial statements are displayed in accumulated other comprehensive income. The $25,000 translation gain is included in accumulated other comprehensive income.

Choice "a" is incorrect. Conversion adjustments associated with translation of financial statements are displayed in accumulated other comprehensive income. The $25,000 translation gain is included in accumulated other comprehensive income. Accumulated other comprehensive income would not reflect $0 in activity.

Choice "b" is incorrect. Conversion adjustments associated with remeasurement of financial statements is displayed in income. The $40,000 remeasurement loss would be displayed in income, and not netted against the translation gain for display in accumulated other comprehensive income.

Choice "c" is incorrect. Conversion adjustments associated with remeasurement of financial statements is displayed in income. The $40,000 remeasurement loss would be displayed in income, not in accumulated other comprehensive income.

**CPA-05200 Type1 M/C A-D Corr Ans: D PM#67 F 2-01**

49. CPA-05200 Released 2006 Page 9

On December 30, Devlin Co. sold goods to Jensen Co. for $10,000, under an arrangement in which (1) Jensen has an unlimited right of return and (2) Jensen's obligation to pay Devlin is contingent upon Jensen's reselling the goods. Past experience has shown that Jensen ordinarily resells 60% of goods and returns the other 40%. What amount should Devlin include in sales revenue for this transaction on its December 31 income statement?

a. $10,000
b. $6,000
c. $4,000
d. $0

**CPA-05200 Explanation**
Choice "d" is correct. When there is an unlimited right of return, nothing should be recorded as sales revenue unless four conditions are satisfied. These conditions are the following:

- The sales price is substantially fixed (it seems like it is in this question).
- The buyer assumes all risk of loss (no information).
- The buyer has paid some form of consideration (no information).
- The amount of returns can be reasonably estimated (which they can in this question).

Since all four conditions have not been satisfied, revenue should not be recognized until they are or until something is actually sold.

Choice "a" is incorrect. No revenue should be recognized because all four conditions have not been satisfied.

Choice "b" is incorrect. No revenue should be recognized because all four conditions have not been satisfied.

Choice "c" is incorrect. No revenue should be recognized because all four conditions have not been satisfied.

**CPA-05206 Type1 M/C A-D Corr Ans: C PM#68 F 2-01**

50. CPA-05206 Released 2006 Page 19

Standard Co. spent $10,000,000 on its new software package that is to be used only for internal use. The amount spent is for costs after the preliminary project stage. The economic life of the product is


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expected to be three years. The equipment on which the package is to be used is being depreciated over five years. What amount of expense should Standard report on its income statement for the first full year?

a. $0
b. $2,000,000
c. $3,333,333
d. $10,000,000

**CPA-05206 Explanation**
Choice "c" is correct. For software developed internally, costs incurred in the preliminary project stage are expensed. In this question, the costs AFTER the preliminary project stage are capitalized and depreciated over the economic life of the product (3 years). Depreciation expense is thus $3,333,333. The 5-year life of the equipment on which the package will be used is a distracter.

Choice "a" is incorrect. In this question, the $10,000,000 of cost is after the preliminary project stage. This cost will be capitalized and depreciated. Thus, depreciation expense is other than $0.

Choice "b" is incorrect. In this question, the software is depreciated over 3 years, not 5 years. The 5-year life of the equipment on which the package will be used is a distracter.

Choice "d" is incorrect. The full $10,000,000 cost would not be expensed in the first year unless the costs were incurred during the preliminary project stage. In this question, the cost was incurred AFTER the preliminary project stage.

**CPA-05218 Type1 M/C A-D Corr Ans: A PM#69 F 2-01**

51. CPA-05218 Released 2006 Page 16

Which of the following is a research and development cost?

a. Development or improvement of techniques and processes.
b. Offshore oil exploration that is the primary activity of a company.
c. Research and development performed under contract for others.
d. Market research related to a major product for the company.

**CPA-05218 Explanation**
Choice "a" is correct. Development or improvement of techniques and processes is a research and development (R&D) cost.

Choice "b" is incorrect. Offshore oil "exploration" costs (assumed to be geological and geophysical expenses) that is the primary activity of a company is not an R&D cost. These costs would be expensed (as cost of services sold) by a company whose primary activity is the incurring of such geological and geophysical costs. If these "exploration" costs are not assumed to be geological and geophysical expenses, they would be the drilling of exploratory wells looking for commercial oil & gas deposits; in that event, they would be capitalized and then amortized. Either way, the costs are not an R&D cost.

Choice "c" is incorrect. Research and development performed under contract for others is not an R&D cost. The purchaser buying the research and development will be able to expense its expenditures as R&D costs.

Choice "d" is incorrect. Market research, even though the term contains the word research, is not an R&D cost.

**CPA-05220 Type1 M/C A-D Corr Ans: A PM#70 F 2-01**

52. CPA-05220 Released 2006 Page 9

North Co. entered into a franchise agreement with South Co. for an initial fee of $50,000. North received $10,000 at the agreement's signing. The remaining balance was to be paid at a rate of $10,000 per year, beginning the following year. North's services per the agreement were not complete in the current year.


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Operating activities will commence next year. What amount should North report as franchise revenue in the current year?

a. $0
b. $10,000
c. $20,000
d. $50,000

**CPA-05220 Explanation**
Choice "a" is correct. Franchise fee revenue of $0 should be recognized in the current year because North's services per the franchise agreement were not complete in the current year. The $10,000 is the first payment of the $50,000 initial franchise fee that was to be paid in installments. From a franchisor's (North Co.) standpoint, initial franchise fees are not revenue until all material conditions of the sale have been "substantially performed." The services were stated in the question to not be complete.

Choice "b" is incorrect. Franchise fee revenue of $0, **not** the $10,000 that was received on the agreement's signing, should be recognized in the current year because North's services per the franchise agreement were not complete in the current year.

Choice "c" is incorrect. Franchise fee revenue of $0, **not** the $10,000 that was received on the agreement's signing and presumably the $10,000 that was to be paid at the beginning of the next year, should be recognized in the current year because North's services per the franchise agreement were not complete in the current year.

Choice "d" is incorrect. Franchise fee revenue of $0, **not** the full $50,000 initial franchise fee, should be recognized in the current year because North's services per the franchise agreement were not complete in the current year.

**CPA-00921 Type1 M/C A-D Corr Ans: A PM#71 F 2-01**

53. CPA-00921 Nov 90 #23 Page 9

Jersey, Inc. is a retailer of home appliances and offers a service contract on each appliance sold. Jersey sells appliances on installment contracts, but all service contracts must be paid in full at the time of sale. Collections received for service contracts should be recorded as an increase in a:

a. Deferred revenue account.
b. Sales contracts receivable valuation account.
c. Stockholders' valuation account.
d. Service revenue account.

**CPA-00921 Explanation**
Choice "a" is correct. Collections received for service contracts S/B recorded as an increase in a "deferred revenue account."

Choices "b" and "c" are incorrect. Since service contracts must be paid in full at the time of sale, valuation accounts (receivables or equity) are not involved.

Choice "d" is incorrect. Service revenue is recognized with the passage of time over the life of the service contracts - not at time of original sale.

**CPA-00922 Type1 M/C A-D Corr Ans: D PM#72 F 2-01**

54. CPA-00922 May 91 #15 Page 9

An automobile dealer sells service contracts. The contracts stipulate that the dealer will perform specific repairs on covered vehicles. The contracts vary in length from 12 to 36 months. Do the following increase when service contracts are sold?

| | *Deferred revenue* | *Service revenue* |
|---|---|---|
| a. | Yes | Yes |


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b. No No
c. No Yes
d. Yes No

**CPA-00922 Explanation**
Choice "d" is correct. Yes - No. When service contracts are sold, deferred revenue increases, but service revenue does not increase until each month passes.

| | Service contracts | |
|---|---|---|
| Assumed amounts and dates: | Deferred revenue (unearned) (liability) | Service revenue (earned) (income) |
| Begin bal, Jan. 1, 1991 | 0 | |
| Add: Sale of service contracts | 36 | |
| Subtotal | 36 | |
| Less: Revenue earned monthly | (1) | 1 |
| End bal, Jan. 31, 1991 | 35 | 1 |

**CPA-05224 Type1 M/C A-D Corr Ans: D PM#72 F 2-01**

55. CPA-05224 Released 2006 Page 19

Yellow Co. spent $12,000,000 during the current year developing its new software package. Of this amount, $4,000,000 was spent before it was at the application development stage and the package was only to be used internally. The package was completed during the year and is expected to have a four-year useful life. Yellow has a policy of taking a full-year's amortization in the first year. After the development stage, $50,000 was spent on training employees to use the program. What amount should Yellow report as an expense for the current year?

a. $1,600,000
b. $2,000,000
c. $6,012,500
d. $6,050,000

**CPA-05224 Explanation**
Choice "d" is correct. The $4,000,000 that was spent before the application development stage (during the preliminary project state) would certainly be expensed. The $50,000 for training employees would certainly be expensed (costs for training and maintenance are expensed). The total so far is $4,050,000. The package was completed during the year and a full year's worth of amortization is taken ($8,000,000 / 4 = $2,000,000). The total then is $6,050,000.

Choice "a" is incorrect. This answer appears to be amortization of the $4,000,000 that was spent before the application development stage and nothing else. That would mean that everything else was capitalized. If everything else were capitalized, what about amortization on those capitalized amounts? It is hard to imagine that they would just "stay out there" forever.

Choice "b" is incorrect. This answer appears to be amortization of the $8,000,000 ($8,000,000 / 4 = $2,000,000). That would mean that everything else was capitalized. If everything else were capitalized, what about amortization on those capitalized amounts?

Choice "c" is incorrect. This answer includes amortization ($50,000 / 4 = $12,500) of the training expenditures. Training should be expensed when incurred. The rest of the answer ($6,000,000) is the same as the correct answer.

**CPA-04680 Type1 M/C A-D Corr Ans: B PM#73 F 2-01**

56. CPA-04680 Released 2005 Page 3


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UVW Broadcast Co. entered into a contract to exchange unsold advertising time for travel and lodging services with Hotel Co. As of June 30, advertising commercials of $10,000 were used. However, travel and lodging services were not provided. How should UVW account for advertising in its June 30 financial statements?

a. Revenue and expense is recognized when the agreement is complete.
b. An asset and revenue for $10,000 is recognized.
c. Both the revenue and expense of $10,000 are recognized.
d. Not reported.

**CPA-04680 Explanation**
Choice "b" is correct. Revenues should be recognized in the period in which they were earned and realized or realizable. Expenses are recognized when an entity's economic benefits are used up in delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations.

UVW provided advertising services but did not yet benefit from the travel or lodging.

Choices "a", "c", and "d" are incorrect, per the above.

**CPA-05426 Type1 M/C A-D Corr Ans: B PM#74 F 2-01**

57. CPA-05426 Released 2007 Page 12

Johan Co. has an intangible asset, which it estimates will have a useful life of 10 years, while Abco Co. has goodwill, which has an indefinite life. Which company should report amortization in its financial statements?

| | *Johan* | *Abco* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |

**CPA-05426 Explanation**
Choice "b" is correct. Johan Co.'s intangible asset is a finite life intangible asset. Finite life intangibles are amortized over the period to be benefited. Abco Co.'s goodwill is not amortized, but is instead analyzed periodically (at least annually) for impairment.

Choices "a", "c", and "d" are incorrect, per the explanation above.

**CPA-05436 Type1 M/C A-D Corr Ans: B PM#75 F 2-01**

58. CPA-05436 Released 2007 Page 7

During 2002, Fleet Co.'s trademark was licensed to Hitch Corp. for royalties of 10% of net sales of the trademarked items. Returns were estimated to be 1% of gross sales. On signing the licensing agreement, Hitch paid Fleet $75,000 as an advance against future royalty earnings. Gross sales of the trademarked items during the year were $600,000. What amount should Fleet report as royalty income for 2002?

a. $54,000
b. $59,400
c. $60,000
d. $75,000

**CPA-05436 Explanation**
Choice "b" is correct. Fleet earns royalties based on 10% of net sales, so the first step is the calculation of net sales:

| | |
|---|---|
| Sale | $600,000 |


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| | |
|---|---|
| Allowance for sales returns | 6,000 = $600,000 x 1% |
| Net Sales | $594,000 |

Net sales can then be used to calculate Fleet's royalty income:

Net Sales x Royalty % = $594,000 x 10% = $59,400

Choice "a" is incorrect. Sales returns are not subtracted from 10% of gross sales to calculate Fleet's royalty income.

Choice "c" is incorrect. Fleet's royalty revenue should be calculated using net sales, rather than gross sales.

Choice "d" is incorrect. Royalty revenue is not equal the advance against future royalty earnings received by Fleet. Fleet's royalty revenue is equal to 10% of the net sales for the period. The advance against future royalty earnings should have been recorded as unearned revenue when received. At the end of 2002, $15,600 ($75,000 advance - $59,400 royalty income earned) of the advance would remain in unearned revenue.

**CPA-05455 Type1 M/C A-D Corr Ans: A PM#76 F 2-01**

59. CPA-05455 Released 2007 Page 15

Which of the following statements is correct concerning start-up costs?

a. Costs of start-up activities, including organization costs, should be expensed as incurred.
b. Costs of start-up activities, including organization costs, should be capitalized and expensed only if an impairment exists.
c. Costs of start-up activities, including organization costs, should be capitalized and amortized on a straight-line basis over the lesser of the estimated economic life of the company, or 60 months.
d. Costs of start-up activities should be capitalized and amortized on a straight-line basis over the lesser of the estimated economic life of the company, or 60 months, while organization cost should be expensed as incurred.

**CPA-05455 Explanation**

Choice "a" is correct. GAAP requires that start-up costs, including organizational costs, be expensed as incurred, without exception.

Choices "b", "c", and "d" are incorrect based on the explanation above.

**CPA-00152 Type1 M/C A-D Corr Ans: C PM#77 F 2-01**

60. CPA-00152 PI Nov 93 #54 Page 12

On January 2, 1989, Lava, Inc. purchased a patent for a new consumer product for $90,000. At the time of purchase, the patent was valid for 15 years; however, the patent's useful life was estimated to be only 10 years due to the competitive nature of the product. On December 31, 1992, the product was permanently withdrawn from sale under governmental order because of a potential health hazard in the product. What amount should Lava charge against income during 1992, assuming amortization is recorded at the end of each year?

a. $9,000
b. $54,000
c. $63,000
d. $72,000

**CPA-00152 Explanation**

Choice "c" is correct. The patent has been permanently impaired and a loss equal to its carrying amount should be recorded. The charge against income is:

| | |
|---|---|
| Patent cost | $90,000 |
| Pre-1992 amortization ($90,000/10) $\times$ 3 | (27,000) |


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| | |
|---|---|
| Total, 1-1-92 | $ 63,000 |

The $63,000 would be amortized for another year (1992) or $9,000 expense and the balance of $54,000 written off. The total charge to income is $63,000 in 1992.

Choice "a" is incorrect. The addition to the $9,000 amortization, a loss for permanent impairment should be recorded.

Choice "b" is incorrect. In addition to the $54,000 impairment loss, $9,000 of patent amortization would also be charged against income in 1992.

Choice "d" is incorrect. Amortization for 3 years should have been recorded, in addition to 1992.

**CPA-05457 Type1 M/C A-D Corr Ans: B PM#77 F 2-01**

61. CPA-05457 Released 2007 Page 21

Goodwill should be tested for value impairment at which of the following levels?

a. Each identifiable long-term asset.
b. Each reporting unit.
c. Each acquisition unit.
d. Entire business as a whole.

**CPA-05457 Explanation**
Choice "b" is correct. GAAP requires that goodwill be tested for impairment at the reporting unit level. The evaluation of goodwill impairment involves two major steps.

**Step 1:** Identify potential impairment by comparing the fair value of each reporting unit with its carrying amount, including goodwill.

(1) Assign assets acquired and liabilities assumed to the various reporting units. Assign goodwill to the reporting units.

(2) Determine the fair values of the reporting units and of the assets and liabilities of those reporting units. Fair value is determined in accordance with SFAS No. 157.

(3) If the fair value of a reporting unit is less than its carrying amount, there is potential goodwill impairment. The impairment is assumed to be due to the reporting unit's goodwill since any impairment in the other assets of the reporting unit will already have been determined and adjusted for (**other impairments are evaluated before goodwill**).

(4) If the fair value of a reporting unit is more than its carrying amount, there is no goodwill impairment and Step 2 is not necessary.

**Step 2:** Measure the amount of goodwill impairment loss by comparing the implied fair value of the reporting unit's goodwill with the carrying amount of that goodwill.

(1) Allocate the fair value of the reporting unit to all assets and liabilities of the unit. Any fair value that cannot be assigned to specific assets and liabilities is the implied goodwill of the reporting unit.

(2) Compare the implied fair value of the goodwill to the carrying value of the goodwill. If the implied fair value of the goodwill is less than its carrying amount, recognize a goodwill impairment loss. Once the goodwill impairment loss has been fully recognized, it cannot be reversed.

Choices "a", "c", and "d" are incorrect, per the explanation above.

**CPA-04687 Type1 M/C A-D Corr Ans: A PM#78 F 2-01**

62. CPA-04687 Released 2005 Page 12


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Tech Co. bought a trademark on January 2, two years ago. Tech accounted for the trademark as instructed under the provisions of FASB #142 during the current year. The carrying value at the beginning of the year was $38,000. It was determined that the cash flow will be generated indefinitely at the current level for the trademark. What amount should Tech report as amortization expense for the current year?

a. $0
b. $922
c. $1,000
d. $38,000

**CPA-04687 Explanation**
Choice "a" is correct. The carrying amount of both tangible and intangible assets held for use needs to be reviewed whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. The future cash flows expected to result from use of the asset and its eventual disposition need to be estimated. If this sum of undiscounted expected (future) cash flows is less than the carrying amount, an impairment loss or expense needs to be recognized. Tech Co anticipates that cash flow will be generated indefinitely at the current level resulting in no impairment. No expense is recognized.

Choices "b", "c", and "d" are incorrect, per the above.

**CPA-04672 Type1 M/C A-D Corr Ans: D PM#78 F 2-01**

63. CPA-04672 Released 2005 Page 15

Wind Co. incurred organization costs of $6,000 at the beginning of its first year of operations. How should Wind treat the organization costs in its financial statements in accordance with GAAP?

a. Never amortized.
b. Amortized over 60 months.
c. Amortized over 40 years.
d. Expensed immediately.

**CPA-04672 Explanation**
Choice "d" is correct. Organization costs expensed for GAAP financial income (no asset) but deducted in later years for tax purposes.

Choice "a" is incorrect. Organization costs are expensed when incurred for GAAP financial reporting.

Choice "b" is incorrect. 60 month option is no longer applicable.

Choice "c" is incorrect. Organization costs are expensed when incurred for GAAP financial reporting.

**Long-term Construction Contracts**

**CPA-00654 Type1 M/C A-D Corr Ans: D PM#4 F 2-02**

64. CPA-00654 PI May 93 #41 Page 29

Haft Construction Co. has consistently used the percentage-of-completion method. On January 10, 1991, Haft began work on a $3,000,000 construction contract. At the inception date, the estimated cost of construction was $2,250,000. The following data relate to the progress of the contract:

| | |
|---|---|
| Income recognized at 12/31/91 | $ 300,000 |
| Costs incurred 1/10/91 through 12/31/92 | 1,800,000 |
| Estimated cost to complete at 12/31/92 | 600,000 |

In its income statement for the year ended December 31, 1992, what amount of gross profit should Haft report?

a. $450,000
b. $300,000


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c. $262,500
d. $150,000

**CPA-00654 Explanation**
Choice "d" is correct. The gross profit for the percentage-of-completion method is as follows:

| | |
|---|---|
| Contract price | $3,000,000 |
| Cost to date | 1,800,000 |
| Est. cost to complete | 600,000 |
| Total cost | 2,400,000 |
| Expected gross profit | 600,000 |
| Percentage complete (18/24) | 75% |
| Profit to date | 450,000 |
| Profit previously recognized | (300,000) |
| 1992 profit | $ 150,000 |

ARB 45 para. 4

Choice "a" is incorrect. $450,000 is the total profit earned to date. Only profit earned in 1992 is to be determined.

Choice "b" is incorrect. $300,000 is the earned profit in 1991. The profit earned in 1992 is to be determined.

Choice "c" is incorrect. The total gross profit as of December 31, 1992 must be computed to determine the profit to be recorded in 1992.

**CPA-00656 Type1 M/C A-D Corr Ans: B PM#5 F 2-02**

65. CPA-00656 Th Nov 92 #8 Page 30

A company used the percentage-of-completion method of accounting for a 5-year construction contract. Which of the following items will the company use to calculate the income recognized in the third year?

| | *Progress billings to date* | *Income previously recognized* |
|---|---|---|
| a. | Yes | No |
| b. | No | Yes |
| c. | No | No |
| d. | Yes | Yes |

**CPA-00656 Explanation**
Choice "b" is correct. No - Yes.

When a company uses the **"percentage-of-completion"** method of accounting for a five-year construction contract, income previously recognized would be used to calculate the income recognized in the second year (but not progress billings to date).

| **Illustration Per Class Exercise** | **Year 2** |
|---|---|
| Total contract sales price | $4,000 |
| Less total estimated cost of contract | 3,200 |
| Total gross Profit | 800 |
| × % of completion | × 75% |
| Gross profit earned to date (Cumulative) | 600 |
| Less income previously recognized | 500 |
| Income recognized in current year | 100 |

**CPA-00658 Type1 M/C A-D Corr Ans: B PM#6 F 2-02**

66. CPA-00658 Th May 92 #44 Page 27


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A company uses the completed-contract method to account for a long-term construction contract. Revenue is recognized when recorded progress billings:

| | *Are collected* | *Exceed recorded costs* |
|---|---|---|
| a. | Yes | Yes |
| b. | No | No |
| c. | Yes | No |
| d. | No | Yes |

**CPA-00658 Explanation**
Choice "b" is correct. No-No. When a company uses the **"completed contract"** method to account for a long-term construction contract, **revenue** is recognized when the job is **completed**, not when progress billings are **collected** or when they exceed recorded costs.

When the **"percentage of completion"** method of recording revenue is used, **engineering estimates** of completion or "costs incurred to date" vs "total estimated costs" is the basis for recognizing revenue, not progress billings.

**CPA-00659 Type1 M/C A-D Corr Ans: D PM#7 F 2-02**

67. CPA-00659 Th Nov 91 #15 Page 27

During 1990, Tidal Co. began construction on a project scheduled for completion in 1992. At December 31, 1990, an overall loss was anticipated at contract completion. What would be the effect of the project on 1990 operating income under the percentage-of-completion method and the completed-contract method?

| | *Percentage-of-completion* | *Completed-contract* |
|---|---|---|
| a. | No effect | No effect |
| b. | No effect | Decrease |
| c. | Decrease | No effect |
| d. | Decrease | Decrease |

**CPA-00659 Explanation**
Choice "d" is correct. Decrease - Decrease on 1990 operating income under both the percentage-of-completion method and the completed-contract method.

**Rule:** For "percentage-of-completion" and "completed-contract," the entire estimated loss is recorded for a loss contract in progress (not only the loss incurred to date).

**CPA-00665 Type1 M/C A-D Corr Ans: A PM#8 F 2-02**

68. CPA-00665 FARE May 95 #26 Page 30

Which of the following is used in calculating the income recognized in the fourth and final year of a contract accounted for by the percentage-of-completion method?

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

**CPA-00665 Explanation**
Choice "a" is correct. Under the percentage-of-completion method, annual gross profit equals [total cost incurred/total expected cost] $\times$ [total expected gross profit] less total gross profit previously recognized. In the final year of the contract, actual rather than expected amounts are used.


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**CPA-00683 Type1 M/C A-D Corr Ans: D PM#9 F 2-02**

69. CPA-00683 PII Nov 90 #15 Page 30

Gow Constructors, Inc. has consistently used the percentage-of-completion method of recognizing income. In 1989, Gow started work on an $18,000,000 construction contract that was completed in 1990. The following information was taken from Gow's 1989 accounting records:

| | |
|---|---|
| Progress billings | $6,600,000 |
| Costs incurred | 5,400,000 |
| Collections | 4,200,000 |
| Estimated costs to complete | 10,800,000 |

What amount of gross profit should Gow have recognized in 1989 on this contract?

a. $1,400,000
b. $1,200,000
c. $900,000
d. $600,000

**CPA-00683 Explanation**
Choice "d" is correct. **$600,000** gross profit recognized in 1989.

| **Step 1 - compute G/P of total contr** | | |
|---|---|---|
| Total contract sales price | $18,000 | |
| Less total estimated costs | 16,200 | |
| Total gross profit | $ 1,800 | |
| **Step 2 - compute % of completion** | **Thousands** | |
| Costs incurred (to date) | $ 5,400 | = 1/3 CMP |
| Estimated cost to complete | 10,800 | = 2/3 |
| Total estimated costs | $16,200 | = 100% |
| **Step 3 - compute G/P earned to date** | | |
| Total contract gross profit | $ 1,800 | |
| × % of completion | 1/3 | |
| G/P earned to date | 600 | |

**CPA-00687 Type1 M/C A-D Corr Ans: D PM#11 F 2-02**

70. CPA-00687 PII May 90 #41 Page 27

During 1988, Mitchell Corp. started a construction job with a total contract price of $600,000. The job was completed on December 15, 1989. Additional data are as follows:

| | *1988* | *1989* |
|---|---|---|
| Actual costs incurred | $225,000 | $255,000 |
| Estimated remaining costs | 225,000 | - |
| Billed to customer | 240,000 | 360,000 |
| Received from customer | 200,000 | 400,000 |

Under the completed contract method, what amount should Mitchell recognize as gross profit for 1989?

a. $45,000
b. $72,000
c. $80,000
d. $120,000

**CPA-00687 Explanation**
Choice "d" is correct. **$120,000** gross profit recognized for 1989 under the **completed contract method**.


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**Completed contract method:**

| | |
|---|---|
| Total contract sales price | $600,000 |
| Less total cost of contract (225,000 + 255,000) = | 480,000 |
| Gross profit recognized when contract is completed | $120,000 |

**CPA-00689 Type1 M/C A-D Corr Ans: C PM#12 F 2-02**

71. CPA-00689 PII May 90 #57 Page 30

Mill Construction Co. uses the percentage-of- completion method of accounting. During 1989, Mill contracted to build an apartment complex for Drew for $20,000,000. Mill estimated that total costs would amount to $16,000,000 over the period of construction. In connection with this contract, Mill incurred $2,000,000 of construction costs during 1989. Mill billed and collected $3,000,000 from Drew in 1989. What amount should Mill recognize as gross profit for 1989?

a. $250,000
b. $375,000
c. $500,000
d. $600,000

**CPA-00689 Explanation**
Choice "c" is correct. **$500,000** gross profit recognized for 1989 under the percentage-of-completion method.

**Percentage-of-completion method:**

| | |
|---|---|
| Total contract sales price | $20,000,000 |
| Less total est. cost of contract | 16,000,000 |
| Total gross profit | 4,000,000 |
| $\frac{\text{Cost incurred to date}}{\text{Total est. cost of contract}} = \frac{2,000,000}{16,000,000}$ | 1/8 |
| Gross profit recognized for 1989 | $ 500,000 |

**CPA-04660 Type1 M/C A-D Corr Ans: D PM#13 F 2-02**

72. CPA-04660 Released 2005 Page 30

The calculation of the income recognized in the third year of a five-year construction contract accounted for using the percentage-of-completion method includes the ratio of:

a. Costs incurred in year 3 to total billings.
b. Costs incurred in year 3 to total estimated costs.
c. Total costs incurred to date to total billings.
d. Total costs incurred to date to total estimated costs.

**CPA-04660 Explanation**
Choice "d" is correct. The formula to calculate the percentage of completion is:

$$\frac{\text{Total cost to date}}{\text{Total estimated cost of contract}}$$

Choices "a", "b", and "c" are incorrect, per formula.

**Accounting for Installment Sales**

**CPA-00696 Type1 M/C A-D Corr Ans: D PM#2 F 2-03**

73. CPA-00696 FARE Nov 95 #31 Page 34


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It is proper to recognize revenue prior to the sale of merchandise when:

I. The revenue will be reported as an installment sale.
II. The revenue will be reported under the cost recovery method.

a. I only.
b. II only.
c. Both I and II.
d. Neither I nor II.

**CPA-00696 Explanation**
Choice "d" is correct. Revenue can be recognized prior to the completion of a long-term project but generally not prior to a merchandise sale, especially not one recognized on the installment method. SFAC 5 para. 83

Choice "a" is incorrect. The installment sales method delays revenue recognition by recognizing revenue as cash is collected rather than accelerating revenue recognition.

Choice "b" is incorrect. The cost recovery method delays revenue recognition until all costs have been collected rather than accelerating revenue recognition.

Choice "c" is incorrect. The installment sales method delays revenue recognition by recognizing revenue as cash is collected rather than accelerating revenue recognition. The cost recovery method delays revenue recognition until all costs have been collected rather than accelerating revenue recognition.

**CPA-00697 Type1 M/C A-D Corr Ans: C PM#3 F 2-03**

74. CPA-00697 FARE May 95 #27 Page 34

According to the installment method of accounting, gross profit on an installment sale is recognized in income:

a. On the date of sale.
b. On the date the final cash collection is received.
c. In proportion to the cash collection.
d. After cash collections equal to the cost of sales have been received.

**CPA-00697 Explanation**
Choice "c" is correct. Under the installment method, total gross profit is deferred until cash payments are received. Realized gross profit equals the gross profit percentage on the sale times the ratio of cash received to the total sale amount.

Choice "a" is incorrect. Under the accrual basis of accounting, all gross profit is recognized and realized at the time of the sale. Recognition is deferred under the installment method.

Choice "b" is incorrect. Recognition of gross profit is not delayed until all cash is collected.

Choice "d" is incorrect. Under the cost recovery method (not the installment method), gross profit is not realized until cash is collected equal to the cost of the goods sold.

**CPA-00705 Type1 M/C A-D Corr Ans: D PM#4 F 2-03**

75. CPA-00705 FARE May 94 #23 Page 34

Since there is no reasonable basis for estimating the degree of collectibility, Astor Co. uses the installment method of revenue recognition for the following sales:

| | *1993* | *1992* |
|---|---|---|
| Sales | $900,000 | $600,000 |
| Collections from: | | |
| 1992 sales | 100,000 | 200,000 |
| 1993 sales | 300,000 | - |


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| | | |
|---|---|---|
| Accounts written off: | | |
| 1992 sales | 150,000 | 50,000 |
| 1993 sales | 50,000 | - |
| Gross profit percentage | 40% | 30% |

What amount should Astor report as deferred gross profit in its December 31, 1993, balance sheet for the 1992 and 1993 sales?

a. $150,000
b. $160,000
c. $225,000
d. $250,000

**CPA-00705 Explanation**
Choice "d" is correct. The total deferred gross profit equals the deferred gross profit from 1992 sales plus the deferred gross profit from 1993 sales.

| | *1993* | *1992* |
|---|---|---|
| Sales | $900,000 | $600,000 |
| Collections | | |
| 1992 sales | | (300,000) |
| 1993 sales | (300,000) | |
| Written off | | |
| 1992 sales | | (200,000) |
| 1993 sales | (50,000) | |
| Installment receivable | 550,000 | 100,000 |
| GP % | 40% | 30% |
| Deferred gross profit | $220,000 | $ 30,000 |

Total deferred gross profit = $30,000 + $220,000 = $250,000

Choices "a", "b", and "c" are incorrect. The total deferred gross profit equals the deferred gross profit from 1992 sales plus the deferred gross profit from 1993 sales.

**CPA-00708 Type1 M/C A-D Corr Ans: D PM#6 F 2-03**

76. CPA-00708PI Nov 93 #16 Page 34

Luge Co., which began operations on January 2, 1992, appropriately uses the installment sales method of accounting. The following information is available for 1992:

| | |
|---|---|
| Installment accounts receivable, December 31, 1992 | $800,000 |
| Deferred gross profit, December 31, 1992 (before recognition of realized gross profit for 1992) | 560,000 |
| Gross profit on sales | 40% |

For the year ended December 31, 1992, cash collections and realized gross profit on sales should be:

| | *Cash collections* | *Realized gross profit* |
|---|---|---|
| a. | $400,000 | $320,000 |
| b. | $400,000 | $240,000 |
| c. | $600,000 | $320,000 |
| d. | $600,000 | $240,000 |

**CPA-00708 Explanation**
Choice "d" is correct. Cash collections and deferred gross profit are computed as follows:

| | |
|---|---|
| Sales ($560,000 ÷ 40%) | $1,400,000 |
| Accounts receivable | (800,000) |
| Cash collected | 600,000 |


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| | |
|---|---|
| Gross profit | × 40% |
| Realized gross profit | $ 240,000 |

Note: The year-end deferred gross profit is 40% of $800,000 or $320,000. Subtracting $320,000 from $560,000 also yields the realized gross profit.

**CPA-00710 Type1 M/C A-D Corr Ans: B PM#7 F 2-03**

77. CPA-00710 Th Nov 93 #39 Page 34

Cash collection is a critical event for income recognition in the:

| | *Cost-recovery method* | *Installment method* |
|---|---|---|
| a. | No | No |
| b. | Yes | Yes |
| c. | No | Yes |
| d. | Yes | No |

**CPA-00710 Explanation**
Choice "b" is correct. Under the cost recovery method, revenue is recognized after cash equaling the cost of the item is collected. Under the installment method, gross profit is recognized as a gross profit percentage times the cash collected from the sale.

**CPA-00711 Type1 M/C A-D Corr Ans: A PM#8 F 2-03**

78. CPA-00711 PI Nov 93 #45 Page 34

On January 2, 1991, Blake Co. sold a used machine to Cooper, Inc. for $900,000, resulting in a gain of $270,000. On that date, Cooper paid $150,000 cash and signed a $750,000 note bearing interest at 10%. The note was payable in three annual installments of $250,000 beginning January 2, 1992. Blake appropriately accounted for the sale under the installment method. Cooper made a timely payment of the first installment on January 2, 1992, of $325,000, which included accrued interest of $75,000. What amount of deferred gross profit should Blake report at December 31, 1992?

a. $150,000
b. $172,500
c. $180,000
d. $225,000

**CPA-00711 Explanation**
Choice "a" is correct. Deferred gross profit is computed by multiplying the balance in the receivable account by the gross profit percentage.

| | |
|---|---|
| Receivable ($750,000 – $250,000) | $500,000 |
| Gross Profit % ($270,000 ÷ $900,000) | 30% |
| Deferred gross profit | $150,000 |

APB 10 para 12

Choice "b" is incorrect. Deferred gross profit is computed by multiplying the balance in the receivable account by the gross profit percentage.

Choice "c" is incorrect. Deferred gross profit is computed by multiplying the balance in the receivable account by the gross profit percentage.

Choice "d" is incorrect. The total of deferred gross profit plus deferred interest earned is $325,000 but interest is not the question, just deferred gross profit.

**CPA-00712 Type1 M/C A-D Corr Ans: D PM#9 F 2-03**


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79. CPA-00712 PI May 93 #13 Page 34

Taylor Corp., which began operations in 1992, accounts for revenues using the installment method. Taylor's sales and collections for the year were $60,000 and $35,000, respectively. Uncollectible accounts receivable of $5,000 were written off during 1992. Taylor's gross profit rate is 30%. In its December 31, 1992, balance sheet, what amount should Taylor report as deferred revenue?

a. $10,500
b. $9,000
c. $7,500
d. $6,000

**CPA-00712 Explanation**
Choice "d" is correct. The deferred revenue is 30% of sales less collections and write-offs.

| | |
|---|---|
| Installment receivable | $60,000 |
| Collections | (35,000) |
| Write off | (5,000) |
| Receivables, 12/31/92 | 20,000 |
| Profit rate | × .30 |
| Deferred revenue (profit) | $ 6,000 |

Choice "a" is incorrect. The $10,500 is the realized gross profit (30% × $35,000).

Choice "b" is incorrect. Deferred revenue represents the unrealized profit from the $60,000 sale. Unrealized profit is $60,000 × 30% = $18,000 less the realized profit and the profit in the uncollectible account.

Choice "c" is incorrect. The $7,500 is the deferred revenue before considering the $5,000 uncollectible account. Since the 30% profit on the $5,000 will not be realized, it must be deducted.

**CPA-00714 Type1 M/C A-D Corr Ans: B PM#10 F 2-03**

80. CPA-00714 PI May 93 #42 Page 34

On January 2, 1992, Yardley Co. sold a plant to Ivory, Inc. for $1,500,000. On that date, the plant's carrying cost was $1,000,000. Ivory gave Yardley $300,000 cash and a $1,200,000 note, payable in 4 annual installments of $300,000 plus 12% interest. Ivory made the first principal and interest payment of $444,000 on December 31, 1992. Yardley uses the installment method of revenue recognition. In its 1992 income statement, what amount of realized gross profit should Yardley report?

a. $344,000
b. $200,000
c. $148,000
d. $100,000

**CPA-00714 Explanation**
Choice "b" is correct. Yardley has collected $300,000 on January 2, 1992 and $300,000 from the note (interest is recorded separately). $600,000 × 1/3 profit rate ($500,000 profit on $1,500,000 sale) is $200,000.

Choice "a" is incorrect. Interest earned is recorded separately from realized gross profit.

Choice "c" is incorrect. Profit on the $300,000 initial payment and also on the first principal payment should be computed.

Choice "d" is incorrect. Profit on the $300,000 initial payment and also on the first principal payment should be computed.

**CPA-05425 Type1 M/C A-D Corr Ans: C PM#11 F 2-03**

81. CPA-05425 Released 2007 Page 29


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Entor Co. sold equipment to Pane Co. for $50,000. The equipment had a net book amount of $30,000. The collections were $20,000 in the first year, $15,000 in the next year, and $15,000 in the last year. What is the amount of gross profit for the third year if Entor used the installment-sales accounting method for the transaction?

a. $0
b. $5,000
c. $6,000
d. $15,000

**CPA-05425 Explanation**
Choice "c" is correct. When the installment sales method is used, gross profit is recognized when cash is collected. Earned gross profit is equal to cash collected multiplied by the gross profit percentage. Entor Co.'s gross profit percentage for this transaction is calculated as:

(Sales - Cost of goods sold) / Sales = ($50,000 - 30,000)/$50,000 = 40%

Year 3 earned gross profit would therefore be $6,000 ($15,000 x 40%)

Choice "a" is incorrect. When the installment sales method is used, gross profit is recognized when cash is collected. Because $15,000 was collected in year 3, earned gross profit will be recognized.

Choice "b" is incorrect. Year 3 earned gross profit under the installment sales method would be $6,000, as calculated above.

Choice "d" is incorrect. The $15,000 collected in year 3 would be recognized as earned gross profit in year 3 under the cost recovery method, not the installment sales method.

**Accounting for Nonmonetary Exchanges**

**CPA-00715 Type1 M/C A-D Corr Ans: B PM#1 F 2-04**

82. CPA-00715 FARE May 95 #30 (Adapted) Page 37

Slate Co. and Talse Co. exchanged similar plots of land with fair values in excess of carrying amounts in an exchange that lacks commercial substance. In addition, Slate received cash of less than 10% of the total consideration received from Talse to compensate for the difference in land values. As a result of the exchange, Slate should recognize:

a. A gain equal to the difference between the fair value and the carrying amount of the land given up.
b. A gain in an amount determined by the ratio of cash received to total consideration.
c. A loss in an amount determined by the ratio of cash received to total consideration.
d. Neither a gain nor a loss.

**CPA-00715 Explanation**
Choice "b" is correct. This transaction is a nonmonetary exchange that lacks commercial substance. As such, the transaction is an exception to the general rule of basing the measurement value of the exchange on fair value.

In this question, as in many such questions on the CPA exam, cash (boot) is received. Because the cash is less than 10% of the total consideration, a proportional amount of the gain is recognized according to the still surviving rules of APB No. 29.

Choice "a" is incorrect. According to SFAS No. 153, fair value is not used to value an exchange that lacks commercial substance.

Choice "c" is incorrect. The fair value of the land surrendered exceeds the book value of the land surrendered, so there is no economic loss on the transaction. Losses have never been calculated by a proportion; that calculation is only for gains.

Choice "d" is incorrect. This answer follows just a portion of the SFAS No. 153 rules for transactions that lack commercial substance. When there is no boot, transactions that lack commercial substance are


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recorded at carrying value, and no gain is recognized for accounting purposes. However, in this question, cash/boot is received, and a proportional amount of the gain is recognized. The question did not ask that the gain actually be calculated.

**CPA-00716 Type1 M/C A-D Corr Ans: B PM#2 F 2-04**

83. CPA-00716 Th Nov 93 #37 Page 34

Bensol Co. and Sable Co. exchanged similar trucks with fair values in excess of carrying amounts in an exchange that lacks commercial substance. In addition, Bensol paid Sable to compensate for the difference in truck values. As a consequence of the exchange, Sable recognizes:

a. A gain equal to the difference between the fair value and carrying amount of the truck given up.
b. A gain determined by the proportion of cash received to the total consideration.
c. A loss determined by the proportion of cash received to the total consideration.
d. Neither a gain nor a loss.

**CPA-00716 Explanation**
Choice "b" is correct. This transaction is a nonmonetary exchange that lacks commercial substance. As such, the transaction is an exception to the general rule of basing the measurement value of the exchange on fair value.

In the question, as in many such questions on the CPA exam, cash (boot) is received. Since the cash appears to be a minor part of the total consideration (there is no way to be sure since that information was not provided in the question), a proportional amount of the gain is recognized according to the still surviving rules of APB No. 29. This question does not ask that the gain actually be calculated.

Choice "a" is incorrect. According to SFAS No. 153, fair value is not used to value an exchange that lacks commercial substance.

Choice "c" is incorrect. The fair value of the truck surrendered exceeds the book value of the truck surrendered, so there is no economic loss on the transaction. Losses have never been calculated by a proportion; that calculation was and is only for gains.

Choice "d" is incorrect. This answer follows just a portion of the SFAS No. 153 rules for transactions that lack commercial substance. When there is no boot, transactions that lack commercial substance are recorded at carrying value, and no gain is recognized for accounting purposes. However, in this question, cash/boot is received, and a proportional amount of the gain is recognized. The question did not ask that the gain actually be calculated.

**CPA-00717 Type1 M/C A-D Corr Ans: C PM#3 F 2-04**

84. CPA-00717 PII May 93 #9 Page 39

During 1992, Beam Co. paid $1,000 cash and traded inventory, which had a carrying amount of $20,000 and a fair value of $21,000, for other inventory in the same line of business with a fair value of $22,000. What amount of gain (loss) should Beam record related to the inventory exchange?

a. $2,000
b. $1,000
c. $0
d. $(1,000)

**CPA-00717 Explanation**
Choice "c" is correct. $0. This transaction (1) lacks commercial substance and (2) appears to be an exchange that was made merely to facilitate sales to customers (inventory was traded).

In order to have commercial substance, either (1) the risk, timing, and amount of the expected future cash flows from the asset transferred differs significantly from the risk, timing, and amount of the expected future cash flows from the asset received, or (2) the entity-specific value (based on the company's


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expectations of value of the asset and not that of the marketplace) of the asset received differs significantly (in relation to the fair values of the assets exchanged) from the asset transferred.

In this case, inventory was traded for inventory, and only $1,000 of cash was paid in the transaction. The future cash flows configuration does not appear to be affected (as both assets are inventory and the $1,000 cash is not significant), nor would it appear that the entity-specific value of the assets received compared to the assets transferred differs much (and is certainly not significant in relation to the fair value of the assets exchanged).

Further (and perhaps even more compelling for the exchange to be treated as lacking commercial substance), the exchange is inventory for inventory, and inventory is a product that is ordinarily held to be sold to customers. One of the three exceptions (the second one) to the general rule of valuing a transaction at fair value is if the exchange was made solely to facilitate a sale to a third party that is not a party to the exchange (such as a customer). Remember that lack of commercial substance was the third exception.

It appears that this exchange would either "lack commercial substance" or fall under the "exchange that facilitates the sale" exception of SFAS No. 153, or both, and, since boot was paid, there would be no gain recognized for accounting purposes. Since the fair value of the inventory relinquished exceeded the carrying amount of that inventory, there would be no loss either.

Choices "a", "b", and "d" are incorrect, per the above explanation.

**CPA-00718 Type1 M/C A-D Corr Ans: A PM#4 F 2-04**

85. CPA-00718 PII May 93 #10 (Adapted) Page 37

Amble, Inc. exchanged a truck with a carrying amount of $12,000 and a fair value of $20,000 for a truck and $4,000 cash. The fair value of the truck received was $16,000. At what amount should Amble record the truck received in the exchange?

a. $9,600
b. $12,000
c. $13,600
d. $16,000

**CPA-00718 Explanation**

Choice "a" is correct. $9,600. The question indicates that Amble exchanged a truck with a carrying amount of $12,000 and a fair value of $20,000 for a truck with a fair value of $16,000 and cash of $4,000. Note that the exchange is for the exact same fair value of $20,000 (with very little apparent difference in timing and a small effect on risk, as some cash was received). Therefore, it is reasonable in this question to assume that the exchange lacks commercial substance.

According to SFAS No. 153, when a nonmonetary exchange lacks commercial substance, the general rule is that no gain or loss is recognized and the book value approach is used. However, in this question, cash/boot is received and a proportional part of the gain is recognized (the $4,000 cash is 20% of the total consideration of $20,000, and the realized gain is $8,000, so $1,600 of the realized gain is recognized and $6,400 of the realized gain is not recognized). The journal entry to record the transaction is as follows:

| | Dr | Cr |
|---|---|---|
| Cash | 4,000 | |
| New Truck | 9,600 | |
| Gain on exchange | | 1,600 |
| Old Truck (net) | | 12,000 |

The question asks for the candidate to determine the amount that should be recorded for the new truck, which is $9,600. Note that the amount recorded for the new truck is merely a plug to make the journal entry balance. Effectively the unrecognized portion of the realized gain of $8,000 that was buried in the


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**old** truck (FMV of $20,000 - carrying amount of $12,000 = $8,000 x .80 = $6,400) is now buried in the new truck (FMV of $16,000 - $6,400 unrecognized gain = $9,600). The unrecognized portion of the gain will presumably be recognized when/if the new truck is disposed of in a monetary transaction.

Note that, as in this particular question, the "lacks commercial substance" might not be specifically stated in the question, even in the future. If not, the "truck for truck" exchange implies a similar productive asset exchange, which would get back to a transaction that lacked commercial substance. But what about, for example, a truck used in the delivery function of a business that is traded for a fancy car to be used for high-value customer service? Are the assets in that case dissimilar enough? And how are the timings, amounts, and risks of expected future cash flows from these kinds of assets measured anyway? This question exhibits all the more reason why we believe that CPA exam questions will indicate whether or not the exchanges in questions "have" or "lack" commercial substance.

Choices "b", "c", and "d" are incorrect, per the above explanation.

**CPA-00719 Type1 M/C A-D Corr Ans: A PM#5 F 2-04**

86. CPA-00719Th May 93 #16 (Adapted) Page 45

In an exchange of **dissimilar** assets, Transit Co. received equipment with a fair value equal to the carrying amount of **other assets** given up. Transit also contributed cash. As a result of the exchange, Transit recognized:

a. A loss equal to the cash given up.
b. A loss determined by the proportion of cash paid to the total transaction value.
c. A gain determined by the proportion of cash paid to the total transaction value.
d. Neither gain nor loss.

**CPA-00719 Explanation**
Choice "a" is correct. This question has been adapted to use the word "dissimilar" so that a point can be illustrated. Note that it is doubtful that a question like this will appear on the exam again, as the "similar" and "dissimilar" asset wording is obsolete and should not be used in the future. But who knows?

While it is not specifically stated in the question, this fact pattern appears to address an exchange that has commercial substance. Transit Co. gave up cash plus other non-equipment assets with a carrying value that exceeded the fair value of the equipment received by the amount of cash needed to complete the transaction (again, note that the assets are specifically stated to be dissimilar equipment and other assets). Transit Co. would recognize a LOSS in the amount of the cash given up, and the accounting would fall under the general rule of SFAS No. 153 (use of fair value to value the exchange), as follows (assume that the fair value of the new equipment is $10,000 and that $1,500 in cash was contributed):

| | | |
|---|---|---|
| NEW Equipment at fair value | $10,000 | |
| LOSS on exchange | 1,500 | |
| OLD Assets at NBV | | $10,000 |
| Cash | | 1,500 |

Note that, the new equipment is recorded at fair value and not book value. The gain or loss on the exchange (in this case a loss) is now the plug to make the journal entry balance. This question actually illustrates a very important exam technique. This question has no numbers. When in doubt for a question like this one, make up numbers to fit the fact situation and see what the journal entry looks like. In this question, the journal entry provides the answer.

Choice "b" is incorrect. Losses are recognized in full on exchanges that do not lack commercial substance (that have commercial substance) and are also recognized on those that lack commercial substance (or fall under another exception of SFAS No. 153) **if** the losses have not been recognized previously as part of the impairment process **(which they should have been; SFAS No. 144 impairment comes first**). Note that losses have never been calculated by a proportion; that calculation was and is only for gains.


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Choice "c" is incorrect. Gains are recognized in full on exchanges than do not lack commercial substance (that have commercial substance). This exchange appears to have commercial substance.

Choice "d" is incorrect. If an exchange lacks commercial substance or meets one of the other exceptions to the general rule of SFAS No. 153, and no boot is received, no gain is recognized; however, this exchange appears to have commercial substance. In this question, as indicated above, a loss is recognized.

**Partnerships**

**CPA-00723 Type1 M/C A-D Corr Ans: B PM#3 F 2-05**

87. CPA-00723 May 95 #24 Page 47

The following condensed balance sheet is presented for the partnership of Alfa and Beda, who share profits and losses in the ratio of 60:40, respectively:

| | |
|---|---|
| Cash | $ 45,000 |
| Other assets | 625,000 |
| Beda, loan | 30,000 |
| | $ 700,000 |
| Accounts payable | $ 120,000 |
| Alfa, capital | 348,000 |
| Beda, capital | 232,000 |
| | $ 700,000 |

Instead of admitting a new partner, Alfa and Beda decide to liquidate the partnership. If the other assets are sold for $500,000, what amount of the available cash should be distributed to Alfa?

a. $255,000
b. $273,000
c. $327,000
d. $348,000

**CPA-00723 Explanation**
Choice "b" is correct. $273,000 should be distributed to Alfa.

**[000's omitted]**

| *Cash* | *Assets* | *Loan* | *A/P* | *Alfa* | *Beta* |
|---|---|---|---|---|---|
| 45 | 625 | 30 | 120 | 348 | 232 |
| 500 | (625) | | | (75) | (50) |
| (120) | | | (120) | | |
| | | (30) | | | (30) |
| 425 | 0 | 0 | 0 | 273 | 152 |

Choice "a" is incorrect. The loan to Beda should directly reduce his capital account.

Choice "c" is incorrect. Accounts payable and the loan to Beda must be taken into consideration before cash is distributed.

Choice "d" is incorrect. The loss from the disposition of other assets must be allocated to the partners.

**CPA-00724 Type1 M/C A-D Corr Ans: C PM#4 F 2-05**

88. CPA-00724 Nov 94 #35 Page 46

When Mill retired from the partnership of Mill, Yale, and Lear, the final settlement of Mill's interest exceeded Mill's capital balance. Under the bonus method, the excess:

a. Was recorded as goodwill.
b. Was recorded as an expense.


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c. Reduced the capital balances of Yale and Lear.
d. Had no effect on the capital balances of Yale and Lear.

**CPA-00724 Explanation**
Choice "c" is correct. Under the bonus method, any premium paid to the retiring partner is allocated to the remaining partners' accounts, based on the original profit and loss ratios.

Choice "a" is incorrect. Goodwill is not recorded in the bonus method.

Choice "b" is incorrect. Expense is not recognized for the premium paid to a retiring partner. Under the bonus method the remaining partners' account balances will be adjusted.

Choice "d" is incorrect. Under the bonus method, the remaining partners' account balances are adjusted.

**CPA-00725 Type1 M/C A-D Corr Ans: B PM#5 F 2-05**

89. CPA-00725 May 94 #36 Page 45

Red and White formed a partnership in 1992. The partnership agreement provides for annual salary allowances of $55,000 for Red and $45,000 for White. The partners share profits equally and losses in a 60/40 ratio. The partnership had earnings of $80,000 for 1993 before any allowance to partners. What amount of these earnings should be credited to each partner's capital account?

| | *Red* | *White* |
|---|---|---|
| a. | $40,000 | $40,000 |
| b. | $43,000 | $37,000 |
| c. | $44,000 | $36,000 |
| d. | $45,000 | $35,000 |

**CPA-00725 Explanation**
Choice "b" is correct.

| *Item* | *Red* | *White* | *Total* |
|---|---|---|---|
| Earnings | | | $ 80,000 |
| Salary allowance | $ 55,000 | $ 45,000 | (100,000) |
| Net earnings to distribute | | | ($20,000) |
| Distribution 60/40 | (12,000) | (8,000) | 20,000 |
| Net to Partners | $ 43,000 | $ 37,000 | 0 |

**CPA-00726 Type1 M/C A-D Corr Ans: A PM#6 F 2-05**

90. CPA-00726 May 94 #37 Page 47

The following condensed balance sheet is presented for the partnership of Smith and Jones, who share profits and losses in the ratio of 60:40, respectively:

| | |
|---|---|
| Other assets | $ 450,000 |
| Smith, loan | 20,000 |
| | $ 470,000 |
| Accounts payable | $ 120,000 |
| Smith, capital | 195,000 |
| Jones, capital | 155,000 |
| | $ 470,000 |

The partners have decided to liquidate the partnership. If the other assets are sold for $385,000, what amount of the available cash should be distributed to Smith?

a. $136,000
b. $156,000
c. $159,000
d. $195,000


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**CPA-00726 Explanation**
Choice "a" is correct. (In thousands)

| | *Beg bal* | *Sale* | *Loss* | *AP* | *Balance* |
|---|---|---|---|---|---|
| Cash | 0 | 385 | | (120) | 265 |
| Other assets | 450 | (385) | (65) | | 0 |
| Loan | 20 | (20) | | | 0 |
| AP | 120 | | | (120) | 0 |
| Smith | 195 | (20) | (39) | | 136 |
| Jones | 155 | | (26) | | 129 |

**CPA-00742 Type1 M/C A-D Corr Ans: C PM#7 F 2-05**

91. CPA-00742 FARE May 93 II #6 Page 48

The condensed balance sheet of Adams & Gray, a partnership, at December 31, 1992, follows:

| | |
|---|---|
| Current assets | $ 250,000 |
| Equipment (net) | 30,000 |
| Total assets | $ 280,000 |
| Liabilities | $ 20,000 |
| Adams, capital | 160,000 |
| Gray, capital | 100,000 |
| Total liabilities and capital | $ 280,000 |

On December 31, 1992, the fair values of the assets and liabilities were appraised at $240,000 and $20,000, respectively, by an independent appraiser. On January 2, 1993, the partnership was incorporated and 1,000 shares of $5 par value common stock were issued. Immediately after the incorporation, what amount should the new corporation report as additional paid-in capital?

a. $275,000
b. $260,000
c. $215,000
d. $0

**CPA-00742 Explanation**
Choice "c" is correct. Additional paid-in capital would be credited for the difference between the fair value of the net assets ($240,000 assets – $20,000 liabilities) and the par value of the common stock issued (1,000 shares × $5 par value), or $220,000 – $5,000 = $215,000. The journal entry would be:

| | | |
|---|---|---|
| Assets (fair value) | 240,000 | |
| Liabilities (fair value) | | 20,000 |
| Common stock (1,000 × $5) | | 5,000 |
| Additional paid-in capital | | 215,000 |

Choice "a" is incorrect. When incorporating a partnership, assets and liabilities are recorded at their fair values, not the book values used by the partnership.

Choices "b" and "d" are incorrect. Common stock is recorded at par value with the excess going to additional paid-in capital.

**CPA-00744 Type1 M/C A-D Corr Ans: C PM#8 F 2-05**

92. CPA-00744 Nov 91 II #11 Page 45

The partnership agreement of Axel, Berg & Cobb provides for the year-end allocation of net income in the following order:

- First, Axel is to receive 10% of net income up to $100,000 and 20% over $100,000.


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- Second, Berg and Cobb each are to receive 5% of the remaining income over $150,000.
- The balance of income is to be allocated equally among the three partners.

The partnership's 1990 net income was $250,000 before any allocations to partners. What amount should be allocated to Axel?

a. $101,000
b. $103,000
c. $108,000
d. $110,000

**CPA-00744 Explanation**
Choice "c" is correct.

| | *Axel* | *Berg* | *Cobb* | *Net Income* |
|---|---|---|---|---|
| 1990 Net Income | | | | $ 250,000 |
| 10% × $100,000 | $ 10,000 | | | (10,000) |
| 20% × $150,000 | 30,000 | | | (30,000) |
| | | | | 210,000 |
| 5% × $60,000 | | $ 3,000 | $ 3,000 | (6,000) |
| | | | | 204,000 |
| 1/3 × $204,000 | 68,000 | 68,000 | 68,000 | (204,000) |
| | $108,000 | $ 71,000 | $ 71,000 | $ 0 |

**CPA-00746 Type1 M/C A-D Corr Ans: C PM#9 F 2-05**

93. CPA-00746 May 91 II #2 Page 43

Dunn and Grey are partners with capital account balances of $60,000 and $90,000, respectively. They agree to admit Zorn as a partner with a one-third interest in capital and profits, for an investment of $100,000, after revaluing the assets of Dunn and Grey. Goodwill to the original partners should be:

a. $0
b. $33,333
c. $50,000
d. $66,667

**CPA-00746 Explanation**
Choice "c" is correct. Since Zorn is receiving a 1/3 interest for $100,000, the implied total capital of the partnership is $300,000 ($100,000 × 3). With Zorn's $100,000 investment, the actual total capital of the partnership would be $250,000 ($100,000 + $60,000 + $90,000). The $50,000 difference ($300,000 – $250,000) is recorded as goodwill to the original partners in accordance with their profit and loss sharing ratio.

**CPA-00747 Type1 M/C A-D Corr Ans: A PM#10 F 2-05**

94. CPA-00747 Nov 90 T #40 Page 41

Hayes and Jenkins formed a partnership, each contributing assets to the business. Hayes contributed inventory with a current market value in excess of its carrying amount. Jenkins contributed real estate with a carrying amount in excess of its current market value. At what amount should the partnership record each of the following assets?

| | *Inventory* | *Real estate* |
|---|---|---|
| a. | Market value | Market value |
| b. | Market value | Carrying amount |
| c. | Carrying amount | Market value |
| d. | Carrying amount | Carrying amount |


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**CPA-00747 Explanation**
Choice "a" is correct, Market value - Market value.

**Rule:** Upon the formation of a partnership, tangible assets (inventory and real estate) would be recorded at fair market value at the date of the investment.

**CPA-00749 Type1 M/C A-D Corr Ans: A PM#11 F 2-05**

95. CPA-00749 FARE Nov 89 II #17 Page 41

Gow and Cubb formed a partnership on March 1, 1989, and contributed the following assets:

| | *Gow* | *Cubb* |
|---|---|---|
| Cash | $80,000 | |
| Equipment (market value) | | $50,000 |

The equipment was subject to a chattel mortgage of $10,000 that was assumed by the partnership. The partners agreed to share profits and losses equally. Cubb's capital account at March 1, 1989 should be:

a. $40,000
b. $45,000
c. $50,000
d. $60,000

**CPA-00749 Explanation**
Choice "a" is correct.

**Rule:** Assets contributed by partners to a partnership are valued at fair market value of the assets, net of any related liabilities.

| | *Total* | | *Gow* | *Cubb* |
|---|---|---|---|---|
| Cash | $ 80,000 | | 80,000 | |
| Equipment at FMV | 50,000 | | | 50,000 |
| total assets | 130,000 | | | |
| Chattel mortgage on equip | (10,000) | | | (10,000) |
| Net assets contributed | 120,000 | = | 80,000 | 40,000 |
| | | | | **A** |

(The fact that the partners agree to **"share profits equally"** does **not** affect their partnership capital accounts from contribution of assets.)

**CPA-00754 Type1 M/C A-D Corr Ans: B PM#12 F 2-05**

96. CPA-00754 FARE Nov 89 II #19 Page 42

Blau and Rubi are partners who share profits and losses in the ratio of 6:4, respectively. On May 1, 1989, their respective capital accounts were as follows:

Blau $60,000
Rubi 50,000

On that date, Lind was admitted as a partner with a one- third interest in capital and profits for an investment of $40,000. The new partnership began with total capital of $150,000. Immediately after Lind's admission, Blau's capital should be:

a. $50,000
b. $54,000
c. $56,667
d. $60,000

**CPA-00754 Explanation**


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Choice "b" is correct. $54,000.

**[000's omitted]**

| | *Net Assets* | *Blau 60%* | *Rubi 40%* | *Lind (New-1/3)* | |
|---|---|---|---|---|---|
| Opening balance | *$110 | 60 | 50 | 0 | |
| Lind invests $40 for 1/3 × $150 | 40 | | | 40 | |
| sub total | 150 | 60 | 50 | 40 | |
| Allocate Lind's bonus to B & R | | (6) | (4) | 10 | ← SQZ |
| Balance after admsn | $150 | 54 | 46 | 50 | (1/3 × 150 total) |
| | | **B** | | | |

**CPA-04552 Type1 M/C A-D Corr Ans: D PM#13 F 2-05**

97. CPA-04552 May 95 #23 Page 41

The following condensed balance sheet is presented for the partnership of Alfa and Beda, who share profits and losses in the ratio of 60:40, respectively:

| | |
|---|---|
| Cash | $ 45,000 |
| Other assets | 625,000 |
| Beda, loan | 30,000 |
| | $700,000 |
| | |
| Accounts payable | $120,000 |
| Alfa, capital | 348,000 |
| Beda, capital | 232,000 |
| | $700,000 |

The assets and liabilities are fairly valued on the balance sheet. Alfa and Beda decide to admit Capp as a new partner with a 20% interest. No goodwill or bonus is to be recorded. What amount should Capp contribute in cash or other assets?

a. $110,000
b. $116,000
c. $140,000
d. $145,000

**CPA-04552 Explanation**
Choice "d" is correct. The fair value of the net assets prior to admitting the new partner is $580,000 ($700,000 assets less $120,000 accounts payable). Capp's capital account will equal 20% of the new fair value of net assets. The new fair value of net assets will equal $580,000 plus Capp's contribution. Thus,

**[000's omitted]**

| | |
|---|---|
| 20% × [$580 + Capp's contribution] | = Capp's contribution |
| $116 + .2 × Capp's contribution | = Capp's contribution |
| $116 | = .8 × Capp's contribution |
| Capp's contribution | = $145 |

**CPA-05194 Type1 M/C A-D Corr Ans: C PM#15 F 2-05**

98. CPA-05194 Released 2006 Page 41

Dex Co. has entered into a joint venture with an affiliate to secure access to additional inventory. Under the joint venture agreement, Dex will purchase the output of the venture at prices negotiated on an arms'-length basis. Which of the following is(are) required to be disclosed about the related party transaction?

I. The amount due to the affiliate at the balance sheet date.


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II. The dollar amount of the purchases during the year.

a. I only.
b. II only.
c. Both I and II.
d. Neither I nor II.

**CPA-05194 Explanation**
Choice "c" is correct. For a related party transaction, **both** the amount due to the affiliate and the dollar amount of the purchases during the year must be disclosed. In disclosure questions, if you are not sure, disclose the most rather than the least.

Choice "a" is incorrect. For a related party transaction, **both** the amount due to the affiliate and the dollar amount of the purchases during the year must be disclosed.

Choice "b" is incorrect. For the related party transaction, **both** the amount due to the affiliate and the dollar amount of the purchases during the year must be disclosed.

Choice "d" is incorrect. For the related party transaction, **both** the amount due to the affiliate and the dollar amount of the purchases during the year must be disclosed.

**Financial Reporting and Changing Prices**

**CPA-01256 Type1 M/C A-D Corr Ans: C PM#1 F 2-06**

99. CPA-01256 FARE Nov 95 #57 Page 49

Financial statements prepared under which of the following methods include adjustments for both specific price changes and general price level changes?

a. Historical cost/nominal dollar.
b. Current cost/nominal dollar.
c. Current cost/constant dollar.
d. Historical cost/constant dollar.

**CPA-01256 Explanation**
Choice "c" is correct, "current cost/constant dollar" method includes both specific and general price level changes.

Choice "a" is incorrect as "historical cost/nominal dollar" method includes no price level changes.

Choice "b" is incorrect as "current cost/nominal dollar" method includes specific price level changes (specific price indexes).

Choice "d" is incorrect as "historical cost/constant dollar" method includes general price level changes (bls cpi).

**CPA-01260 Type1 M/C A-D Corr Ans: D PM#3 F 2-06**

100. CPA-01260 Th Nov 93 #1 Page 49

When computing purchasing power gain or loss on net monetary items, which of the following accounts is classified as nonmonetary?

a. Advances to unconsolidated subsidiaries.
b. Allowance for uncollectible accounts.
c. Unamortized premium on bonds payable.
d. Accumulated depreciation of equipment.

**CPA-01260 Explanation**
Choice "d" is correct. Property, plant, and equipment the related accumulated depreciation are nonmonetary items. SFAS 89 para. 96


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Choice "a" is incorrect. Advances to unconsolidated subsidiaries are monetary items. SFAS 89 para. 96

Choice "b" is incorrect. Receivables and the related allowance for uncollectible accounts are monetary items. SFAS 89 para. 96

Choice "c" is incorrect. Bonds payable and the related unamortized premium on bonds payable are monetary items. SFAS 89 para. 96

**CPA-01264 Type1 M/C A-D Corr Ans: C PM#4 F 2-06**

101. CPA-01264 Th Nov 93 #2 Page 49

Deecee Co. adjusted its historical cost income statement by applying specific price indexes to its depreciation expense and cost of goods sold. Deecee's adjusted income statement is prepared according to:

a. Fair value accounting.
b. General purchasing power accounting.
c. Current cost accounting.
d. Current cost/general purchasing power accounting.

**CPA-01264 Explanation**
Choice "c" is correct. Under current cost accounting, specific price indexes may be used to restate financial statements items. SFAS 89 para.19

Choice "a" is incorrect. Under fair value accounting, individual fair market values are identified for each item. No specific price indexes are applied.

Choice "b" is incorrect. General purchasing power accounting does not apply specific price indexes to expenses.

Choice "d" is incorrect. Under current cost/general purchasing power accounting, general price indexes are used to adjust financial statement items.

**CPA-01265 Type1 M/C A-D Corr Ans: B PM#5 F 2-06**

102. CPA-01265 Nov 92 #39 Page 51

During a period of inflation in which a liability account balance remains constant, which of the following occurs?

a. A purchasing power gain, if the item is a nonmonetary liability.
b. A purchasing power gain, if the item is a monetary liability.
c. A purchasing power loss, if the item is a nonmonetary liability.
d. A purchasing power loss, if the item is a monetary liability.

**CPA-01265 Explanation**
Choice "b" is correct. Purchasing power gains and losses are associated with monetary assets and liabilities. During periods of inflation, current dollars purchase less so any liability would then be settled with dollars with lower purchasing power. Thus, a purchasing power gain is recognized. SFAS 89 para. 44

Choice "a" is incorrect. Purchasing power gains and losses are associated with monetary assets and liabilities.

Choice "c" is incorrect. Purchasing power gains and losses are associated with monetary assets and liabilities.

Choice "d" is incorrect. Purchasing power gains and losses are associated with monetary assets and liabilities. During periods of inflation, current dollars purchase less so any liability would then be settled with dollars with lower purchasing power. Thus, a purchasing power gain is recognized.


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**CPA-01267 Type1 M/C A-D Corr Ans: B PM#6 F 2-06**

103. CPA-01267 Nov 90 #11 Page 51

During a period of inflation, an account balance remains constant. When supplemental statements are being prepared, a purchasing power gain is reported if the account is a:

a. Monetary asset.
b. Monetary liability.
c. Nonmonetary asset.
d. Nonmonetary liability.

**CPA-01267 Explanation**
Choice "b" is correct. During a period of inflation, holding a monetary liability would result in a purchasing power gain. The liability is constant while the purchasing power of the monetary unit declines. SFAS 89 para. 40, 66

Choice "a" is incorrect. During a period of inflation, holding a monetary asset would result in a purchasing power loss.

Choice "c" is incorrect. A purchasing power gain is the net gain determined by restating in units of constant purchasing power the opening and closing balances of, and transactions in, monetary assets and liabilities. Nonmonetary assets are not considered in determining the purchasing power gain or loss. SFAS 89 para. 40

Choice "d" is incorrect. A purchasing power gain is the net gain determined by restating in units of constant purchasing power the opening and closing balances of, and transactions in, monetary assets and liabilities. Nonmonetary liabilities are not considered in determining the purchasing power gain or loss. SFAS 89 para. 40

**CPA-01575 Type1 M/C A-D Corr Ans: A PM#7 F 2-06**

104. CPA-01575 Nov 88 I #52 Page 49

At December 31, 1987, Jannis Corp. owned two assets as follows:

| | *Equipment* | *Inventory* |
|---|---|---|
| Current cost | $100,000 | $80,000 |
| Recoverable amount | $ 95,000 | $90,000 |

Jannis voluntarily discl osed supplementary information about current cost at December 31, 1987. In such a disclosure, at what amount would Jannis report total assets?

a. $175,000
b. $180,000
c. $185,000
d. $190,000

**CPA-01575 Explanation**
Choice "a" is correct. $175,000.

Current cost amounts of inventory and property, plant and equipment are measured at current cost or lower recoverable amount at the measurement date:

| | |
|---|---|
| Equipment - Current cost of $100,000 is limited to lower recoverable amount | $ 95,000 |
| Inventory - Current cost of not effected by higher recoverable amt | $ 80,000 |
| | $175,000 |

**CPA-01577 Type1 M/C A-D Corr Ans: B PM#8 F 2-06**


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105. CPA-01577 May 90 II #50 Page 49

The following assets were among those that appeared on Baird Co.'s books at the end of the year:

| | |
|---|---|
| Demand bank deposits | $650,000 |
| Net long-term receivables | 400,000 |
| Patents and trademarks | 150,000 |

In preparing constant dollar financial statements, how much should Baird classify as monetary assets?

a. $1,200,000
b. $1,050,000
c. $800,000
d. $650,000

**CPA-01577 Explanation**
Choice "b" is correct. $1,050,000 monetary assets.

Demand bank deposits and long-term receivables are monetary assets. Patents and trademarks are non-monetary assets.

**Foreign Currency Accounting (SFAS 52)**

**CPA-01270 Type1 M/C A-D Corr Ans: D PM#1 F 2-07**

106. CPA-01270 R99 #16 Page 54

In preparing consolidated financial statements of a U.S. parent company with a foreign subsidiary, the foreign subsidiary's functional currency is the currency:

a. In which the subsidiary maintains its accounting records.
b. Of the country in which the subsidiary is located.
c. Of the country in which the parent is located.
d. Of the environment in which the subsidiary primarily generates and expends cash.

**CPA-01270 Explanation**
Choice "d" is correct. The foreign subsidiary's functional currency is the currency of the environment in which the subsidiary primarily generates and expends cash.

**Rule:** The functional currency of a company may be:

1. A foreign entity's local currency, which is typically the one in which the entity keeps its books;
2. The currency in which the financial statements will be presented, which is the currency of the parent company; or
3. A foreign currency other than the one in which the foreign entity maintains its books.

**Rule:** The functional currency of an entity generally depends upon the environment in which the entity generates and expends cash (unless there is a requirement by law to use another currency), which may be any of the above three. However, the functional currency cannot be the local currency if the foreign entity operates in a highly inflationary environment (i.e., approximately 100% over three years).

Choices "a", "b", and "c" are incorrect, any of which could be considered a functional currency, given the proper circumstances. The definition of a functional currency is given in the correct selection, "d".

**CPA-01271 Type1 M/C A-D Corr Ans: A PM#2 F 2-07**

107. CPA-01271 FARE Nov 95 #32 Page 60

Fogg Co., a U.S. company, contracted to purchase foreign goods. Payment in foreign currency was due one month after the goods were received at Fogg's warehouse. Between the receipt of goods and the time of payment, the exchange rates changed in Fogg's favor. The resulting gain should be included in Fogg's financial statements as a(an):


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a. Component of income from continuing operations.
b. Extraordinary item.
c. Deferred credit.
d. Separate component of other comprehensive income.

**CPA-01271 Explanation**
Choice "a" is correct, component of income from continuing operations.

**Rule:** Gains and losses resulting from foreign exchange transactions that are an "extension" of the parent's domestic operations are included as a component of "income from continuing operations" in the period in which they occur. They are not extraordinary items.

**CPA-01275 Type1 M/C A-D Corr Ans: C PM#5 F 2-07**

108. CPA-01275 Th Nov 93 #14 Page 54

Which of the following should be reported in a stockholders' equity contra account?

a. Discount on convertible bonds that are common stock equivalents.
b. Premium on convertible bonds that are common stock equivalents.
c. Cumulative foreign exchange translation loss.
d. Organization costs.

**CPA-01275 Explanation**
Choice "c" is correct. Cumulative foreign exchange translation loss should be reported as a component of accumulated other comprehensive income. A cumulative foreign exchange translation loss would be a debit to accumulated other comprehensive income; therefore, contra to shareholders' equity.

**Rule:** "Translation" adjustments are not included in determining net income for the period but are disclosed and accumulated as a component of other comprehensive income in consolidated equity until sale or until liquidation of the investment takes place.

Choice "a" is incorrect. Discount on convertible bonds that are common stock equivalents should be shown as a contra account to bonds payable and are shown as part of the "carrying amount" of bonds payable on the balance sheet.

Choice "b" is incorrect. Bond premiums are included as part of the "carrying amount" of bonds payable on the balance sheet.

Choice "d" is incorrect. Organization costs are expensed as incurred.

**CPA-01277 Type1 M/C A-D Corr Ans: B PM#6 F 2-07**

109. CPA-01277 Th Nov 93 #35 Page 60

On October 1, 1992, Mild Co., a U.S. company, purchased machinery from Grund, a German company, with payment due on April 1, 1993. If Mild's 1992 operating income included no foreign exchange transaction gain or loss, then the transaction could have:

a. Resulted in an extraordinary gain.
b. Been denominated in U.S. dollars.
c. Caused a foreign currency gain to be reported as a contra account against machinery.
d. Caused a foreign currency translation gain to be reported as a component of other comprehensive income in stockholders' equity.

**CPA-01277 Explanation**
Choice "b" is correct. If the transaction is denominated in U.S. dollars, however, there is no foreign exchange gain or loss.

**Rule:** Foreign exchange transactions gains and losses are generally included in determining net income for the period in which exchange rates change.


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Choice "a" is incorrect. Foreign currency transaction gains and losses are included in operating income, not as extraordinary items.

Choice "c" is incorrect. Foreign currency transaction gains and losses are included in operating income, not as an adjustment to the asset purchased.

Choice "d" is incorrect. Foreign exchange translation gains and losses are generally included as a component of other comprehensive income in stockholders' equity, but foreign exchange transactions (like this one) are not.

**CPA-01278 Type1 M/C A-D Corr Ans: A PM#7 F 2-07**

110. CPA-01278 Th Nov 93 #36 Page 55

When remeasuring foreign currency financial statements into the functional currency, which of the following items would be remeasured using historical exchange rates?

a. Inventories carried at cost.
b. Marketable equity securities reported at market values.
c. Bonds payable.
d. Accrued liabilities.

**CPA-01278 Explanation**
Choice "a" is correct, inventories carried at cost.

**Rule:** Balance sheet accounts are generally included at the current exchange rate, **excep**t for:

1. A self contained subsidiary with a 3 year inflation rate of 100% or more.
2. A foreign entity which does not maintain its accounts in a foreign functional currency.

In these circumstances, the remeasurement method is used and the historical rates should be used only for those balance sheet accounts carried at "cost" (most non-monetary items). Otherwise follow the general rule and use the "current" rate.

Choices "b", "c", and "d" are incorrect. Bonds payable, and accrued liabilities are "monetary" items. Marketable equity securities are non-monetary items, but are reported at fair value. Because they are reported at fair value, they should be remeasured using the current exchange rate.

**CPA-01281 Type1 M/C A-D Corr Ans: B PM#8 F 2-07**

111. CPA-01281 Th May 93 #34 Page 60

On October 1, 1992, Velec Co., a U.S. company, contracted to purchase foreign goods requiring payment in francs one month after their receipt at Velec's factory. Title to the goods passed on December 15, 1992. The goods were still in transit on December 31, 1992. Exchange rates were one dollar to 22 francs, 20 francs, and 21 francs on October 1, December 15, and December 31, 1992, respectively. Velec should account for the exchange rate fluctuation in 1992 as:

a. A loss included in net income before extraordinary items.
b. A gain included in net income before extraordinary items.
c. An extraordinary gain.
d. An extraordinary loss.

**CPA-01281 Explanation**
Choice "b" is correct. The transaction would first be journalized when title transfers to the buyer on December 15. At fiscal year-end, the exchange rate has increased from one dollar to 20 francs on 12/15 to one dollar to 21 francs on 12/31, so a foreign exchange gain would be recognized.

Choice "a" is incorrect. The transaction would first be journalized when title transfers to the buyer. At fiscal year-end, the exchange rate has increased so a foreign exchange gain would be recognized.


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Choice "c" is incorrect. Foreign exchange gains and losses are not classified as extraordinary items.

Choice "d" is incorrect. Foreign exchange gains and losses are not classified as extraordinary items.

**CPA-01284 Type1 M/C A-D Corr Ans: D PM#9 F 2-07**

112. CPA-01284 Nov 91 I #46 Page 60

On September 1, 1990, Cano & Co., a U.S. corporation, sold merchandise to a foreign firm for 250,000 francs. Terms of the sale require payment in francs on February 1, 1991. On September 1, 1990, the spot exchange rate was $.20 per franc. At December 31, 1990, Cano's year end, the spot rate was $.19, but the rate increased to $.22 by February 1, 1991, when payment was received. How much should Cano report as foreign exchange gain or loss in its 1991 income statement?

a. $0
b. $2,500 loss.
c. $5,000 gain.
d. $7,500 gain.

**CPA-01284 Explanation**
Choice "d" is correct. Foreign exchange gains and losses are recorded at year end on uncompleted contracts. The gain for 1991 is the exchange rate change from 12/31/90 to 2/1/91 ($.22 – $.19) or .03 × $250,000 = $7,500 SFAS 52 para. 15

**CPA-01285 Type1 M/C A-D Corr Ans: B PM#10 F 2-07**

113. CPA-01285 May 90 #22 Page 55

A balance arising from the translation or remeasurement of a subsidiary's foreign currency financial statements is reported in the consolidated income statement when the subsidiary's functional currency is the:

| | *Foreign currency* | *U.S. dollar* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | No |
| d. | Yes | Yes |

**CPA-01285 Explanation**
Choice "b" is correct. A subsidiary's financial statements are usually maintained in its local currency. If the subsidiary's functional currency is its local currency, the subsidiary's financial statements are simply "translated" to U.S. dollars (the reporting currency). The resulting adjustment is reported as other comprehensive income. If the subsidiary's functional currency is not the same as its local currency (the functional currency may be the U.S. dollar or a 3rd currency), the subsidiary's financial statements must be "remeasured" into the functional currency. The resulting gain or loss on remeasurement is reported in the consolidated income statement.

**CPA-01288 Type1 M/C A-D Corr Ans: C PM#11 F 2-07**

114. CPA-01288 May 90 II #44 Page 54

Certain balance sheet accounts of a foreign subsidiary of Rowan, Inc., at December 31, 1989, have been translated into U.S. dollars as follows:

| | *Translated at* | |
|---|---|---|
| | *Current rates* | *Historical rates* |
| Note receivable, long-term | $240,000 | $200,000 |


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| | | |
|---|---|---|
| Prepaid rent | 85,000 | 80,000 |
| Patent | 150,000 | 170,000 |
| | $475,000 | $450,000 |

The subsidiary's functional currency is the currency of the country in which it is located. What total amount should be included in Rowan's December 31, 1989 consolidated balance sheet for the above accounts?

a. $450,000
b. $455,000
c. $475,000
d. $495,000

**CPA-01288 Explanation**
Choice "c" is correct. The rate to be used to translate all assets and all liabilities from the functional currency to the reporting currency (the U.S. dollar) is the current rate, that is, the exchange rate in effect at the balance sheet date. SFAS 52 para. 12

**Supplemental Questions**

**CPA-00758 Type1 M/C A-D Corr Ans: A PM#1 F 2-99**

115. CPA-00758 May 90 #31 Page 37

Scott Co. exchanged similar nonmonetary assets with Dale Co. and no cash was exchanged. The carrying amount of the asset surrendered by Scott exceeded both the fair value of the asset received and Dale's carrying amount of that asset. Scott should:

a. Recognize the difference between the carrying amount of the asset it surrendered and the fair value of the asset it surrendered as a loss.
b. Recognize the difference between the carrying amount of the asset it surrendered and the fair value of the asset it received as a gain.
c. Recognize the difference between the carrying amount of the asset it surrendered and the carrying amount of the asset it received as a loss.
d. Recognize no gain or loss.

**CPA-00758 Explanation**
Choice "a" is correct. It appears, based on the information provided in the question, that this transaction is a nonmonetary exchange that lacks commercial substance. As such, it is an exception to the general rule of basing the measurement value of the exchange on fair value.

Why does the exchange appear to lack commercial substance? The assets are stated to be similar, which is often an indication that the risk, timing, or amount of the expected future cash flows from the assets received do not appear to differ significantly from the risk, timing, or amount of expected future cash flows from the assets transferred. In this question, the assets have a similar productive use, and no cash changes hands, so a conclusion that the exchange lacks commercial substance appears to be warranted.

Now that we know that the exchange does not have commercial substance, let's look at the transaction a little closer. In the question, no boot is received or paid. However, the carrying amount of the asset surrendered exceeds the fair value of the asset surrendered. That means a loss. The loss should have already been recognized as part of the impairment process, but since it was not, a loss would be recognized in the exchange transaction.

Choices "b", "c", and "d" are incorrect per the above explanation.

**CPA-00759 Type1 M/C A-D Corr Ans: C PM#2 F 2-99**

116. CPA-00759 Nov 90 I #35 Page 37


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On January 1, 1988, Mill Co. exchanged equipment for a $200,000 noninterest bearing note due on January 1, 1991. The prevailing rate of interest for a note of this type at January 1, 1988, was 10%. The present value of $1 at 10% for three periods is 0.75. What amount of interest revenue should be included in Mill's 1989 income statement?

a. $0
b. $15,000
c. $16,500
d. $20,000

**CPA-00759 Explanation**
Choice "c" is correct. $16,500 interest for 1989.

This transaction is NOT a nonmonetary transaction; it is an exchange of equipment for a non-interest bearing note receivable, which is a transaction like exchanging equipment for CASH. The exchange is clearly a monetary exchange, which is the culmination of the earnings process and which is recorded using the fair value of the asset (the equipment or the note, in this case) with the more readily available fair value. In this question, the fair value of the note is more readily available (the fair value of the equipment is not even given in the fact pattern). The interest to be recorded is calculated as follows:

| | |
|---|---|
| Face amount of non-interest-bearing note | $200,000 |
| Present value factor at $10 for 3 periods | x .75 |
| Carrying amount at 1-1-88 | 150,000 |
| Interest for 1988 is 10% x $150,000 which is added to the carrying amount | 15,000 |
| Carrying amount at 12-31-88 | 165,000 |
| **Interest for 1989 is 10% x $165,000** | **16,500** |
| Carrying amount at 12-31-89 | $181,500 |

**CPA-00760 Type1 M/C A-D Corr Ans: D PM#3 F 2-99**

117. CPA-00760 Nov 90 II #20 Page 40

During 1989, property owned by Arp Co. was acquired by the city in connection with a condemnation proceeding, resulting in a payment of $100,000 to Arp. The property's carrying amount was $70,000. Arp paid $45,000 in 1989 for replacement property. In Arp's income statement for the year ended December 31, 1989, what amount of gain should be reported on this involuntary conversion, disregarding income tax considerations?

a. $0
b. $15,000
c. $25,000
d. $30,000

**CPA-00760 Explanation**
Choice "d" is correct. $30,000 gain on involuntary conversion.

**Rule:** When a fixed asset is sold (voluntarily or involuntarily), gain or loss is recognized as part of income from continuing operations. The amount of the gain or loss is equal to the difference between the proceeds from the sale and the carrying amount (FMV) of the fixed asset sold or converted.

| | |
|---|---|
| Selling price of condemned property | $100,000 |
| Carrying amount | 70,000 |
| Gain on involuntary conversion | $ 30,000 |
| Carrying amount of replacement property | $ 45,000 |

**CPA-00761 Type1 M/C A-D Corr Ans: B PM#4 F 2-99**

118. CPA-00761 May 91 I #27 Page 40


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On December 31, 1990, a building owned by Carr, Inc. was destroyed by fire. Carr paid $12,000 for removal and clean-up costs. The building had a book value of $250,000 and a fair value of $280,000 on December 31, 1990. What is the loss on this involuntary conversion?

a. $250,000
b. $262,000
c. $280,000
d. $292,000

**CPA-00761 Explanation**
Choice "b" is correct. $262,000 loss on involuntary conversion (fire)

**Rule:** Gains or losses on fixed assets (including involuntary conversions) are always recognized during the period incurred based on recorded amount (NBV) plus any costs associated with the transaction.

| | |
|---|---|
| Recorded value of building | $250,000 |
| Removal and clean-up costs | 12,000 |
| Total loss on fire | $262,000 |

Choice "a" is incorrect. Removal and clean-up costs are incurred in the loss.

Choices "c" and "d" are incorrect. Fair market value is not used.

**CPA-00763 Type1 M/C A-D Corr Ans: A PM#5 F 2-99**

119. CPA-00763 May 92 #13 Page 40

Lano Corp.'s forestland was condemned for use as a national park. Compensation for the condemnation exceeded the forestland's carrying amount. Lano purchased similar, but larger, replacement forest land for an amount greater than the condemnation award. As a result of the condemnation and replacement, what is the net effect on the carrying amount of forestland reported in Lano's balance sheet?

a. The amount is increased by the excess of the replacement forestland's cost over the condemned forestland's carrying amount.
b. The amount is increased by the excess of the replacement forestland's cost over the condemnation award.
c. The amount is increased by the excess of the condemnation award over the condemned forestland's carrying amount.
d. No effect, because the condemned forestland's carrying amount is used as the replacement forestland's carrying amount.

**CPA-00763 Explanation**
Choice "a" is correct. The net effect on the carrying amount of forestland would be equal to the excess of the replacement forestland's cost over the condemned forestland's carrying amount.

**Rule:** When a fixed asset is sold (voluntarily or involuntarily) gain or loss is recognized (proceeds vs. carrying amount) as part of income from continuing operations.

The carrying amount of the replacement property is equal to the FMV of the consideration paid for it.

This problem involves two transactions; (1) the condemnation and (2) the replacement.

**CPA-00767 Type1 M/C A-D Corr Ans: D PM#6 F 2-99**

120. CPA-00767 Nov 92 I #46 Page 37

Dahl Co. traded a delivery van and $5,000 cash for a newer van owned by West Corp. The following information relates to the values of the vans on the exchange date:

| | *Carrying value* | *Fair value* |
|---|---|---|
| Old van | $30,000 | $45,000 |
| New van | 40,000 | 50,000 |


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Dahl's income tax rate is 30%. What amounts should Dahl report as gain on exchange of the vans?

a. $15,000
b. $1,000
c. $700
d. $0

**CPA-00767 Explanation**
Choice "d" is correct. $0. It appears, based on the information provided in the question, that this transaction is a nonmonetary exchange that lacks commercial substance. As such, it is an exception to the general rule of basing the measurement value of the exchange on fair value. Gain is recorded if boot/cash is received, but in this question, boot/cash is paid. No loss is recorded since the fair value of the old van is greater than the carrying value of the old van.

Why does the exchange appear to lack commercial substance? The assets are similar since they are both vans, which is often an indication that the risk, timing, or amount of the expected future cash flows from the asset received does not differ significantly from the risk, timing, or amount of the expected future cash flows from the asset transferred, especially if the cash received in the same transaction is insignificant. In this question, the assets have a similar productive use, and the amount of cash that changes hands is insignificant (10% of the fair value of the asset received), so a conclusion that the exchange lacks commercial substance appears to be warranted. A further analysis of the question might provide additional proof that the exchange lacks commercial substance by showing that Dahl's entity-specific values of the delivery vans do not differ significantly from each other, and, although it is not stated in the fact pattern, this is likely the case.

In this exchange of assets that lacks commercial substance, when boot is paid, Dahl would use the book value of the van exchanged plus the cash paid to measure the cost of the van received. The net book value/carrying value of Dahl's van is $30,000, and its fair value is $45,000. The $15,000 gain is deferred, and the acquired van is valued at the net book value of the van given up, $30,000, plus cash paid, $5,000, for a total of $35,000.

| | | |
|---|---|---|
| NBV of old van | $30,000 | (a Cr in the journal entry) |
| Cash paid | 5,000 | (a Cr in the journal entry) |
| Cost of new van | $35,000 | (a Dr in the journal entry) |

Choices "a", "b", and "c" are incorrect. Exchange transactions that lack commercial substance are recorded at carrying value plus cash paid when no boot is received, and no gain is recognized for accounting purposes.

**CPA-00768 Type1 M/C A-D Corr Ans: D PM#7 F 2-99**

121. CPA-00768 Nov 92 #24 Page 37

Vik Auto and King Clothier exchanged goods, held for resale, with equal fair values. Each will use the other's goods to promote their own products. The retail price of the car that Vik gave up is less than the retail price of the clothes received. What profit should Vik recognize for the nonmonetary exchange?

a. A profit is not recognized.
b. A profit equal to the difference between the retail prices of the clothes received and the car.
c. A profit equal to the difference between the retail price and the cost of the car.
d. A profit equal to the difference between the fair value and the cost of the car.

**CPA-00768 Explanation**
Choice "d" is correct. Vik should recognize a profit equal to the difference between the fair value of the clothing goods received (which is the same as the fair value of Vik's car given up) and Vik's cost of the car. According to SFAS No. 153, nonmonetary exchanges that have commercial substance are recorded using fair value, and any resulting gains or losses are recognized in the financial statements. This exchange appears to have commercial substance because it is an exchange that is the culmination of the earnings process-the goods are exchanged for promotional purposes, and the economic position (or cash configuration) of each company changed because they received advertising in exchange for their goods


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(i.e., neither company is in the same economic position as it was before). Note that there is nothing to indicate that the exchange was purely to facilitate the sale of a product to a party that was not a party to the exchange (the second exception).

Gains on exchanges culminating the earnings process are fully recognized and are equal to the difference between the fair value and the cost of the asset(s) surrendered. The retail prices are not a factor.

Choice "a" is incorrect. A profit is recognized by Vik because the fair value of Vik's car is presumably higher than its cost.

Choices "b" and "c" are incorrect; retail prices are not as good an indication of value as fair values.

**CPA-00770 Type1 M/C A-D Corr Ans: C PM#8 F 2-99**

122. CPA-00770 Nov 89 #13 Page 9

A company receives an advance payment for special order goods that are to be manufactured and delivered within six months. The advance payment should be reported in the company's balance sheet as a:

a. Deferred charge.
b. Contra asset account.
c. Current liability.
d. Noncurrent liability.

**CPA-00770 Explanation**
Choice "c" is correct. The advance payment received for special order goods that are to be manufactured and delivered within six months should be reported in the company's balance sheet as a current liability. (It is not a "deferred credit" because the "special order" goods have not yet been manufactured).

Choice "a" is incorrect. Deferred charge is often used to report long-term prepayments made to others (not prepayments received from others). A deferred charge is an asset.

Choice "b" is incorrect. Contra asset account is used to disclose, in two amounts, information about a single account (e.g., "accounts receivable" and the contra asset account "allowance for doubtful accounts").

Choice "d" is incorrect. Noncurrent liability is used to report liabilities expected to be liquidated beyond one year. (In this case, the special order will be delivered in six months.)

**CPA-00771 Type1 M/C A-D Corr Ans: A PM#9 F 2-99**

123. CPA-00771 Nov 90 I #32 Page 9

In November and December 1989, Dorr Co., a newly organized magazine publisher, received $72,000 for 1,000 three-year subscriptions at $24 per year, starting with the January 1990 issue. Dorr elected to include the entire $72,000 in its 1989 income tax return. What amount should Dorr report in its 1989 income statement for subscriptions revenue?

a. $0
b. $4,000
c. $24,000
d. $72,000

**CPA-00771 Explanation**
Choice "a" is correct. $0 should be reported in the 1989 income statement for subscriptions revenue, since the subscriptions start with the January 1990 issue.

**Rule:** Deferred credit represents future income contracted for and/or collected in advance, but which has not yet been earned by the passing of time or other criteria.


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**CPA-00772 Type1 M/C A-D Corr Ans: B PM#10 F 2-99**

124. CPA-00772 May 91 I #21 Page 18

During 1990, Pitt Corp. incurred costs to develop and produce a routine, low-risk computer software product, as follows:

| | |
|---|---|
| Completion of detail program design | $13,000 |
| Costs incurred for coding and testing to establish technological feasibility | 10,000 |
| Other coding costs after establishment of technological feasibility | 24,000 |
| Other testing costs after establishment of technological feasibility | 20,000 |
| Costs of producing product masters for training materials | 15,000 |
| Duplication of computer software and training materials from product masters (1,000 units) | 25,000 |
| Packaging product (500 units) | 9,000 |

In Pitt's December 31, 1990, balance sheet, what amount should be reported in inventory?

a. $25,000
b. $34,000
c. $40,000
d. $49,000

**CPA-00772 Explanation**

Choice "b" is correct. $34,000 inventory.

| | #21 Inv | #22 Cap | R&D |
|---|---|---|---|
| Completion of detail program design | | | 13 |
| Coding & testing to establish technological feasibility | | | 10 |
| Coding costs after establishment of technological feasibility | | 24 | |
| Testing costs after establishment of technological feasibility | | 20 | |
| Costs of producing product masters for training materials | | 15 | |
| Duplication of software & training materials from product masters (1,000) | 25 | | |
| Packaging product (500 units) | 9 | | |
| | 34 | 59 | 23 |
| | **B** | **C** | |

**CPA-00775 Type1 M/C A-D Corr Ans: C PM#11 F 2-99**

125. CPA-00775 May 91 I #22 Page 18

During 1990, Pitt Corp. incurred costs to develop and produce a routine, low-risk computer software product, as follows:

| | |
|---|---|
| Completion of detail program design | $13,000 |
| Costs incurred for coding and testing to establish technological feasibility | 10,000 |
| Other coding costs after establishment of technological feasibility | 24,000 |
| Other testing costs after establishment of technological feasibility | 20,000 |
| Costs of producing product masters for training materials | 15,000 |
| Duplication of computer software and training materials from product masters (1,000 units) | 25,000 |
| Packaging product (500 units) | 9,000 |

In Pitt's December 31, 1990, balance sheet, what amount should be capitalized as software cost, subject to amortization?

a. $54,000
b. $57,000


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c. $59,000
d. $69,000

**CPA-00775 Explanation**
Choice "c" is correct. $59,000 capitalized software cost, subject to amortization.

| | #21 INV | #22 CAP | R&D |
|---|---|---|---|
| Completion of detail program design | | | 13 |
| Coding & testing to establish technological feasibility | | | 10 |
| Coding costs after establishment of technological feasibility | | 24 | |
| Testing costs after establishment of technological feasibility | | 20 | |
| Costs of producing product masters for training materials | | 15 | |
| Duplication of software & training materials from product masters (1,000) | 25 | | |
| Packaging product (500 units) | 9 | | |
| | 34 | 59 | 23 |
| | **C** | **C** | |

**CPA-00777 Type1 M/C A-D Corr Ans: B PM#12 F 2-99**

126. CPA-00777 May 91 I #29 Page 5

On July 1, 1990, Roxy Co. obtained fire insurance for a 3-year period at an annual premium of $72,000 payable on July 1 of each year. The first premium payment was made July 1, 1990. On October 1,1990, Roxy paid $24,000 for real estate taxes to cover the period ending September 30, 1991. This prepayment was made to obtain a discount. In its December 31, 1990, balance sheet, Roxy should report prepaid expenses of:

a. $60,000
b. $54,000
c. $48,000
d. $36,000

**CPA-00777 Explanation**
Choice "b" is correct. $54,000 prepaid expenses in 12/31/90 BS. (All figures in thousands.)

| | | Coverage Period | | Prepaid Expenses | | |
|---|---|---|---|---|---|---|
| Date | Action | From | To | Insur | Taxes | Total |
| 7/1/90 | Pymt | 7/1/90 | 6/30/91 | 72 | | 72 |
| 10/1/90 | Pymt | 10/1/90 | 9/30/91 | | 24 | 24 |
| 12/31/90 | Amort | 7/1/90 | 12/31/90 | (36) | | (36) |
| 12/31/90 | Amort | 10/1/90 | 12/31/90 | | (6) | (6) |
| 12/31/90 | Balances | | | 36 | 18 | 54 |

**CPA-00778 Type1 M/C A-D Corr Ans: D PM#13 F 2-99**

127. CPA-00778 May 91 I #40 Page 10

On December 31, 1990, Rice, Inc. authorized Graf to operate as a franchisee for an initial franchise fee of $150,000. Of this amount, $60,000 was received upon signing the agreement and the balance, represented by a note, is due in three annual payments of $30,000 each beginning December 31, 1991. The present value on December 31, 1990, of the three annual payments appropriately discounted is $72,000. According to the agreement, the nonrefundable down payment represents a fair measure of the services already performed by Rice; however, substantial future services are required of Rice. Collectibility of the note is reasonably certain. In Rice's December 31, 1990, balance sheet, unearned franchise fees from Graf's franchise should be reported as:


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a. $132,000
b. $100,000
c. $90,000
d. $72,000

**CPA-00778 Explanation**
Choice "d" is correct. $72,000 unearned franchise fee liability at 12/31/90.

| | Franchise Fees | |
|---|---|---|
| | Earned | Unearned |
| Nonrefundable down payment represents a fair measure of the services already performed | 60,000 | |
| Present value of 3 annual payments require substantial future services | | 72,000 |
| Full JE would be: | | |
| Cash | 60,000 | |
| Note receivable | 90,000 | |
| Revenue | | 60,000 |
| Discount on note receivable | | 18,000 |
| Unearned franchise revenue | | 72,000 |

**CPA-00780 Type1 M/C A-D Corr Ans: C PM#14 F 2-99**

128. CPA-00780 May 91 I #43 Page 9

Aneen's Video Mart sells 1 and 2-year mail order subscriptions for its video-of-the-month business. Subscriptions are collected in advance and credited to sales. An analysis of the recorded sales activity revealed the following:

| | *1989* | *1990* |
|---|---|---|
| Sales | $420,000 | $500,000 |
| Less cancellations | 20,000 | 30,000 |
| Net sales | $400,000 | $470,000 |
| Subscriptions expirations: | | |
| 1989 | $120,000 | |
| 1990 | 155,000 | $130,000 |
| 1991 | 125,000 | 200,000 |
| 1992 | | 140,000 |
| | $400,000 | $470,000 |

In Aneen's December 31, 1990, balance sheet, the balance for unearned subscription revenue should be:

a. $495,000
b. $470,000
c. $465,000
d. $340,000

**CPA-00780 Explanation**
Choice "c" is correct. $465,000 unearned subscription revenue.

| Subscription | Net Sales | | | | Subscription Revenue | | |
|---|---|---|---|---|---|---|---|
| Expirations | 1989 | | 1990 | | Earned | | Unearned |
| 1989 Earned | 120 | + | | = | 120 | | |
| 1990 Earned | 155 | + | 130 | = | 285 | | |
| 1991 Unearned | 125 | + | 200 | = | | | 325 |
| 1992 Unearned | | + | 140 | = | | | 140 |
| | 400 | + | 470 | = | 405 | + | 465 |


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**CPA-00790 Type1 M/C A-D Corr Ans: D PM#15 F 2-99**

129. CPA-00790 May 91 #13 Page 5

On May 1, 1990, Marno County issued property tax assessments for the fiscal year ended June 30, 1991. The first of two equal installments was due on November 1, 1990. On September 1, 1990, Dyur Co. purchased a 4-year old factory in Marno subject to an allowance for accrued taxes. Dyur did not record the entire year's property tax obligation, but instead records tax expenses at the end of each month by adjusting prepaid property taxes or property taxes payable, as appropriate. The recording of the November 1, 1990, payment by Dyur should have been allocated between an increase in prepaid property taxes and a decrease in property taxes payable in which of the following percentages?

| | *Percentage allocated to* | |
|---|---|---|
| | *Increase in prepaid property taxes* | *Decrease in property taxes payable* |
| a. | 66 2/3% | 33 1/3% |
| b. | 0% | 100% |
| c. | 50% | 50% |
| d. | 33 1/3% | 66 2/3% |

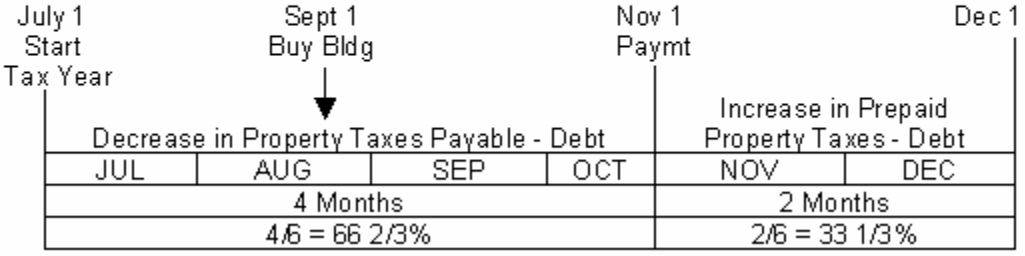
**CPA-00790 Explanation**

Choice "d" is correct. 33 1/3% increase in prepaid.

Property Taxes (Debit) 2 Months

66 2/3% Decrease in Property Taxes Payable (Debit) 4 Months

Decrease in Cash (Credit) 6 Months




**CPA-00794 Type1 M/C A-D Corr Ans: D PM#16 F 2-99**

130. CPA-00794 Nov 91 I #29 Page 9

Winn Co. sells subscriptions to a specialized directory that is published semiannually and shipped to subscribers on April 15 and October 15. Subscriptions received after the March 31 and September 30 cutoff dates are held for the next publication. Cash from subscribers is received evenly during the year and is credited to deferred subscription revenue. Data relating to 1990 are as follows:

| | |
|---|---|
| Deferred subscription revenue, 1/1/90 | $ 750,000 |
| Cash receipts from subscribers | 3,600,000 |

In its December 31, 1990, balance sheet, Winn should report deferred subscription revenue of:

a. $2,700,000
b. $1,800,000
c. $1,650,000
d. $900,000

**CPA-00794 Explanation**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Choice "d" is correct. $900,000.

| | Deferred Subscription Revenue |
|---|---|
| Begin balance, 1-1-90 | $ 750 |
| Add: Cash receipts from subscribers | 3,600 |
| Subtotal | 4,350 |
| Less: Revenues earned from 10-1-89 to 9-30-90 | |
| Oct., Nov., Dec. 1989 collection (3 mos) | (750) |
| Jan., Feb., Mar. 1990 (3 mos) | (900) |
| Apr. to Sept. 1990 (6 mos) | (1,800) |
| Ending balance, 12-31-90 | $ 900 |

**CPA-00796 Type1 M/C A-D Corr Ans: C PM#17 F 2-99**

131. CPA-00796 Nov 91 I #31 Page 3

On January 1, 1990, Dell, Inc. contracted with the city of Little to provide custom built desks for the city schools. The contract made Dell the city's sole supplier and required Dell to supply no less than 4,000 desks and no more than 5,500 desks per year for two years. In turn, Little agreed to pay a fixed price of $110 per desk. During 1990, Dell produced 5,000 desks for Little. At December 31, 1990, 500 of these desks were segregated from the regular inventory and were accepted and awaiting pickup by Little. Little paid Dell $450,000 during 1990. What amount should Dell recognize as contract revenue in 1990?

a. $450,000
b. $495,000
c. $550,000
d. $605,000

**CPA-00796 Explanation**
Choice "c" is correct. $550,000. (5,000 desks produced at $110 per desk.)

The 500 desks not shipped were "set aside" and therefore (as you will learn in Regulation lecture 1 on "sales") belong to the buyer even though they were not yet shipped.

**CPA-00797 Type1 M/C A-D Corr Ans: B PM#18 F 2-99**

132. CPA-00797 Nov 91 I #47 Page 16

In 1990, Ball Labs incurred the following costs:

| | |
|---|---|
| Direct costs of doing contract research and development work for the government to be reimbursed by governmental unit | $ 400,000 |

Research and development costs not included above were:

| | |
|---|---|
| Depreciation | $ 300,000 |
| Salaries | 700,000 |
| Indirect costs appropriately allocated | 200,000 |
| Materials | 180,000 |

What was Ball's total research and development expense in 1990?

a. $1,080,000
b. $1,380,000
c. $1,580,000
d. $1,780,000

**CPA-00797 Explanation**
Choice "b" is correct. $1,380,000 R & D expense in 1990.


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| | Capitalize | R&D Expense |
|---|---|---|
| R&D costs reimbursable by govt. | $400 | |
| Depreciation | | 300 |
| Salaries | | 700 |
| Indirect costs appropriately allocated | | 200 |
| Materials | | 180 |
| | 400 | 1,380 |

**CPA-00798 Type1 M/C A-D Corr Ans: B PM#19 F 2-99**

133. CPA-00798 Nov 91 I #58 Page 3

On August 1, 1990, Metro, Inc. leased a luxury apartment unit to Klum. The parties signed a 1-year lease beginning September 1, 1990, for a $1,000 monthly rent payable on the first day of the month. At the August 1 signing date, Metro collected $540 as a nonrefundable fee for allowing Klum to sign a 1-year lease (the normal lease term is three years) and $1,000 rent for September. Klum has made timely payments each month, but prepaid January's rent on December 20. In Metro's 1990 income statement, rent revenue should be reported as:

a. $4,000
b. $4,180
c. $4,540
d. $5,180

**CPA-00798 Explanation**
Choice "b" is correct. $4,180 rent revenue.

| | Rent Revenue |
|---|---|
| Sign-up fee $\frac{\$540}{12 \text{ months}} \times 4 \text{ months} =$ | $180 |
| Monthly rent $1000 x 4 months = | 4,000 |
| | $4,180 |

**CPA-00799 Type1 M/C A-D Corr Ans: D PM#20 F 2-99**

134. CPA-00799 Nov 91 #19 Page 9

How would the proceeds received from the advance sale of nonrefundable tickets for a theatrical performance be reported in the seller's financial statements before the performance?

a. Revenue for the entire proceeds.
b. Revenue to the extent of related costs expended.
c. Unearned revenue to the extent of related costs expended.
d. Unearned revenue for the entire proceeds.

**CPA-00799 Explanation**
Choice "d" is correct. Proceeds received from the advance sale of nonrefundable tickets for a theatrical performance should be reported in the seller's financial statements before the performance as unearned revenue for the entire proceeds.

Choice "a" is incorrect. After the performance, the proceeds should be reported as revenue for the entire proceeds.

Choices "b" and "c" are incorrect. Revenue should not be partially recognized before the performance - there is always the possibility of an occurrence that could require a refund (even on nonrefundable tickets) such as the cancellation of the performance due to illness or death of the star.


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**CPA-00800 Type1 M/C A-D Corr Ans: A PM#21 F 2-99**

135. CPA-00800 Nov 91 #32 Page 16

On January 1, 1990, Jambon purchased equipment for use in developing a new product. Jambon uses the straight-line depreciation method. The equipment could provide benefits over a 10-year period. However, the new product development is expected to take five years, and the equipment can be used only for this project. Jambon's 1990 expense equals:

a. The total cost of the equipment.
b. One-fifth of the cost of the equipment.
c. One-tenth of the cost of the equipment.
d. Zero.

**CPA-00800 Explanation**
Choice "a" is correct. Since the equipment can be used only for this project it should be expensed immediately, even though the project is expected to take 5 years. It would be capitalized over its useful life, only if the equipment had an alternative use.

**CPA-00810 Type1 M/C A-D Corr Ans: B PM#22 F 2-99**

136. CPA-00810 May 92 I #37 Page 3

On October 1, 1991, Acme Fuel Co. sold 100,000 gallons of heating oil to Karn Co. at $3 per gallon. Fifty thousand gallons were delivered on December 15, 1991, and the remaining 50,000 gallons were delivered on January 15, 1992. Payment terms were: 50% due on October 1, 1991, 25% due on first delivery, and the remaining 25% due on second delivery. What amount of revenue should Acme recognize from this sale during 1991?

a. $75,000
b. $150,000
c. $225,000
d. $300,000

**CPA-00810 Explanation**
Choice "b" is correct. $150,000 revenue recognized from sales shipped during 1991 (50,000 gallons at $3 per gallon). Since heating oil is a generic product, sales are based on shipments.

However, if the product was custom produced for a specific customer, sales would be based on production, even if not shipped but merely "set aside" for future shipment.

**CPA-00811 Type1 M/C A-D Corr Ans: C PM#23 F 2-99**

137. CPA-00811 May 92 I #51 Page 16

West, Inc. made the following expenditures relating to Product Y:

- Legal costs to file a patent on Product Y - $10,000. Production of the finished product would not have been undertaken without the patent.
- Special equipment to be used solely for development of Product Y - $60,000. The equipment has no other use and has an estimated useful life of four years.
- Labor and material costs incurred in producing a prototype model - $200,000.
- Cost of testing the prototype - $80,000.

What is the total amount of costs that will be expensed when incurred?

a. $280,000
b. $295,000
c. $340,000
d. $350,000

**CPA-00811 Explanation**


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Choice "c" is correct. $340,000 will be expensed when incurred.

| | EXP | CAP |
|---|---|---|
| • Legal costs to file a patent on Product Y - $10,000. Production of the finished product would not have been undertaken without the patent. (Patents should be capitalized) | 0 | 10,000 |
| • Special equipment to be used solely for development of Product Y - $60,000. The equipment has no other use and has an estimated useful life of four years. (Capitalize only if it has alternative use) | 60,000 | 0 |
| • Labor and material costs incurred in producing a prototype model - $200,000. (R & D should be expensed) | 200,000 | 0 |
| • Cost of testing the prototype - $80,000. (R & D should be expensed) | 80,000 | 0 |
| Totals | $340,000 | $10,000 |

**CPA-00812 Type1 M/C A-D Corr Ans: D PM#24 F 2-99**

138. CPA-00812 Nov 92 I #53 Page 16

Heller Co. incurred the following costs in 1991:

| | |
|---|---|
| Research and development services performed by Kay Corp. for Heller | $150,000 |
| Testing for evaluation of new products | 125,000 |
| Laboratory research aimed at discovery of new knowledge | 185,000 |

What amount should Heller report as research and development costs in its income statement for the year ended December 31, 1991?

a. $125,000
b. $150,000
c. $335,000
d. $460,000

**CPA-00812 Explanation**
Choice "d" is correct. $460,000.

**Rule:** Research and development costs are expensed as incurred except if for:
1. Costs to be reimbursed by another company.
2. Costs for a long lived tangible asset with alternate uses.

| | Capitalized | Expensed |
|---|---|---|
| R & D performed by another company | - | $150,000 |
| Evaluation of new products | - | 125,000 |
| Research aimed at new knowledge | - | 185,000 |
| | 0 | $460,000 |

**CPA-00815 Type1 M/C A-D Corr Ans: A PM#25 F 2-99**

139. CPA-00815 Nov 92 #42 Page 7

Buc Co. receives deposits from its customers to protect itself against nonpayments for future services. These deposits should be classified by Buc as:

a. A liability.
b. Revenue.
c. A deferred credit deducted from accounts receivable.
d. A contra account.


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**CPA-00815 Explanation**
Choice "a" is correct. Liability (called "advances [or deposits] from customers").

**Rule:** A "cash deposit received from a customer" for future services is a liability until the "sale" takes place.

Choice "b" is incorrect. Revenue cannot be recognized until the sale is completed.

Choice "c" is incorrect. Deferred credits are for future income contracted for or collected in advance. This question indicates a (potential) future sale of services.

Choice "d" is incorrect. "Allowance for doubtful accounts receivable" is a contra account subtracted from accounts receivable, "deposits from customers" is choice a "contra account".

**CPA-00817 Type1 M/C A-D Corr Ans: B PM#26 F 2-99**

140. CPA-00817 May 93 I #27 Page 6

An analysis of Thrift Corp.'s unadjusted prepaid expense account at December 31, 1992, revealed the following:

- An opening balance of $1,500 for Thrift's comprehensive insurance policy. Thrift had paid an annual premium of $3,000 on July 1, 1991.
- A $3,200 annual insurance premium payment made July 1, 1992.
- A $2,000 advance rental payment for a warehouse Thrift leased for one year beginning January 1, 1993.

In its December 31, 1992, balance sheet, what amount should Thrift report as prepaid expenses?

a. $5,200
b. $3,600
c. $2,000
d. $1,600

**CPA-00817 Explanation**
Choice "b" is correct. $3,600 prepaid expenses at 12/31/92.

| | 12/31/92 Balance |
|---|---|
| Annual insurance premium paid 7/1/91 | |
| (period benefited – 7/1/91 – 6/30/92) | $0 |
| Annual premium paid 7/2/92 on insurance | |
| (period benefited – 7/1/92 – 6/30/92) | |
| ($3200 × 6/12) | 1,600 |
| Annual advance rental payment for a warehouse lease | |
| (period benefited – 1/1/93 – 12/31/93) | |
| ($2,000 × 12/12) | 2,000 |
| Balance at 12/31/92 | $3,600 |

**CPA-00819 Type1 M/C A-D Corr Ans: B PM#27 F 2-99**

141. CPA-00819 May 93 I #49 Page 5

Zach Corp. pays commissions to its sales staff at the rate of 3% of net sales. Sales staff are not paid salaries but are given monthly advances of $15,000. Advances are charged to commission expense, and reconciliations against commissions are prepared quarterly. Net sales for the year ended March 31, 1992, were $15,000,000. The unadjusted balance in the commissions expense account on March 31, 1992, was $400,000. March advances were paid on April 3, 1992. In its income statement for the year ended March 31, 1992, what amount should Zach report as commission expense?

a. $465,000
b. $450,000


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c. $415,000
d. $400,000

**CPA-00819 Explanation**
Choice "b" is correct. $450,000 commission expense for the year ended 3/31/92.

Sales of $15,000,000 x 3% = $450,000

**Note:** "Advances" affect cash flow but do not affect accrual basis expense, thus information on "advances" is a "distractor."

**CPA-00820 Type1 M/C A-D Corr Ans: C PM#28 F 2-99**

142. CPA-00820 Nov 94 #47 Page 5

Clark Co.'s advertising expense account had a balance of $146,000 at December 31, 1993, before any necessary year-end adjustment relating to the following:

- Included in the $146,000 is the $15,000 cost of printing catalogs for a sales promotional campaign in January 1994.
- Radio advertisements broadcast during December 1993 were billed to Clark on January 2, 1994. Clark paid the $9,000 invoice on January 11, 1994.

What amount should Clark report as advertising expense in its income statement for the year ended December 31, 1993?

a. $122,000
b. $131,000
c. $140,000
d. $155,000

**CPA-00820 Explanation**

| | | |
|---|---|---|
| Preliminary balance Dec. 31, 1993 | | $146,000 |
| Less: | Printed catalogs paid before year-end for Jan 1994 promotional campaign | (15,000) |
| Add: | Radio ads broadcast during Dec. 1993, but not billed until Jan. 2, 1994 | 9,000 |
| Advertising expense for 1993 | | $140,000 |

Choice "c" is correct. $140,000 advertising expense.

**CPA-00822 Type1 M/C A-D Corr Ans: B PM#29 F 2-99**

143. CPA-00822 R98 #11 Page 16

Wizard Co. purchased two machines for $250,000 each on January 2, 1997. The machines were put into use immediately. Machine A has a useful life of five years and can only be used in one research project. Machine B will be used for two years on a research and development project and then used by the production division for an additional eight years. Wizard uses the straight-line method of depreciation. What amount should Wizard include in 1997-research and development expense?

a. $75,000
b. $275,000
c. $375,000
d. $500,000

**CPA-00822 Explanation**
Choice "b" is correct. $275,000

Research and development costs should be expensed when incurred unless the costs are (1) for tangible assets with long lives and alternative uses, or (2) reimbursable by another. Since machine a can only be used for one research project, its costs should be expensed in the period it is purchased. Since machine


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b has an alternative use in the production division, it should be capitalized and depreciated over its useful life of 10 years. Therefore, the research and development expense for 1997 should be:

| | |
|---|---|
| Machine A - Cost | $250,000 |
| Machine B - Cost = $250,000/10 Years | 25,000 |
| Total R&D Expense | $275,000 |

**CPA-00824 Type1 M/C A-D Corr Ans: A PM#30 F 2-99**

144. CPA-00824 May 90 I #45 Page 3

On December 31, 1988, Mill Co. sold construction equipment to Drew, Inc. for $1,800,000. The equipment had a carrying amount of $1,200,000. Drew paid $300,000 cash on December 31, 1988 and signed a $1,500,000 note bearing interest at 10%, payable in five annual installments of $300,000. Mill appropriately accounts for the sale under the installment method. On December 31, 1989, Drew paid $300,000 principal and $150,000 interest. For the year ended December 31, 1989, what total amount of revenue should Mill recognize from the construction equipment sale and financing?

a. $250,000
b. $150,000
c. $120,000
d. $100,000

**CPA-00824 Explanation**

Choice "a" is correct. The total amount of revenue Mill should recognize from the construction equipment sale and financing would be $250,000.

| | |
|---|---|
| Sales price | 1,800,000 |
| Carrying amount | (1,200,000) |
| Gain | 600,000 |
| Gross profit % | 33% |

| Payments received in 1989: | Amount Received |
|---|---|
| Principal 300,000 x 33% = | $100,000 |
| Interest income | 150,000 |
| Total revenue recognized | $250,000 |

**CPA-00825 Type1 M/C A-D Corr Ans: B PM#31 F 2-99**

145. CPA-00825 Nov 90 I #6 Page 34

Kemp, Inc. appropriately uses the installment method of accounting to recognize income in its financial statements. Some pertinent data relating to this method of accounting include:

| | *1987* | *1988* | *1989* |
|---|---|---|---|
| Installment sales | $300,000 | $ 375,000 | $ 360,000 |
| Cost of installment sales | 225,000 | 285,000 | 252,000 |
| Gross profit | $ 75,000 | $ 90,000 | $ 108,000 |
| Rate of gross profit on installment sales | 25% | 24% | 30% |
| Balance of deferred gross profit at Year-end: | | | |
| 1987 | $ 52,500 | $ 15,000 | $ -0- |
| 1988 | | 54,000 | 9,000 |
| 1989 | | | 72,000 |
| Total | $ 52,500 | $ 69,000 | $ 81,000 |

What amount of installment accounts receivable should be presented in Kemp's December 31, 1989 balance sheet?


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a. $270,000
b. $277,500
c. $279,000
d. $300,000

**CPA-00825 Explanation**
Choice "b" is correct. $277,500

| Deferred gross profit | 1988 | | 1989 | Total |
|---|---|---|---|---|
| Balance at year end | 9,000 | | 72,000 | 81,000 |
| ÷ gross profit % | ÷ 24% | | ÷ 30% | |
| Installment accounts rec. | $37,500 | + | $240,000 | $277,500 |

**CPA-00831 Type1 M/C A-D Corr Ans: C PM#32 F 2-99**

146. CPA-00831 Nov 90 I #34 Page 34

On January 1, 1988, Rex Co. sold a used machine to Lake, Inc. for $525,000. On this date, the machine had a depreciated cost of $367,500. Lake paid $75,000 cash on January 1, 1988 and signed a $450,000 note bearing interest at 10%. The note was payable in three annual installments of $150,000 beginning January 1, 1989. Rex appropriately accounted for the sale under the installment method. Lake made a timely payment of the first installment on January 1, 1989 of $195,000, which included interest of $45,000 to date of payment. At December 31, 1989, Rex has deferred gross profit of:

a. $105,000
b. $99,000
c. $90,000
d. $76,500

**CPA-00831 Explanation**
Choice "c" is correct. Rex has deferred gross profit of $90,000 at 12-31-89.

| | |
|---|---|
| Amount realized | $525,000 |
| Adjusted basis | 367,500 |
| Gain recognized | 157,500 |
| Gross profit % (157,500 ÷ 525,000) | 30% |
| | |
| Amount realized | $525,000 |
| Less: collections in 1988 | (75,000) |
| Less: principal collected in 1989 (195,000 – 45,000) | (150,000) |
| | |
| Balance to be received | $300,000 |
| Gross profit % | 30% |
| Deferred gross profit at 12-31-89 | 90,000 |

**CPA-00832 Type1 M/C A-D Corr Ans: C PM#33 F 2-99**

147. CPA-00832 Nov 90 T #18 Page 34

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

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


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**CPA-00832 Explanation**
Choice "c" is correct. The amount of deferred gross profit relating to installment AR collections 12 months beyond the balance sheet date should be reported in the current asset section as a contra account.

Choices "a", "b", and "d" are incorrect, per above.

**CPA-00833 Type1 M/C A-D Corr Ans: C PM#34 F 2-99**

148. CPA-00833 Nov 91 T #6 Page 34

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

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

**CPA-00833 Explanation**
Choice "c" is correct. For financial statement purposes, the installment method of accounting may be used if the ultimate amount collectible is indeterminate. Otherwise, the installment method of recognizing revenue is not acceptable for GAAP, and the entire gain is recognized in the year of sale.

Choices "a", "b", and "d" are incorrect, per above.

**CPA-00834 Type1 M/C A-D Corr Ans: C PM#35 F 2-99**

149. CPA-00834 May 92 I #21 Page 34

Dolce Co., which began operations on January 1, 1990, appropriately uses the installment method of accounting to record revenues. The following information is available for the years ended December 31, 1990 and 1991:

| | *1990* | *1991* |
|---|---|---|
| Sales | $1,000,000 | $2,000,000 |
| Gross profit realized on sales made in: | | |
| 1990 | 150,000 | 90,000 |
| 1991 | - | 200,000 |
| Gross profit percentages | 30% | 40% |

What amount of installment accounts receivable should Dolce report in its December 31, 1991, balance sheet?

a. $1,225,000
b. $1,300,000
c. $1,700,000
d. $1,775,000

**CPA-00834 Explanation**
Choice "c" is correct. $1,700,000 installment accounts receivable in Dec. 31, 1991 BS.

| | Installment A/R |
|---|---|
| Sales 1990 | $1,000,000 |
| Less collections ($150,000 gross profit/.30 g/p rate) = | (500,000) |
| A/R balance 12/31/90 | 500,000 |
| Sales 1991 | 2,000,000 |
| Subtotal | 2,500,000 |
| Less: | |


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| | |
|---|---|
| Collections from 1990 ($90,000/.30) = | (300,000) |
| Collections from 1991 ($200,000/.40) = | (500,000) |
| A/R balance 12/31/91 | $1,700,000 |

**CPA-00835 Type1 M/C A-D Corr Ans: C PM#36 F 2-99**

150. CPA-00835 May 92 T #45 Page 34

Income recognized using the installment method of accounting generally equals cash collected multiplied by the:

a. Net operating profit percentage.
b. Net operating profit percentage adjusted for expected uncollectible accounts.
c. Gross profit percentage.
d. Gross profit percentage adjusted for expected uncollectible accounts.

**CPA-00835 Explanation**

Choice "c" is correct. Gross profit percentage.

**Rule:** When a "nondealer" in real estate and a "nonmerchant" in personal property make an installment sale, they need only report income over the period in which the cash payments are received. They merely compute the gross profit from the original sale and apply the gross profit percentage to cash collected to arrive at realized gross profit.

Income recognized using the installment method of accounting generally equals cash collected multiplied by the gross profit percentage.

**CPA-00836 Type1 M/C A-D Corr Ans: B PM#37 F 2-99**

151. CPA-00836 Nov 92 I #28 Page 34

Gant Co., which began operations on January 1, 1991, appropriately uses the installment method of accounting. The following information pertains to Gant's operations for the year 1991:

| | |
|---|---|
| Installment sales | $500,000 |
| Regular sales | 300,000 |
| Cost of installment sales | 250,000 |
| Cost of regular sales | 150,000 |
| General and administrative expenses | 50,000 |
| Collections on installment sales | 100,000 |

In its December 31,1991, balance sheet, what amount should Gant report as deferred gross profit?

a. $250,000
b. $200,000
c. $160,000
d. $75,000

**CPA-00836 Explanation**

| | Amount | % |
|---|---|---|
| Installment sales | $500,000 | 100% |
| Cost of installment sales | (250,000) | (50) |
| Gross profit | $250,000 | 50% |

| | |
|---|---|
| Installment sales | $500,000 |
| Collections on installment sale | 100,000 |
| Uncollected sales | 400,000 |
| Gross profit % | 50% |


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Deferred gross profit at 12/31/91 $200,000 **B**

Choice "b" is correct. $200,000 deferred gross profit at 12-31-91.

Note: Regular sales, cost of regular sales and G&A expenses are distractors.

**CPA-00850 Type1 M/C A-D Corr Ans: C PM#38 F 2-99**

152. CPA-00850 Nov 92 I #43 Page 36

Several of Fox, Inc.'s customers are having cash flow problems. Information pertaining to these customers for the years ended March 31, 1991 and 1992 follows:

| | *3/31/91* | *3/31/92* |
|---|---|---|
| Sales | $10,000 | $15,000 |
| Cost of sales | 8,000 | 9,000 |
| Cash collections | | |
| on 1991 sales | 7,000 | 3,000 |
| on 1992 sales | - | 12,000 |

If the cost recovery method is used, what amount would Fox report as gross profit from sales to these customers for the year ended March 31, 1992?

a. $2,000
b. $3,000
c. $5,000
d. $15,000

**CPA-00850 Explanation**
**Rule:** Under the cost recovery method no profit is recognized until cash collections exceed the cost of sales.

| | Cumulative 3/31/91 | 3/31/92 | | Total | |
|---|---|---|---|---|---|
| Cash collections | | | | | |
| On 1991 sales | 7,000 | 3,000 | | | |
| On 1992 sales | - | 12,000 | | | |
| Totals | 7,000 | 15,000 | | 22,000 | |
| Cost of sales | 8,000 | 9,000 | | 17,000 | |
| Gross profit (deficit) | (1,000) | 6,000 | → | 5,000 | **C** |

Choice "c" is correct. $5,000 gross profit for the year ended 3/31/92 (using cost recovery method), since collections were less than cost at prior year-end (3/31/91).

**CPA-00852 Type1 M/C A-D Corr Ans: C PM#39 F 2-99**

153. CPA-00852 R98 #8 Page 34

Bear Co., which began operations on January 2, 1997, appropriately uses the installment sales method of accounting. The following information is available for 1997:

| | |
|---|---|
| Installment sales | $1,400,000 |
| Realized gross profit on installment sales | 240,000 |
| Gross profit percentage on sales | 40% |

For the year ended December 31, 1997, what amounts should Bear report as accounts receivable and deferred gross profits?

| | *Accounts receivable* | *Deferred gross profit* |
|---|---|---|
| a. | $600,000 | $320,000 |


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b. $600,000 $360,000
c. $800,000 $320,000
d. $800,000 $560,000

**CPA-00852 Explanation**
Choice "c" is correct. $800,000; $320,000

The amount of accounts receivable is computed as:

| | |
|---|---|
| Installment sales | $1,400,000 |
| Collection of installment sales: | |
| $240,000 = .40 of collections | |
| .40c = $240,000 | |
| c = $240,000/.40 | |
| c = | 600,000 |
| Balance of accounts receivable | $ 800,000 |

The deferred gross profit is computed as:

| | |
|---|---|
| Installment sales | $1,400,000 |
| Gross profit rate | .40 |
| Total gross profit | $ 560,000 |
| Less: gross profit realized | 240,000 |
| Deferred gross profit | $ 320,000 |

**CPA-00853 Type1 M/C A-D Corr Ans: A PM#40 F 2-99**

154. CPA-00853 May 90 II #49 Page 7

On January 1, 1988, Layton Co. acquired the copyright to a book owned by Garner for royalties of 15% of future book sales. Royalties are payable on September 30 for sales in January through June of the same year, and on March 31 for sales in July through December of the preceding year. During 1988 and 1989, Layton remitted royalty checks to Garner as follows:

| | *March 31* | *September 30* |
|---|---|---|
| 1988 | $ -- | $25,000 |
| 1989 | 22,000 | 40,000 |

Layton's sales of the Garner book totaled $300,000 for the last half of 1989. In its 1989 income statement, Layton should report royalty expense of:
a. $85,000
b. $67,000
c. $62,000
d. $45,000

**CPA-00853 Explanation**
Choice "a" is correct. $85,000 royalty expense for 1989.

| | | |
|---|---|---|
| Accrued June 30, 1989 (Jan-Jun) | $40,000 | (paid Sept 30, 1989) |
| Accrued Dec 31, 1989 (Jul-Dec) | 45,000 | ($300,000 × 15% – payable Mar 31, 1990) |
| Royalty expense for 1989 | $85,000 | |

**A**

**CPA-00855 Type1 M/C A-D Corr Ans: A PM#41 F 2-99**

155. CPA-00855 May 91 I #56 Page 7

Based on 1990 sales of compact discs recorded by an artist under a contract with Bain Co., the artist earned $100,000 after an adjustment of $8,000 for anticipated returns. In addition, Bain paid the artist


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$75,000 in 1990 as a reasonable estimate of the amount recoverable from future royalties to be earned by the artist. What amount should Bain report in its 1990 income statement for royalty expense?

a. $100,000
b. $108,000
c. $175,000
d. $183,000

**CPA-00855 Explanation**
Choice "a" is correct. $100,000 royalty expense for 1990 represents the amount the artist "earned." All other payments are "advances" or "prepaids."

| | Asset Prepaid Royalty Expense | |
|---|---|---|
| Begin balance, 1/1/90 | 0 | |
| Add: Cash payments for 1990 | 100,000 | |
| Cash payments for future | 75,000 | |
| Subtotal | 175,000 | |
| Less: Royalty expense for 1990 | (100,000) | **A** |
| Ending balance, 12/31/90 | 75,000 | |

**CPA-00860 Type1 M/C A-D Corr Ans: B PM#42 F 2-99**

156. CPA-00860 May 92 T #46 Page 7

Under a royalty agreement with another enterprise, a company will receive royalties from the assignment of a patent for three years. The royalties received should be reported as revenue:

a. At the date of the royalty agreement.
b. In the period earned.
c. In the period received.
d. Evenly over the life of the royalty agreement.

**CPA-00860 Explanation**
Choice "b" is correct. Royalties received should be reported as revenue in the period earned.

Choices "a" and "d" are incorrect. At the date of the royalty agreement, the amounts are normally unknown since royalties are usually a percentage of actual sales generated unevenly over the life of the royalty agreement.

Choice "c" is incorrect. Royalties are normally received "after" the period in which they are earned.

**CPA-00862 Type1 M/C A-D Corr Ans: D PM#43 F 2-99**

157. CPA-00862 May 93 I #44 Page 7

In 1990, Super Comics Corp. sold a comic strip to Fantasy, Inc. and will receive royalties of 20% of future revenues associated with the comic strip. At December 31, 1991, Super reported royalties receivable of $75,000 from Fantasy. During 1992, Super received royalty payments of $200,000. Fantasy reported revenues of $1,500,000 in 1992 from the comic strip. In its 1992 income statement, what amount should Super report as royalty revenue?

a. $125,000
b. $175,000
c. $200,000
d. $300,000

**CPA-00862 Explanation**


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| | Royalties Receivable |
|---|---|
| Begin balance, Dec. 31, 1991 | 75,000 |
| Add: Royalty revenue ($1,500,000 x 20%) | 300,000 **D** |
| Subtotal | 375,000 |
| Less: Collections | (200,000) Not **C** |
| Ending balance, Dec. 31, 1992 | 175,000 Not **B** |

Choice "d" is correct. $300,000 royalty revenue for 1992 ($1,500,000 × 20%) – Note: All other information are distractors.

**CPA-00865 Type1 M/C A-D Corr Ans: B PM#44 F 2-99**

158. CPA-00865 Nov 89 II #18 Page 41

The December 31, 1988 condensed balance sheet of Mason & Gross, a partnership, follows:

| | |
|---|---|
| Current assets | $ 125,000 |
| Equipment (net) | 15,000 |
| Total assets | $ 140,000 |
| Liabilities | $ 10,000 |
| Mason, Capital | 80,000 |
| Gross, Capital | 50,000 |
| Total liabilities and capital | $ 140,000 |

Market values at December 31, 1988 are as follows:

| | |
|---|---|
| Current assets | $ 90,000 |
| Equipment | 30,000 |
| Liabilities | 10,000 |

On January 2, 1989, the partnership was incorporated and 1,000 shares of $5 par value common stock were issued. What amount should be credited to additional contributed capital?

a. $0
b. $105,000
c. $125,000
d. $135,000

**CPA-00865 Explanation**
Choice "b" is correct, $105,000.

**Rule:** Assets contributed by a partnership (or sole proprietorship) to a corporation in its formation are valued at the assets fair market value, less any related liabilities assumed by the corporation (e.g., mortgage note on real property). Stock issued is credited at par value and any difference is credited to additional paid-in capital.

| | |
|---|---|
| Fair market value of assets contributed | $ 120,000 |
| Less liabilities assumed | (10,000) |
| Net assets | 110,000 |
| Common stock (1,000 shares @ $5 par) | 5,000 |
| Additional paid-in capital squeeze | 105,000 |
| Shareholders' equity | $ 110,000 |

**CPA-00866 Type1 M/C A-D Corr Ans: C PM#45 F 2-99**

159. CPA-00866 Nov 89 T #24 Page 41


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On July 1, 1988, a partnership was formed by Johnson and Smith. Johnson contributed cash. Smith, previously a sole proprietor, contributed property other than cash including realty subject to a mortgage, which was assumed by the partnership. Smith's capital account at July 1, 1988, should be recorded at:

a. Smith's book value of the property at July 1, 1988.
b. Smith's book value of the property less the mortgage payable at July 1, 1988.
c. The fair value of the property less the mortgage payable at July 1, 1988.
d. The fair value of the property at July 1, 1988.

**CPA-00866 Explanation**
Choice "c" is correct, the fair market value of the property less mortgage payable at 7/1/88.

**Rule:** Assets contributed by partners to a partnership are valued at fair market value of the assets, net of any related liabilities.

Choices "a", "b", and "d" are incorrect, per the above rule.

**CPA-00867 Type1 M/C A-D Corr Ans: C PM#46 F 2-99**

160. CPA-00867 Th May 93 #9 Page 41

On April 30, 1993, Algee, Belger, and Ceda formed a partnership by combining their separate business proprietorships. Algee contributed cash of $50,000. Belger contributed property with a $36,000 carrying amount, a $40,000 original cost, and $80,000 fair value. The partnership accepted responsibility for the $35,000 mortgage attached to the property. Ceda contributed equipment with a $30,000 carrying amount, a $75,000 original cost, and $55,000 fair value. The partnership agreement specifies that profits and losses are to be shared equally but is silent regarding capital contributions. Which partner has the largest April 30, 1993, capital account balance?

a. Algee.
b. Belger.
c. Ceda.
d. All capital account balances are equal.

**CPA-00867 Explanation**
Choice "c" is correct. Ceda's capital account balance is the fair market value of the equipment donated. The $55,000 contribution is greater than Algee's $50,000 contribution and Belger's $45,000 contribution, ($80,000 fair value - $35,000 mortgage assumed by the partnership).

Choice "a" is incorrect. Algee's capital account balance would be his cash contribution of $50,000.

Choice "b" is incorrect. Belger's capital account balance would be the fair market value of the property donated ($80,000) less the mortgage assumed with the property ($35,000). The net contribution is $45,000.

Choice "d" is incorrect. The partners' capital account balances equal the fair value of assets contributed less liabilities assumed by the partnership.

**CPA-00868 Type1 M/C A-D Corr Ans: A PM#47 F 2-99**

161. CPA-00868 May 94 #35 Page 41

When property other than cash is invested in a partnership, at what amount should the noncash property be credited to the contributing partner's capital account?

a. Fair value at the date of contribution.
b. Contributing partner's original cost.
c. Assessed valuation for property tax purposes.
d. Contributing partner's tax basis.

**CPA-00868 Explanation**


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Choice "a" is correct. Partners' contributions to the partnership are valued at the fair market value at the date of contribution of the noncash property contributed. Thus, the partner's capital account would be credited for the fair market value of the property at the date of contribution.

Choice "b" is incorrect. The original cost of the noncash property is not relevant to the acquiring entity.

Choice "c" is incorrect. Property tax assessed valuation might be used as a substitute for fair market value if the fair market value is not known or is not readily determinable.

Choice "d" is incorrect. The contributing partner's tax basis of the noncash property is not relevant to the acquiring entity.

**CPA-00869 Type1 M/C A-D Corr Ans: A PM#48 F 2-99**

162. CPA-00869 Nov 94 #36 Page 41

On January 2, 1993, Smith purchased the net assets of Jones' Cleaning, a sole proprietorship, for $350,000, and commenced operations of Spiffy Cleaning, a sole proprietorship. The assets had a carrying amount of $375,000 and a market value of $360,000. In Spiffy's cash-basis financial statements for the year ended December 31, 1993, Spiffy reported revenues in excess of expenses of $60,000. Smith's drawings during 1993 were $20,000. In Spiffy's financial statements, what amount should be reported as Capital-Smith?

a. $390,000
b. $400,000
c. $410,000
d. $415,000

**CPA-00869 Explanation**
Choice "a" is correct, $390,000 Capital-Smith at 12/31/93.

| | |
|---|---|
| Balance at 1/2/93 | $350,000 |
| Revenues in excess of expenses | 60,000 |
| Drawings | (20,000) |
| Balance at 12/31/93 | $390,000 |

**CPA-00870 Type1 M/C A-D Corr Ans: D PM#49 F 2-99**

163. CPA-00870 May 91 II #1 Page 42

Abel and Carr formed a partnership and agreed to divide initial capital equally, even though Abel contributed $100,000 and Carr contributed $84,000 in identifiable assets. Under the bonus approach to adjust the capital accounts, Carr's unidentifiable asset should be debited for:

a. $46,000
b. $16,000
c. $8,000
d. $0

**CPA-00870 Explanation**
Choice "d" is correct, $0 debit to Carr's unidentifiable asset.

| | *Total Assets* | *50% Abel* | *50% Carr* |
|---|---|---|---|
| Initial contributions: | | | |
| Abel - cash | $100,000 | 100,000 | 0 |
| Carr - identifiable assets | 84,000 | 0 | 84,000 |
| Subtotal | 184,000 | 100,000 | 84,000 |
| Bonus from Abel to Carr | 0 | (8,000) | 8,000 |
| Total | $184,000 | 92,000 | 92,000 |


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**Note:** The examiners were trying to be tricky - it is important to reread the question to be sure you answered it.

**CPA-00871 Type1 M/C A-D Corr Ans: D PM#50 F 2-99**

164. CPA-00871 May 92 T #35 Page 42

In the Adel-Brick partnership, Adel and Brick had a capital ratio of 3:1 and a profit and loss ratio of 2:1, respectively. The bonus method was used to record Colter's admittance as a new partner. What ratio would be used to allocate, to Adel and Brick, the excess of Colter's contribution over the amount credited to Colter's capital account?

a. Adel and Brick's new relative capital ratio.
b. Adel and Brick's new relative profit and loss ratio.
c. Adel and Brick's old capital ratio.
d. Adel and Brick's old profit and loss ratio.

**CPA-00871 Explanation**
Choice "d" is correct. Adel and Brick's old profit and loss ratio would be used to allocate the excess of Colter's contribution over the amount credited to Colter's capital account.

Choices "a", "b", and "c" are incorrect. Capital ratios are inappropriate to reflect operating effectiveness of the old partners; thus bonus paid has the same impact as additional net income, and is shared in the old profit and loss ratio.

**CPA-00872 Type1 M/C A-D Corr Ans: D PM#51 F 2-99**

165. CPA-00872 FARE May 93 II #19 Page 42

Kern and Pate are partners with capital balances of $60,000 and $20,000, respectively. Profits and losses are divided in the ratio of 60:40. Kern and Pate decided to form a new partnership with Grant, who invested land valued at $15,000 for a 20% capital interest in the new partnership. Grant's cost of the land was $12,000. The partnership elected to use the bonus method to record the admission of Grant into the partnership. Grant's capital account should be credited for:

a. $12,000
b. $15,000
c. $16,000
d. $19,000

**CPA-00872 Explanation**
Choice "d" is correct. Under the bonus method, Grant's capital account is calculated as follows:

| | |
|---|---|
| Existing capital balances ($60,000 + $20,000) | $ 80,000 |
| Grant's land investment (fair value) | 15,000 |
| New partnership's capital balances | 95,000 |
| Grant's capital interest | × 20% |
| Grant's capital balance | $ 19,000 |

This $4,000 difference between the credit to Grant's capital account and the land's fair value would be debited to Kern and Pate's capital accounts based on their profit and loss sharing ratio.

**CPA-00874 Type1 M/C A-D Corr Ans: D PM#52 F 2-99**

166. CPA-00874 Nov 92 II #48 Page 43

Cor-Eng Partnership was formed on January 2, 1991. Under the partnership agreement, each partner has an equal initial capital balance accounted for under the goodwill method. Partnership net income or loss is allocated 60% to Cor and 40% to Eng. To form the partnership, Cor originally contributed assets costing $30,000 with a fair value of $60,000 on January 2, 1991, while Eng contributed $20,000 in cash.


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Drawings by the partners during 1991 totaled $3,000 by Cor and $9,000 by Eng. Cor-Eng's 1991 net income was $25,000.

Eng's initial capital balance in Cor-Eng is closest to:

a. $20,000
b. $25,000
c. $40,000
d. $60,000

**CPA-00874 Explanation**
Choice "d" is correct, $60,000 = Eng's initial capital balance.

| | *Net assets* | *Cor 60%* | *Eng 40%* |
|---|---|---|---|
| Cor's contribution | 60 | 60 | |
| Eng's contribution | 20 | | 20 |
| | 80 | 60 | 20 |
| Goodwill to Eng | 40 | | 40 |
| Initial capital balances (50/50) | 120 | 60 | 60 |
| Net income (60/40) | 25 | 15 | 10 |
| Draws | (12) | (3) | (9) |
| Ending balance 12/31/91 | 133 | 72 | 61 |

**CPA-00876 Type1 M/C A-D Corr Ans: A PM#53 F 2-99**

167. CPA-00876 Nov 92 II #49 Page 43

Cor-Eng Partnership was formed on January 2, 1991. Under the partnership agreement, each partner has an equal initial capital balance accounted for under the goodwill method. Partnership net income or loss is allocated 60% to Cor and 40% to Eng. To form the partnership, Cor originally contributed assets costing $30,000 with a fair value of $60,000 on January 2, 1991, while Eng contributed $20,000 in cash. Drawings by the partners during 1991 totaled $3,000 by Cor and $9,000 by Eng. Cor-Eng's 1991 net income was $25,000.

Cor's share of Cor-Eng's 1991 net income is:

a. $15,000
b. $12,500
c. $12,000
d. $7,800

**CPA-00876 Explanation**
Choice "a" is correct, $15,000 = Cor's share of 1991 net income.

| | *Net assets* | *Cor 60%* | *Eng 40%* |
|---|---|---|---|
| Cor's contribution | 60 | 60 | |
| Eng's contribution | 20 | | 20 |
| | 80 | 60 | 20 |
| Goodwill to Eng | 40 | | 40 |
| Initial capital balances (50/50) | 120 | 60 | 60 |
| Net income (60/40) | 25 | 15 | 10 |
| Draws | (12) | (3) | (9) |
| Ending balance 12/31/91 | 133 | 72 | 61 |

**CPA-00877 Type1 M/C A-D Corr Ans: B PM#54 F 2-99**

168. CPA-00877 May 91 II #3 Page 45


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The partnership agreement of Reid and Simm provides that interest at 10% per year is to be credited to each partner on the basis of weighted-average capital balances. A summary of Simm's capital account for the year ended December 31, 1990, is as follows:

| | |
|---|---|
| Balance, January 1 | $140,000 |
| Additional investment, July 1 | 40,000 |
| Withdrawal, August 1 | (15,000) |
| Balance, December 31 | 165,000 |

What amount of interest should be credited to Simm's capital account for 1990?

a. $15,250
b. $15,375
c. $16,500
d. $17,250

**CPA-00877 Explanation**
Choice "b" is correct, $15,375 credited to Simm's capital account for 1990.

| | *Capital account activity* | | *Month* | | *Wgt'd avg.* |
|---|---|---|---|---|---|
| Balance, January 1 | $140,000 | × | 6 mos | = | 840,000 |
| Additional investment, July 1 | 40,000 | | | | |
| Subtotal, July 1 | 180,000 | × | 1 mo | = | 180,000 |
| Withdrawal, August 1 | (15,000) | | | | |
| Balance, 8/1 to 12/31 | $165,000 | × | 5 mos | = | 825,000 |
| Total Dollar Months | | | | = | 1,845,000 |
| 1,845,000 | | ÷ | 12 mos | = | 153,750 |
| Interest rate | | | | | × .10 |
| Interest credited to Simm's capital account | 15,375 | | | | |

**CPA-00880 Type1 M/C A-D Corr Ans: B PM#55 F 2-99**

169. CPA-00880 Nov 91 T #15 Page 46

The Flat and Iron partnership agreement provides for Flat to receive a 20% bonus on profits before the bonus. Remaining profits and losses are divided between Flat and Iron in the ratio of 2 to 3, respectively. Which partner has a greater advantage when the partnership has a profit or when it has a loss?

| | *Profit* | *Loss* |
|---|---|---|
| a. | Flat | Iron |
| b. | Flat | Flat |
| c. | Iron | Flat |
| d. | Iron | Iron |

**CPA-00880 Explanation**
Choice "b" is correct, Flat - Flat has a greater advantage when the partnership has a profit or when it has a loss.

| | *Total* | *Flat* | *Iron* |
|---|---|---|---|
| Profit before bonus | 100% | | |
| 20% bonus to Flat | (20) | 20% | 0 |
| Subtotal | 80 | | |
| Balance 2 to 3, respectively | (80) | 32 | 48 |
| | 0 | 52% | 48% |
| Loss before bonus | (100%) | | |
| 20% bonus to Flat | 0 | | 0 |
| Subtotal | (100) | | |


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| | | | |
|---|---|---|---|
| Balance 2 to 3 | 100 | (40%) | (60%) |

**CPA-00881 Type1 M/C A-D Corr Ans: D PM#56 F 2-99**

170. CPA-00881 May 90 T #17 Page 46

Allen retired from the partnership of Allen, Beck and Chale. Allen's cash settlement from the partnership was based on new goodwill determined at the date of retirement plus the carrying amount of the other net assets. As a consequence of the settlement, the capital accounts of Beck and Chale were decreased. In accounting for Allen's withdrawal, the partnership could have used the:

| | *Bonus method* | *Goodwill method* |
|---|---|---|
| a. | No | Yes |
| b. | No | No |
| c. | Yes | Yes |
| d. | Yes | No |

**CPA-00881 Explanation**
Choice "d" is correct, yes - bonus method; no - goodwill method. In accounting for partnership withdrawal, dissolution or admission: The bonus method increases (or decreases) the individual partners accounts without changing total net assets of the partnership. Since the capital accounts of Beck and Chale decreased, goodwill was not recorded as an asset, but instead the bonus paid to Allen was charged against the capital accounts of the remaining partners. The goodwill method increases the individual partners accounts and also changes total net assets of the partnership.

**CPA-04543 Type1 M/C A-D Corr Ans: C PM#57 F 2-99**

171. CPA-04543 FARE R02 #10 Page 68

Green, a calendar-year taxpayer, is preparing a personal statement of financial condition as of April 30, 2001. Green's 2000 income tax liability was paid in full on April 15, 2001. Green's tax on income earned between January and April 2001 is estimated at $20,000. In addition, $40,000 is estimated for income tax on the differences between the estimated current values and current amounts of Green's assets and liabilities and their tax bases at April 30, 2001. No withholdings or payments have been made towards the 2001 income tax liability. In Green's April 30, 2001, statement of financial condition, what amount should be reported, between liabilities and net worth, as estimated income taxes?

a. $0
b. $20,000
c. $40,000
d. $60,000

**CPA-04543 Explanation**
Choice "c" is correct. On a personal statement of financial condition, estimated income taxes equals the difference between fair values and tax bases of assets and liabilities.

**CPA-04544 Type1 M/C A-D Corr Ans: A PM#58 F 2-99**

172. CPA-04544 FARE May 94 #53 Page 67

For the purpose of estimating income taxes to be reported in personal financial statements, assets and liabilities measured at their tax bases should be compared to assets and liabilities measured at their:

| | *Assets* | *Liabilities* |
|---|---|---|
| a. | Estimated current value | Estimated current amount |
| b. | Historical cost | Historical cost |
| c. | Estimated current value | Historical cost |
| d. | Historical cost amount | Estimated current |

**CPA-04544 Explanation**


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Choice "a" is correct. On personal financial statements, all items are reported at their fair market values (estimated current values).

**CPA-04545 Type1 M/C A-D Corr Ans: C PM#59 F 2-99**

173. CPA-04545 FARE May 95 #55 Page 67

Personal financial statements usually consist of:

a. A statement of net worth and a statement of changes in net worth.
b. A statement of net worth, an income statement, and a statement of changes in net worth.
c. A statement of financial condition and a statement of changes in net worth.
d. A statement of financial condition, a statement of changes in net worth, and a statement of cash flows.

**CPA-04545 Explanation**
Choice "c" is correct. Personal financial statements usually include a statement of financial condition (similar to a balance sheet) and a statement of changes in net worth (similar to an income statement).

**CPA-04546 Type1 M/C A-D Corr Ans: D PM#60 F 2-99**

174. CPA-04546 FARE Nov 95 #54 Page 68

A business interest that constitutes a large part of an individual's total assets should be presented in a personal statement of financial condition as:

a. A separate listing of the individual assets and liabilities at cost.
b. Separate line items of both total assets and total liabilities at cost.
c. A single amount equal to the proprietorship equity.
d. A single amount equal to the estimated current value of the business interest.

**CPA-04546 Explanation**
Choice "d" is correct. A business interest that constitutes a large part of an individual's total assets should be presented in a personal statement of financial condition as a single amount equal to the estimated current value of the business interest.

Choices "a", "b", and "c" are incorrect. Net assets are presented at FMV rather than:

A. Individual assets and liabilities at cost
B. Total assets and liabilities at cost
C. Proprietorship equity at cost

**CPA-04547 Type1 M/C A-D Corr Ans: D PM#61 F 2-99**

175. CPA-04547 FARE Nov 95 #55 Page 67

Quinn is preparing a personal statement of financial condition as of April 30, 1995. Included in Quinn's assets are the following:

- 50% of the voting stock of Ink Corp. A stockholders' agreement restricts the sale of the stock and, under certain circumstances, requires Ink to repurchase the stock. Quinn's tax basis for the stock is $430,000, and at April 30, 1995, the buyout value is $675,000.
- Jewelry with a fair value aggregating $70,000 based on an independent appraisal on April 30, 1995, for insurance purposes. This jewelry was acquired by purchase and gift over a 10-year period and has a total tax basis of $40,000.

What is the total amount at which the Ink stock and jewelry should be reported in Quinn's April 30, 1995, personal statement of financial condition?

a. $470,000
b. $500,000


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c. $715,000
d. $745,000

**CPA-04547 Explanation**
Choice "d" is correct, $745,000 total amount at which stock and jewelry should be reported.

**Rule:** Assets are reported at estimated fair value.

| | |
|---|---|
| Ink stock at buyout value (fair value) | $675,000 |
| Jewelry at fair value | 70,000 |
| Total | $745,000 |

**Note** - Any tax liability due upon the sale of appreciated property would be disclosed separately as a "deferred tax liability" and not "netted" against the estimated fair value of the asset.

**CPA-04548 Type1 M/C A-D Corr Ans: B PM#62 F 2-99**

176. CPA-04548 Th Nov 93 #44 Page 67

Personal financial statements should report assets and liabilities at:

a. Estimated current values at the date of the financial statements and, as additional information, at historical cost.
b. Estimated current values at the date of the financial statements.
c. Historical cost and, as additional information, at estimated current values at the date of the financial statements.
d. Historical cost.

**CPA-04548 Explanation**
Choice "b" is correct, personal financial statements should report assets and liabilities at estimated current values at the date of the financial statements.

Choices "a", "c", and "d" are incorrect. Historical costs are not used or additionally disclosed.

**CPA-01578 Type1 M/C A-D Corr Ans: D PM#63 F 2-99**

177. CPA-01578 May 90 #3 Page 49

During a period of inflation, the specific price of a parcel of land increased at a lower rate than the consumer price index. The accounting method that would measure the land at the highest amount is:

a. Historical cost/nominal dollar.
b. Current cost/nominal dollar.
c. Current cost/constant dollar.
d. Historical cost/constant dollar.

**CPA-01578 Explanation**
Choice "d" is correct. "Historical cost/constant dollar."

Accounting is based on historical cost which is then adjusted for inflation using the consumer price index. Since the CPI increased at a rate higher than the specific price of the land, it would result in the highest amount.

Choice "a" is incorrect. "Historical cost/nominal dollar" accounting uses the original cost which would include no increase in value.

Choices "b" and "c" are incorrect. These methods are based on "current cost" which in this example increased at a rate lower than the consumer price index.

**CPA-01580 Type1 M/C A-D Corr Ans: A PM#64 F 2-99**


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178. CPA-01580 May 91 #2 Page 49

Could current cost financial statements report holding gains for goods sold during the period and holding gains on inventory at the end of the period?

| | *Goods sold* | *Inventory* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |

**CPA-01580 Explanation**
Choice "a" is correct. Yes - Yes. Current cost financial statements report holding gains for goods sold during the period and holding gains on inventory at the end of the period. They also include holding gains and losses on all other accounts in the financial statements.

**CPA-01584 Type1 M/C A-D Corr Ans: D PM#65 F 2-99**

179. CPA-01584 May 92 II #13 Page 49

The following information pertains to each unit of merchandise purchased for resale by Vend Co.:

| *March 1, 1991* | |
|---|---|
| Purchase price | $ 8 |
| Selling price | $ 12 |
| Price level index | 110 |

| *December 31, 1991* | |
|---|---|
| Replacement cost | $ 10 |
| Selling price | $ 15 |
| Price level index | 121 |

Under current cost accounting, what is the amount of Vend's holding gain on each unit of this merchandise?

a. $0
b. $0.80
c. $1.20
d. $2.00

**CPA-01584 Explanation**
Choice "d" is correct. $2.00 holding gain on each unit of merchandise inventory.

**Rule:** Under "current cost" accounting, holding gain on inventory is the excess of replacement cost at the balance sheet date over the original purchase price.

Note 1: Price level index is used for the "historic cost/constant dollar" method - not the "current cost" method.

Note 2: Selling prices are not a component of "holding gains."

| | | | | |
|---|---|---|---|---|
| Excess of: | Replacement cost | 12/31/91 | $10.00 | |
| Over: | Purchase price | 3/1/91 | 8.00 | |
| Equals: | Holding gain on inventory | | $ 2.00 | **D** |

**CPA-01586 Type1 M/C A-D Corr Ans: C PM#66 F 2-99**

180. CPA-01586 May 92 #4 Page 49

In a period of rising general price levels, Pollard Corp. discloses income on a current cost basis in accordance with FASB Statement #89, *Financial Reporting and Changing Prices.*


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Compared to historical cost income from continuing operations, which of the following conditions increases Pollard's current cost income from continuing operations?

a. Current cost of equipment is greater than historical cost.
b. Current cost of land is greater than historical cost.
c. Current cost of cost of goods sold is less than historical cost.
d. Ending net monetary assets are less than beginning net monetary assets.

**CPA-01586 Explanation**
Choice "c" is correct. "Current cost" of cost of goods sold is less than "historical cost." As such, "current cost" income from continuing operations would be higher than "historical cost" income from continuing operations.

Choices "a" and "b" are incorrect. Changes in current cost of non-monetary assets such as equipment and land are not included in "current cost" income from continuing operations, but instead are classified as "holding gains or losses" in the current cost statements.

Choice "d" is incorrect. A reduction in net monetary assets would not result in an increase in current cost income.

**CPA-01588 Type1 M/C A-D Corr Ans: A PM#67 F 2-99**

181. CPA-01588 May 92 #5 Page 49

In a period of rising general price levels, Pollard Corp. discloses income on a current cost basis in accordance with FASB Statement #89, *Financial Reporting and Changing Prices.*

Which of the following contributes to Pollard's purchasing power loss on net monetary items?

a. Refundable deposits with suppliers.
b. Equity investment in unconsolidated subsidiaries.
c. Warranty obligations.
d. Wages payable.

**CPA-01588 Explanation**
Choice "a" is correct. Refundable deposits with suppliers (monetary asset) contribute to purchasing power loss in a period of rising general price levels.

**Rule:** Holding net monetary assets during inflation will result in a loss of purchasing power. Conversely, holding net monetary liabilities will result in a gain.

Choice "b" is incorrect. Equity investment in unconsolidated subsidiaries is nonmonetary.

Choice "c" is incorrect. Warranty obligations are non-monetary.

Choice "d" is incorrect. Wages payable (monetary liability) contribute to a gain in purchasing power.

**CPA-01589 Type1 M/C A-D Corr Ans: A PM#68 F 2-99**

182. CPA-01589 May 94 #58 Page 49

In its financial statements, Hila Co. discloses supplemental information on the effects of changing prices in accordance with Statement of Financial Accounting Standards #89, *Financial Reporting and Changing Prices.* Hila computed the increase in current cost of inventory as follows:

| | |
|---|---|
| Increase in current cost (nominal dollars) | $15,000 |
| Increase in current cost (constant dollars) | $12,000 |

What amount should Hila disclose as the inflation component of the increase in current cost of inventories?

a. $3,000
b. $12,000


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c. $15,000
d. $27,000

**CPA-01589 Explanation**
Choice "a" is correct. $3,000.

Increase in current cost of inventory:

| | |
|---|---|
| Based on (today's) nominal dollars | $15,000 |
| Based on (last year's) constant dollars | 12,000 |
| Inflation component of increase in inventory | $ 3,000 |

Choices "b", "c", and "d" are incorrect, per above explanation.

**CPA-01590 Type1 M/C A-D Corr Ans: C PM#69 F 2-99**

183. CPA-01590 Nov 94 #4 Page 49

A company that wishes to disclose information about the effect of changing prices in accordance with Statement of Financial Accounting Standards #89, *Financial Accounting and Changing Prices,* should report this information in:

a. The body of the financial statements.
b. The notes to the financial statements.
c. Supplementary information to the financial statements.
d. Management's report to shareholders.

**CPA-01590 Explanation**
**Rule:** FAS 89, financial accounting and changing prices "encourages" (but does not "require") supplemental information on the effects of changing prices. This information, if presented, is to be included in "supplementary information" to the financial statements.

Choice "c" is correct. A company that wishes to disclose information about the effect of changing prices in accordance with FAS 89, should report this information in supplementary information to the financial statements.

Choices "a" and "b" are incorrect. As information on changing prices is not to be included in the body of the financial statements or notes to the financial statements.

Choice "d" is incorrect. Management's report to the shareholders can discuss the impact of changing prices, but FAS 89 encourages the reporting of this information in supplementary information to the F/S.

**CPA-01591 Type1 M/C A-D Corr Ans: A PM#70 F 2-99**

184. CPA-01591 May 90 I #52 Page 60

Fay Corp. had a realized foreign exchange loss of $15,000 for the year ended December 31, 1989 and must also determine whether the following items will require year-end adjustment:

- Fay had an $8,000 loss resulting from the translation of the accounts of its wholly owned foreign subsidiary for the year ended December 31, 1989.
- Fay had an account payable to an unrelated foreign supplier payable in the supplier's local currency. The U.S. dollar equivalent of the payable was $64,000 on the October 31, 1989 invoice date, and it was $60,000 on December 31, 1989. The invoice is payable on January 30, 1990.

In Fay's 1989 consolidated income statement, what amount should be included as foreign exchange loss?

a. $11,000
b. $15,000
c. $19,000
d. $23,000


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**CPA-01591 Explanation**
Choice "a" is correct. $11,000 foreign exchange loss.

| | | |
|---|---|---|
| Foreign exchange loss before adjustment | | $15,000 |
| Account payable: | | |
| U.S. Equivalent at invoice date | $64,000 | |
| U.S. Equivalent at payment date | 60,000 | |
| Payable exchange gain | | 4,000 |
| Foreign exchange loss included in consolidated income statement | | $11,000 **A** |

Choice "b" is incorrect. The $4,000 gain on the invoice transaction must be included.

Choice "c" is incorrect. The $8,000 translation loss from its wholly owned foreign subsidiary is not included in net income as it does not impact cash flows. It would be included in other comprehensive income in shareholders' equity.

Choice "d" is incorrect, per explanation above.

**CPA-01592 Type1 M/C A-D Corr Ans: D PM#71 F 2-99**

185. CPA-01592 Nov 90 I #43 Page 60

Ball Corp. had the following foreign currency transactions during 1989:

- Merchandise was purchased from a foreign supplier on January 20, 1989 for the U.S. dollar equivalent of $90,000. The invoice was paid on March 20, 1989 at the U.S. dollar equivalent of $96,000.
- On July 1, 1989, Ball borrowed the U.S. dollar equivalent of $500,000 evidenced by a note that was payable in the lender's local currency on July 1,1991. On December 31, 1989, the U.S. dollar equivalents of the principal amount and accrued interest were $520,000 and $26,000, respectively. Interest on the note is 10% per annum.

In Ball's 1989 income statement, what amount should be included as foreign exchange loss?

a. $0
b. $6,000
c. $21,000
d. $27,000

**CPA-01592 Explanation**
Choice "d" is correct. $27,000 foreign exchange loss.

| | | Foreign exchange gain or loss |
|---|---|---|
| Merchandise purchased from a foreign supplier on 1/20/89 for $90,000 was paid on 3/20/89 with $96,000 | | $ 6,000 Loss |
| Loan made on 7/1/89 for $500,000 payable on 7/1/91: | | |
| Principal U.S. $ equivalent 7/1/89 | $500,000 | |
| Principal U.S. $ equivalent 12/31/89 | $520,000 | |
| Foreign exchange loss on principal | | $20,000 Loss |
| Accrued interest for six months | | |
| U.S. $ equivalent 7/1/89 ($500,000 × 10% × 1/2 year) | $ 25,000 | |
| U.S. $ equivalent 12/31/89 | $ 26,000 | |
| Foreign exchange loss | | $ 1,000 Loss |
| Total foreign exchange loss for 1989 | | $27,000 Loss |

**CPA-01593 Type1 M/C A-D Corr Ans: D PM#72 F 2-99**


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186. CPA-01593 Nov 90 #39 Page 56

Gains from remeasuring a foreign subsidiary's financial statements from the local currency, which is not the functional currency, into the parent company's currency should be reported:

a. As a deferred foreign exchange gain.
b. As a component of other comprehensive income.
c. As an extraordinary item, net of income taxes.
d. As part of continuing operations.

**CPA-01593 Explanation**
Choice "d" is correct. Part of continuing operations.

**Rule:** If an entity's books are not maintained in its functional currency, remeasurement into the functional currency prior to the translation process is required. Any gains or losses are included in determining net income and are classified as part of continuing operations.

**CPA-01594 Type1 M/C A-D Corr Ans: B PM#73 F 2-99**

187. CPA-01594 Nov 91 #18 Page 60

Shore Co. records its transactions in U.S. dollars. A sale of goods resulted in a receivable denominated in Japanese yen, and a purchase of goods resulted in a payable denominated in French francs. Shore recorded a foreign exchange gain on collection of the receivable and an exchange loss on settlement of the payable. The exchange rates are expressed as so many units of foreign currency to one dollar. Did the number of foreign currency units exchangeable for a dollar increase or decrease between the contract and settlement dates?

| | *Yen exchangeable for $1* | *Francs exchangeable for $1* |
|---|---|---|
| a. | Increase | Increase |
| b. | Decrease | Decrease |
| c. | Decrease | Increase |
| d. | Increase | Decrease |

**CPA-01594 Explanation**
Choice "b" is correct. Decrease - Decrease.

Approach: Set up assumed values for transactions and test for appropriate gain or loss.

**Receivable**
Denominated in yen. Assume transaction is for 1000 yen. On settlement date, there is a foreign exchange gain on the receipt of 1000 yen. In order for there to be a gain, the 1000 yen must be worth more dollars than on the transaction date. Therefore fewer yen must be equal to a dollar (for there to be more dollars), so the number of yen exchangeable into dollars decreased.

**Payable**
Denominated in francs. Assume transaction is for 2000 francs on settlement date, there is a foreign exchange loss on the payment of 2000 francs. For there to be a loss, it must take more dollars to buy the same francs. Therefore, the number of francs exchangeable into dollars must have decreased.

**CPA-01598 Type1 M/C A-D Corr Ans: B PM#74 F 2-99**

188. CPA-01598 Nov 92 I #50 Page 59

On December 12, 1991, Imp entered into three forward exchange contracts, each to purchase 100,000 francs in 90 days. The relevant exchange rates are as follows:

| Spot rate | Forward rate (for March 12, 1991) |
|---|---|


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| | | |
|---|---|---|
| December 12, 1991 | $.88 | $.90 |
| December 31, 1991 | .98 | .93 |

Imp entered into the third forward contract for speculation. At December 31, 1991, what amount of foreign currency transaction gain should Imp include in income from this forward contract?

a. $0
b. $3,000
c. $5,000
d. $10,000

**CPA-01598 Explanation**
**Rule:** A gain or loss from a forward exchange contract for speculation (e.g., does not relate to a specific transaction) is equal to the difference in the forward rate at the date the contract is purchased and the forward rate at the BS date.

| | Per Unit | 10,000 Francs | |
|---|---|---|---|
| 3/12/92 future rate on 12/12/91 | $.90 | $90,000 | |
| 3/12/92 future rate on 12/31/91 | $.93 | $93,000 | |
| Gain recognized in 1991 | $.03 | $ 3,000 | **B** |

Choice "b" is correct. $3,000 gain.

**CPA-00622 Type1 M/C A-D Corr Ans: A PM#75 F 2-99**

189. CPA-00622 PII May 90 #46 Page 5

Doren Co.'s officers' compensation expense account had a balance of $490,000 at December 31, 1989 before any appropriate year-end adjustment relating to the following:

- No salary accrual was made for the week of December 25-31, 1989. Officers' salaries for this period totaled $18,000 and were paid on January 5, 1990.
- Bonuses to officers for 1989 were paid on January 31, 1990 in the total amount of $175,000.

The adjusted balance for officers' compensation expense for the year ended December 31, 1989 should be:

a. $683,000
b. $665,000
c. $508,000
d. $490,000

**CPA-00622 Explanation**
Choice "a" is correct. $683,000 compensation expense for year ended Dec. 31, 1989.

| | |
|---|---|
| Compensation exp balance before year-end adjustments | $490,000 |
| Add: Salary accrual for week of Dec. 25-31, 1989 **not** paid until Jan. 5, 1990 | 18,000 |
| Add: 1989 officers' bonuses **not** paid until Jan. 31, 1990 | 175,000 |
| Compensation exp after year-end adjustments | $683,000 |

**CPA-01597 Type1 M/C A-D Corr Ans: B PM#76 F 2-99**

190. CPA-01597 Nov 92 I #49 Page 59

On December 12, 1991, Imp entered into three forward exchange contracts, each to purchase 100,000 francs in 90 days. The relevant exchange rates are as follows:

| | Spot rate | Forward rate (for March 12, 1991) |
|---|---|---|
| December 12, 1991 | $.88 | $.90 |
| December 31, 1991 | .98 | .93 |


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Imp entered into the second forward contract to hedge a commitment to purchase equipment being manufactured to Imp's specifications. At December 31, 1991, what amount of foreign currency transaction gain should Imp include in income from this forward contract?

a. $0
b. $3,000
c. $5,000
d. $10,000

**CPA-01597 Explanation**
**Rule:** FAS 133 requires that gains or losses on hedges of firm commitment's for a future purchase (or sale) be recognized in current income. In addition, the firm commitment must be adjusted to fair value with the resulting gain or loss recognized in current income. The difference between the gain or loss on the hedge contract and the gain or loss on the firm commitment is the net effect on current income.

100,000 francs x (.93 – .90) = $3,000.

Choice "b" is correct. $3,000 gain at 12/31/91.

**CPA-00686 Type1 M/C A-D Corr Ans: C PM#77 F 2-99**

191. CPA-00686 Th May 90 #19 Page 30

A company used the percentage-of-completion method of accounting for a four-year construction contract. Which of the following items would be used to calculate the income recognized in the second year?

| | *Income previously recognized* | *Progress billings to date* |
|---|---|---|
| a. | Yes | Yes |
| b. | No | Yes |
| c. | Yes | No |
| d. | No | No |

**CPA-00686 Explanation**
Choice "c" is correct. Yes - No.

When a company uses the **"percentage-of-completion"** method of accounting for a four-year construction contract, **income previously recognized** would be used to calculate the income recognized in the second year (but not progress billings to date).

| **Illustration per class exercise** | **Year 2** |
|---|---|
| Total contract sales price | $4,000 |
| Less total est cost of contract | 3,200 |
| Total gross profit | 800 |
| × % of completion | × 75% |
| Gross profit earned to date (cumulative) | 600 |
| Less **income previously recognized** | (500) |
| Income recognized in current year | 100 |

**CPA-00246 Type1 M/C A-D Corr Ans: B PM#77 F 2-99**

192. CPA-00246 Nov 94 #19 Page 38

On July 1, 1993, Ran County issued realty tax assessments for its fiscal year ended June 30, 1994. On September 1, 1993, Day Co. purchased a warehouse in Ran County. The purchase price was reduced by a credit for accrued realty taxes. Day did not record the entire year's real estate tax obligation, but instead records tax expenses at the end of each month by adjusting prepaid real estate taxes or real estate taxes payable, as appropriate. On November 1, 1993, Day paid the first of two equal installments


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of $12,000 for realty taxes. What amount of this payment should Day record as a debit to real estate taxes payable?

a. $4,000
b. $8,000
c. $10,000
d. $12,000

**CPA-00246 Explanation**

| Key: DR (CR) | | Real estate taxes payable | Prepaid R/E taxes |
|---|---|---|---|
| 9/1/93 | Real estate closing statement credit (July & Aug = 2/12 × 24,000) | (4,000) | |
| 9/30/93 | Accrue Sept. (1/12 × 24,000) | (2,000) | |
| 10/30/93 | Accrue Oct. (1/12 × 24,000) | (2,000) | |
| | Subtotal | (8,000) | |
| 11/1/93 | Payment of $12,000 debited to | 8,000 | 4,000 |
| | Balance | 0 | 4,000 |

Choice "b" is correct. $8,000 debit to real estate taxes payable, and $4,000 debit to prepaid real estate taxes, as of Dec 31, 1993.


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# CPA PassMaster Questions–Financial 3
# Export Date: 10/30/08


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**Marketable Securities**

**CPA-00263 Type1 M/C A-D Corr Ans: B PM#1 F 3-01**

1. CPA-00263 FARE R96 #6 Page 3

When the fair value of an investment in debt securities exceeds its amortized cost, how should each of the following debt securities be reported at the end of the year?

| | *Debt securities classified as* | |
|---|---|---|
| | *Held-to-maturity* | *Available-for-sale* |
| a. | Amortized cost | Amortized cost |
| b. | Amortized cost | Fair value |
| c. | Fair value | Fair value |
| d. | Fair value | Amortized cost |

**CPA-00263 Explanation**
Choice "b" is correct. According to SFAS 115, debt securities (bonds) classified as held-to-maturity are reported at amortized cost (that is, cost adjusted for amortization of premium or discount; approaches face value). Debt securities classified as available-for-sale are reported at fair value. Note that SFAS 130 changes the treatment of unrealized holding gains and losses from available-for-sale securities. Such gain/loss is excluded from earnings (per SFAS 115), however, per SFAS 130, it is reported as a component of accumulated other comprehensive income.

Choice "a" is incorrect. While amortized cost is the appropriate treatment for debt securities classified as held-to-maturity, this is not the correct treatment for securities classified as available-for-sale.

Choice "c" is incorrect. Fair value is not the appropriate treatment for debt securities classified as held-to-maturity.

Choice "d" is incorrect. Fair value is not the appropriate treatment for debt securities classified as held-to-maturity. Nor is amortized cost the appropriate treatment for debt securities classified as available-for-sale.

**CPA-00266 Type1 M/C A-D Corr Ans: B PM#3 F 3-01**

2. CPA-00266 FARE Nov 94 #10 Page 3

Kale Co. has adopted Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities.* Kale purchased bonds at a discount on the open market as an investment and intends to hold these bonds to maturity. Kale should account for these bonds at:

a. Cost.
b. Amortized cost.
c. Fair value.
d. Lower of cost or market.

**CPA-00266 Explanation**
Choice "b" is correct. Bond investments which are intended to be held until the maturity date are classified as held-to-maturity securities and are reported at their amortized cost.

Choice "a" is incorrect. Investments in marketable securities are reported at fair value or at their amortized cost, depending on their classification.

Choice "c" is incorrect. Trading securities and available-for-sale securities are reported at their fair value.

Choice "d" is incorrect. The lower of cost or market method has been superseded by the methods specified in SFAS 115.

**CPA-00267 Type1 M/C A-D Corr Ans: B PM#4 F 3-01**

3. CPA-00267 FARE May 94 #14 Page 3


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Nola Co. has adopted Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities.* Nola has a portfolio of marketable equity securities which it does not intend to sell in the near term. How should Nola classify these securities, and how should it report unrealized gains and losses from these securities?

| | *Classify as* | *Report as a* |
|---|---|---|
| a. | Trading securities | Component of income from continuing operations |
| b. | Available-for-sale securities | Component of other comprehensive income |
| c. | Trading securities | Component of other comprehensive income |
| d. | Available-for-sale securities | Component of income from continuing operations |

**CPA-00267 Explanation**
Choice "b" is correct. Investments in marketable equity securities which the company does not intend to sell in the near term should be classified as available-for-sale. Unrealized gains and losses on available-for-sale securities should be reported as a separate component of other comprehensive income.

**CPA-00268 Type1 M/C A-D Corr Ans: A PM#5 F 3-01**

4. CPA-00268 PI Nov 93 #2 (Adapted) Page 3

The following data pertains to Tyne Co.'s investments in marketable equity securities:

| | | *Market value* | |
|---|---|---|---|
| | *Cost* | *12/31/X2* | *12/31/X1* |
| Trading | $150,000 | $155,000 | $100,000 |
| Available-for-sale | 150,000 | 130,000 | 120,000 |

What amount should Tyne report as unrealized gain (loss) in its 20X2 income statement?

a. $55,000
b. $50,000
c. $60,000
d. $65,000

**CPA-00268 Explanation**
Choice "a" is correct, $55,000 unrealized holding gain on trading securities reported in 1995 income statement:

| *Trading Portfolio* | *Fair Value* |
|---|---|
| 12/31/X2 | $155,000 |
| 12/31/X1 | (100,000) |
| Unrealized gain, reflected in income | $ 55,000 |

**Rule:** Unrealized gains and losses are reported as follows: trading securities-reported at fair value with unrealized gains and losses included in earnings (along with "realized" gains and losses, if any).

Available-for-sale securities-reported at fair value with unrealized gains and losses reported as a separate component of other comprehensive income until realized.

**CPA-00270 Type1 M/C A-D Corr Ans: D PM#6 F 3-01**

5. CPA-00270 PI Nov 93 #3 (Adapted) Page 3

The following data pertains to Tyne Co.'s investments in marketable equity securities:

| | *Market value* | |
|---|---|---|
| *Cost* | *12/31/X2* | *12/31/X1* |


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| | | | |
|---|---|---|---|
| Trading | $150,000 | $155,000 | $100,000 |
| Available-for-sale | 150,000 | 130,000 | 120,000 |

What amount should Tyne report as net unrealized loss on available-for-sale marketable equity securities at December 31, 20X2, in accumulated other comprehensive income on the balance sheet?

a. $0
b. $10,000
c. $15,000
d. $20,000

**CPA-00270 Explanation**
Choice "d" is correct, $20,000 net unrealized loss on available-for-sale securities reported as a separate component of other comprehensive income on the statement of comprehensive income and as a separate component of accumulated other comprehensive income on the balance sheet:

| *Available-for-Sale Portfolio* | |
|---|---|
| Cost | $150,000 |
| 12/31/X2 fair value | (130,000) |
| Net unrealized loss at 12/31/X2 | $ 20,000 |

**CPA-00272 Type1 M/C A-D Corr Ans: C PM#7 F 3-01**

6. CPA-00272 Th Nov 93 #7 (Adapted) Page 5

On January 10, 20X2, Box, Inc. purchased marketable equity securities of Knox, Inc. and Scot, Inc. Box classified both securities as available-for-sale assets over which it could not exercise significant influence. At December 31, 20X2, the cost of each investment was greater than its fair market value. The loss on the Knox investment was considered permanent and that on Scot was considered temporary. How should Box report the effects of these investing activities in its 20X2 income statement?

I. Excess of cost of Knox stock over its market value.
II. Excess of cost of Scot stock over its market value.

a. An unrealized loss equal to I plus II.
b. An unrealized loss equal to I only.
c. A realized loss equal to I only.
d. No income statement effect.

**CPA-00272 Explanation**
**Rule:** "Available-for-sale equity" securities are carried at fair value. Permanent impairment in value results in a writedown and a charge to income as if the loss was realized.

Choice "c" is correct, record a realized loss on the Knox stock because the loss is considered permanent.

Choices "a" and "b" are incorrect. The loss on Knox is permanent and therefore a realized loss. The loss on Scot is not permanent and should not be reported on the income statement.

Choice "d" is incorrect. Realized losses are reflected in current year income.

**CPA-00275 Type1 M/C A-D Corr Ans: C PM#9 F 3-01**

7. CPA-00275 PI Nov 93 #13 (Adapted) Page 3

On July 2, 19X2, Wynn, Inc., purchased as an available-for-sale security a $1,000,000 face value Kean Co. 8% bond for $910,000 plus accrued interest to yield 10%. The bonds mature on January 1, 19X9, and pay interest annually on January 1. On December 31, 19X2, the bonds had a market value of $945,000. On February 13, 19X3, Wynn sold the bonds for $920,000. In its December 31, 19X2, balance sheet, what amount should Wynn report for available-for-sale investments in debt securities?

a. $910,000
b. $920,000


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c. $945,000
d. $950,000

**CPA-00275 Explanation**
Choice "c" is correct. The security would be recorded at fair value on July 2, 19X2, or $910,000. Accrued interest is a receivable and does not affect cost. The $90,000 discount is not amortized on short-term investments. On December 31, 19X2, the investment would be adjusted to fair value, $945,000. The unrealized holding gain of $35,000 would be reported as a separate component of other comprehensive income. SFAS 115 para. 12,13 as amended by SFAS 130 para. 33

Choice "a" is incorrect. The investment would be recorded at cost on July 2, 19X2 or $910,000. However, the investment would reflect fair value as of December 31, 19X2.

Choice "b" is incorrect. $920,000 reflects the fair value of the investment on the date it was sold, not 12/31/X2. The investment is short-term.

Choice "d" is incorrect. The accrued interest of $40,000 at 12/31/X2 would be recorded as interest receivable, not as part of the investment account.

**CPA-00277 Type1 M/C A-D Corr Ans: A PM#10 F 3-01**

8. CPA-00277 PI May 93 #3 (Adapted) Page 5

Sun Corp. had investments in marketable equity securities costing $650,000. On June 30, 20X2, Sun decided to hold the investments indefinitely and accordingly reclassified them from trading to available-for-sale on that date. The investments' market value was $575,000 at December 31, 20X1, $530,000 at June 30, 20X2, and $490,000 at December 31, 20X2.

What amount of loss from investments should Sun report in its 20X2 income statement?

a. $45,000
b. $85,000
c. $120,000
d. $160,000

**CPA-00277 Explanation**
Choice "a" is correct, $45,000 loss should be reported in the 20X2 income statement.

**Rule:** When marketable equity securities are transferred between trading and available-for-sale, the transfer is made at fair value, and the difference (if any) is recorded as unrealized loss and charged to the income statement. The new carrying amount becomes the basis for any future gain or loss.

| | |
|---|---|
| Original cost | $650,000 |
| Unrealized I/S loss for 20X1 | (75,000) |
| FMV at 12/31/X1 | 575,000 |
| FMV at 6/30/X2 | (530,000) |
| Unrealized loss in 2002 I/S | $ 45,000 |

**CPA-00279 Type1 M/C A-D Corr Ans: A PM#11 F 3-01**

9. CPA-00279 PI May 93 #4 (Adapted) Page 5

Sun Corp. had investments in marketable equity securities costing $650,000. On June 30, 20X2, Sun decided to hold the investments indefinitely and accordingly reclassified them from trading to available-for-sale on that date. The investments' market value was $575,000 at December 31, 20X1, $530,000 at June 30, 20X2, and $490,000 at December 31, 20X2.

What amount should Sun report as net unrealized loss on available-for-sale marketable equity securities in its 20X2 statement of stockholders' equity?

a. $40,000
b. $45,000


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c. $85,000
d. $160,000

**CPA-00279 Explanation**
Choice "a" is correct, $40,000 "net unrealized loss on available-for-sale marketable equity securities" in the 20X2 statement of stockholders' equity.

**Rule:** Available-for-sale marketable equity securities are recorded at the fair value, and any temporary difference is reported as "net unrealized loss on available-for-sale marketable equity securities" in the statement of stockholders' equity.

| | |
|---|---|
| Carrying amount 6/30/X2 | $530,000 |
| FMV December 31, 20X2 | (490,000) |
| Net unrealized loss at 12/31/X2 | $ 40,000 |

**CPA-00281 Type1 M/C A-D Corr Ans: C PM#12 F 3-01**

10. CPA-00281Th May 93 #22 (Adapted) Page 3

When the market value of an investment in debt securities in which the company has a positive intent and ability to hold to maturity exceeds its carrying amount, how should each of the following assets be reported at the end of the year?

| | *Long-term marketable debt securities* | *Short-term marketable debt securities* |
|---|---|---|
| a. | Market value | Carrying amount |
| b. | Carrying amount | Market value |
| c. | Carrying amount | Carrying amount |
| d. | Market value | Market value |

**CPA-00281 Explanation**
Choice "c" is correct, carrying amount, carrying amount.

Marketable debt securities that the company has the intent and ability to hold to maturity, both "long" and "short" term, are reported at carrying amount (amortized cost) unless there is a permanent decline in market value.

**CPA-00282 Type1 M/C A-D Corr Ans: B PM#13 F 3-01**

11. CPA-00282Th May 93 #23 (Adapted) Page 5

On both December 31, 19X1, and December 31, 19X2, Kopp Co.'s only marketable equity security had the same market value, which was below cost. Kopp considered the decline in value to be temporary in 19X1 but other than temporary in 19X2. At the end of both years the security was classified as an available-for-sale asset. Kopp could not exercise significant influence over the investee. What should be the effects of the determination that the decline was other than temporary on Kopp's 19X2 net available-for-sale assets and net income?

a. No effect on both net available-for-sale assets and net income.
b. No effect on net available-for-sale assets and decrease in net income.
c. Decrease in net available-for-sale assets and no effect on net income.
d. Decrease in both net available-for-sale assets and net income.

**CPA-00282 Explanation**
Choice "b" is correct. In 19X1, the security would be written down to fair value. The unrealized holding loss would be reported in other comprehensive income. In 19X2, the unrealized holding loss would be removed from accumulated other comprehensive income and recognized in earnings as a realized loss since the decline is classified as other than temporary in 19X2. This 19X2 entry has no effect on


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available-for-sale assets and decreases net income by the amount of the realized loss. SFAS 115 para 13, 16, SFAS 130

Choice "a" is incorrect. In 19X2, the unrealized holding loss would be removed from accumulated other comprehensive income and recognized in earnings as a realized loss.

Choice "c" is incorrect. In 19X1, the security would be written down to fair value. The unrealized holding loss would be reported in other comprehensive income. In 19X2, the unrealized loss would be removed from accumulated other comprehensive income and recognized in earnings as a realized loss.

Choice "d" is incorrect. In 19X1, the security would be written down to fair value.

**CPA-04659 Type1 M/C A-D Corr Ans: D PM#14 F 3-01**

12. CPA-04659 Released 2005 Page 3

At year-end, Rim Co. held several investments with the intent of selling them in the near term. The investments consisted of $100,000, 8%, five-year bonds, purchased for $92,000, and equity securities purchased for $35,000. At year-end, the bonds were selling on the open market for $105,000 and the equity securities had a market value of $50,000. What amount should Rim report as trading securities in its year-end balance sheet?

a. $50,000
b. $127,000
c. $142,000
d. $155,000

**CPA-04659 Explanation**
Choice "d" is correct. Trading securities, both debt and equity, are to be reported at fair value at the end of the current reporting period.

| | |
|---|---|
| Bonds FMV at year end | $105,000 |
| Equities FMV at year end | 50,000 |
| Total reportable amount | $155,000 |

**CPA-05419 Type1 M/C A-D Corr Ans: B PM#25 F 3-01**

13. CPA-05419 Released 2007 Page 4

At the end of year 1, Lane Co. held trading securities that cost $86,000 and which had a year-end market value of $92,000. During year 2, all of these securities were sold for $104,500. At the end of year 2, Lane had acquired additional trading securities that cost $73,000 and which had a year-end market value of $71,000. What is the impact of these stock activities on Lane's year 2 income statement?

a. Loss of $2,000.
b. Gain of $10,500.
c. Gain of $16,500.
d. Gain of $18,500.

**CPA-05419 Explanation**
Choice "b" is correct. Because these are trading securities, the year 2 income statement will be affected by both the realized gain from the securities sold and the unrealized loss on the securities acquired in year 2:

Realized gain on securities sold = Sales price - Carrying value = $104,500 - 92,000 = $12,500

Unrealized loss in securities acquired = Year-end market value - Cost = $71,000 - 73,000 = (2,000)

Total income statement impact = Realized gain (loss) + Unrealized gain (loss) = $12,500 + (2,000) = $10,500 gain


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Choice "a" is incorrect. The gain on the securities sold will affect the year 2 income statement. Realized gains and losses are always reported on the income statement in the period incurred.

Choice "c" is incorrect. Because these are trading securities, the gain on the securities sold is not equal to the difference between the sales price and the original cost of the securities. In year 1, the difference between the cost of $86,000 and the ending fair value of $92,000 would have been recorded on the year 1 income statement as a $6,000 unrealized gain. Then, in year 2, the realized gain on the sale is calculated using the carrying value of $92,000 and the sales price of $104,500 ($104,500 - 92,000 = $12,500 realized gain).

Choice "d" is incorrect. Because these are trading securities, unrealized gains and losses are recorded on the income statement. Therefore, when the securities acquired in year 2 are adjusted to fair value at the end of the year, a $2000 unrealized loss is recorded on the income statement equal to the difference between the ending market value of the securities and their original cost ($71,000 - 73,000). Additionally, the gain on the trading securities sold is not equal to the difference between the sales price and the original cost of the securities. In year 1, the difference between the cost of $86,000 and the ending fair value of $92,000 would have been recorded on the year 1 income statement as a $6,000 unrealized gain. Then, in year 2, the realized gain on the sale is calculated using the carrying value of $92,000 and the sales price of $104,500 ($104,500 - 92,000 = $12,500 realized gain).

**CPA-05463 Type1 M/C A-D Corr Ans: B PM#26 F 3-01**

14. CPA-05463 Released 2007 Page 5

Beach Co. determined that the decline in the fair market value (FMV) of an investment was below the amortized cost and permanent in nature. The investment was classified as available-for-sale on Beach's books. The controller would properly record the decrease in FMV by including it in which of the following?

a. Other comprehensive income section of the income statement only.
b. Earnings section of the income statement and writing down the cost basis to FMV.
c. Extraordinary items section of the income statement, net of tax, and writing down the cost basis to FMV.
d. Other comprehensive income section of the income statement, and writing down the cost basis to FMV.

**CPA-05463 Explanation**

Choice "b" is correct. When an available-for-sale security is determined to be impaired because of a permanent decline in fair value below cost, the asset must be written down to the lower fair value by recording a loss that is recognized on the income statement.

Choice "a" is incorrect. The impairment of an available-for-sale security must be recorded on the income statement. Only gains and non-permanent losses on available-for-sale securities are reported in other comprehensive income.

Choice "c" is incorrect. The impairment of an available-for-sale security is reported as a component of income from continuing operations and is not considered an extraordinary item.

Choice "d" is incorrect. The impairment of an available-for-sale security must be recorded on the income statement. Only gains and non-permanent losses on available-for-sale securities are reported in other comprehensive income.

**Business Combinations / Consolidations**

**CPA-04697 Type1 M/C A-D Corr Ans: B PM#3 F 3-02**

15. CPA-04697 Releaed 2005 Page 10

Sun Co. is a wholly owned subsidiary of Star Co. Both companies have separate general ledgers, and prepare separate financial statements. Sun requires stand-alone financial statements. Which of the following statements is correct?


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a. Consolidated financial statements should be prepared for both Star and Sun.
b. Consolidated financial statements should only be prepared by Star and **not** by Sun.
c. After consolidation, the accounts of both Star and Sun should be changed to reflect the consolidated totals for future ease in reporting.
d. After consolidation, the accounts of both Star and Sun should be combined together into one general-ledger accounting system for future ease in reporting.

**CPA-04697 Explanation**
Choice "b" is correct. Consolidate ALL majority-owned subsidiaries to have one management and one economic entity. Per SFAS 94, this includes domestic, foreign, similar, and dissimilar subsidiaries. Consolidated financial statements are prepared when a parent-subsidiary relationship has been formed. An investor is considered to have parent status when control over an investee is established or more than 50% of the voting stock of the investee has been acquired.

Choices "a", "c", and "d" are incorrect, per the above.

**Cost Method (external reporting)**

**CPA-00286 Type1 M/C A-D Corr Ans: A PM#2 F 3-03**

16. CPA-00286 Nov 92 T #30 Page 12

Pal Corp.'s 1991 dividend income included only part of the dividend received from its Ima Corp. investment. The balance of the dividend reduced Pal's carrying amount for its Ima investment. This reflects that Pal accounts for its Ima investment by the:

a. Cost method, and only a portion of Ima's 1991 dividends represent Pal's earnings after Pal's acquisition.
b. Cost method, and its carrying amount exceeded the proportionate share of Ima's market value.
c. Equity method, and Ima incurred a loss in 1991.
d. Equity method, and its carrying amount exceeded the proportionate share of Ima's market value.

**CPA-00286 Explanation**
Choice "a" is correct. The facts indicate a portion of the dividends were considered income and a portion a return of capital. This implies the cost method and dividends in excess of earnings.

**Rule:** Under the cost method, dividends (not earnings) are reflected as income by the investor. The cost basis investment account is reduced only if:

1. Shares of stock are sold, or
2. Cumulative dividends exceed cumulative earnings (a return of capital), or
3. Subsidiary incurs losses that substantially reduced net worth.

Choice "b" is incorrect. Cost method investments are not adjusted for changes in market value but that does not explain the portion of the dividend not recognized in income.

Choice "c" is incorrect. Under the equity method, 100% of the dividends paid would reduce the investment account.

Choice "d" is incorrect. 100% of the dividends are considered a reduction of the investment account under all circumstances when using the equity method.

**Equity Method (external reporting)**

**CPA-00309 Type1 M/C A-D Corr Ans: D PM#4 F 3-04**

17. CPA-00309 FARE R96 #2 Page 15

When the equity method is used to account for investments in common stock, which of the following affect(s) the investor's reported investment income?

*A change*


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| | *in market value of investee's common stock* | *Cash dividends from investee* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |

**CPA-00309 Explanation**
Choice "d" is correct, No - No.

**Rule:** Investor records as revenue its "share of the investee's earnings" (not "dividends received") under the equity method.

Dividends from an investee company are recorded by the investor as a reduction in the carrying amount of the investment on the balance sheet of the investor.

Changes in the market value of investee's common stock are not considered income to the parent under the equity method.

Under the cost method, receipt of a dividend is recorded as income and does not affect the investment account.

**CPA-00310 Type1 M/C A-D Corr Ans: B PM#5 F 3-04**

18. CPA-00310 Nov 95 #26 Page 15

Grant, Inc. acquired 30% of South Co.'s voting stock for $200,000 on January 2, 1993. Grant's 30% interest in South gave Grant the ability to exercise significant influence over South's operating and financial policies. During 1993, South earned $80,000 and paid dividends of $50,000. South reported earnings of $100,000 for the six months ended June 30, 1994, and $200,000 for the year ended December 31, 1994. On July 1, 1994, Grant sold half of its stock in South for $150,000 cash. South paid dividends of $60,000 on October 1, 1994.

Before income taxes, what amount should Grant include in its 1993 income statement as a result of the investment?

a. $15,000
b. $24,000
c. $50,000
d. $80,000

**CPA-00310 Explanation**
Choice "b" is correct, $24,000 income in 1993 income statement.

| | | | | *Investment account* | |
|---|---|---|---|---|---|
| | 100% | × | 30% = | 30% | |
| | | | | *Equity interest* | |
| Purchase price 1/2/93 | | | | $ 200,000 | |
| Add: 1993 income | 80,000 | × | 30% = | 24,000 | #26 |
| Less: 1993 dividends | | | | | |
| | 50,000 | × | 30% = | (15,000) | |
| Balance at 12/31/93 | | | | 209,000 | #27 |
| Add: 1994 income - 1/2 yr | 100,000 | × | 30% = | 30,000 | |
| Balance at 6/30/94 | | | | 239,000 | |
| Percentage sold | | | | 50% | |
| Cost of half sold | | | | 119,500 | |


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| | | | | | |
|---|---|---|---|---|---|
| Selling price | | | | 150,000 | |
| Gain on sale | | | | $ 30,500 | #28 |

**CPA-00315 Type1 M/C A-D Corr Ans: B PM#6 F 3-04**

19. CPA-00315 Nov 95 #27 Page 15

Grant, Inc. acquired 30% of South Co.'s voting stock for $200,000 on January 2, 1993. Grant's 30% interest in South gave Grant the ability to exercise significant influence over South's operating and financial policies. During 1993, South earned $80,000 and paid dividends of $50,000. South reported earnings of $100,000 for the six months ended June 30, 1994, and $200,000 for the year ended December 31, 1994. On July 1, 1994, Grant sold half of its stock in South for $150,000 cash. South paid dividends of $60,000 on October 1, 1994.

In Grant's December 31, 1993, balance sheet, what should be the carrying amount of this investment?

a. $200,000
b. $209,000
c. $224,000
d. $230,000

**CPA-00315 Explanation**
Choice "b" is correct, $209,000 carrying amount of investment in 12/31/93 balance sheet.

| | | | | *Investment account* | |
|---|---|---|---|---|---|
| | 100% | × | 30% = | 30% | |
| | | | | *Equity interest* | |
| Purchase price 1/2/93 | | | | $ 200,000 | |
| Add: 1993 income | 80,000 | × | 30% = | 24,000 | #26 |
| Less: 1993 dividends | 50,000 | × | 30% = | (15,000) | |
| Balance at 12/31/93 | | | | 209,000 | #27 |
| Add: 1994 income - 1/2 yr | 100,000 | × | 30% = | 30,000 | |
| Balance at 6/30/94 | | | | 239,000 | |
| Percentage sold | | | | 50% | |
| Cost of half sold | | | | 119,500 | |
| Selling price | | | | 150,000 | |
| Gain on sale | | | | $ 30,500 | #28 |

**CPA-00317 Type1 M/C A-D Corr Ans: B PM#7 F 3-04**

20. CPA-00317 Nov 95 #28 Page 15

Grant, Inc. acquired 30% of South Co.'s voting stock for $200,000 on January 2, 1993. Grant's 30% interest in South gave Grant the ability to exercise significant influence over South's operating and financial policies. During 1993, South earned $80,000 and paid dividends of $50,000. South reported earnings of $100,000 for the six months ended June 30, 1994, and $200,000 for the year ended December 31, 1994. On July 1, 1994, Grant sold half of its stock in South for $150,000 cash. South paid dividends of $60,000 on October 1, 1994.

In its 1994 income statement, what amount should Grant report as gain from the sale of half of its investment?

a. $24,500
b. $30,500
c. $35,000


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d. $45,500

**CPA-00317 Explanation**
Choice "b" is correct, $30,500 gain on sale of half of its investment.

| | | | | *Investment account* | |
|---|---|---|---|---|---|
| | 100% | × | 30% = | 30% | |
| | | | | *Equity interest* | |
| Purchase price 1/2/93 | | | | $ 200,000 | |
| Add: 1993 income | 80,000 | × | 30% = | 24,000 | #26 |
| Less: 1993 dividends | 50,000 | × | 30% = | (15,000) | |
| Balance at 12/31/93 | | | | 209,000 | #27 |
| Add: 1994 income - 1/2 yr | 100,000 | × | 30% = | 30,000 | |
| Balance at 6/30/94 | | | | 239,000 | |
| Percentage sold | | | | 50% | |
| Cost of half sold | | | | 119,500 | |
| Selling price | | | | 150,000 | |
| Gain on sale | | | | $ 30,500 | #28 |

**CPA-00318 Type1 M/C A-D Corr Ans: A PM#8 F 3-04**

21. CPA-00318 FARE Nov 94 #15 Page 15

Moss Corp. owns 20% of Dubro Corp.'s preferred stock and 40% of its common stock. Dubro's stock outstanding at December 31, 1993, is as follows:

| | |
|---|---|
| 10% cumulative preferred stock | $100,000 |
| Common stock | 700,000 |

Dubro reported net income of $60,000 and paid dividends of $10,000 to its preferred shareholders for the year ended December 31, 1993. How much total revenue should Moss record due to its investment in Dubro?

a. $22,000
b. $20,000
c. $70,000
d. $50,000

**CPA-00318 Explanation**
Since Moss owns 40% of Dubro's common stock, the equity method is appropriate.

Preferred Stock:
$100,000 x 10% =
$10,000 dividends x 20% ownership = $2,000 dividends received

Common Stock:

| | | |
|---|---|---|
| net income | $60,000 | |
| less pref'd dividends | (10,000) | |
| net income available to common shareholders | 50,000 | |
| Moss' percentage owned | x 40% = | $20,000 equity in earnings |

Choice "a" is correct, $20,000 from equity in earnings plus $2,000 from dividend revenue.


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**CPA-00321 Type1 M/C A-D Corr Ans: D PM#10 F 3-04**

22. CPA-00321 FARE Nov 94 #39 Page 14

Stock dividends on common stock should be recorded at their fair market value by the investor when the related investment is accounted for under which of the following methods?

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

**CPA-00321 Explanation**
Choice "d" is correct, No - No.

**Rule:** Stock dividends and stock splits are not considered income to the recipient.

Therefore, investors do not record stock dividends at fair market value. They simply reallocate the investment account balance (under either method -- cost or equity) over more shares so that value per share decreases.

Choices "a", "b", and "c" are incorrect, per rule above.

**CPA-00322 Type1 M/C A-D Corr Ans: D PM#11 F 3-04**

23. CPA-00322 FARE May 94 #19 (Adapted) Page 14

On January 2, 2002, Kean Co. purchased a 30% interest in Pod Co. for $250,000. On this date, Pod's stockholders' equity was $500,000. The carrying amounts of Pod's identifiable net assets approximated their fair values, except for land whose fair value exceeded its carrying amount by $200,000. Pod reported net income of $100,000 for 2002, and paid no dividends. Kean accounts for this investment using the equity method. In its December 31, 2002, balance sheet, what amount should Kean report as investment in subsidiary?

a. $210,000
b. $220,000
c. $270,000
d. $280,000

**CPA-00322 Explanation**
Choice "d" is correct. Under the equity method, the investment account will be increased by the investor's share of investee's net income (30% × $100,000) and decreased by any dividends declared (none). Thus, the Investment in Pod, at December 31, 2002 is equal to $280,000: $250,000 + $30,000. In order to determine the amount of goodwill, the fair value of the net assets acquired must be determined and then compared with the purchase price:

| | |
|---|---|
| Stockholders' equity | $ 500,000 |
| Excess of FMV, land | 200,000 |
| Total FMV | 700,000 |
| Percentage acquired | 30% |
| FMV of net assets acquired | 210,000 |
| Purchase price | 250,000 |
| Goodwill | $ 40,000 |

Under the equity method, the investment account will be increased by the investor's share of investee's net income (30% × $100,000) and decreased by any dividends declared (none). Thus, the Investment in Pod, at December 31, 2002 is equal to $280,000: $250,000 + $30,000.


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**CPA-00325 Type1 M/C A-D Corr Ans: A PM#13 F 3-04**

24. CPA-00325 Nov 93 T #9 Page 14

Peel Co. received a cash dividend from a common stock investment. Should Peel report an increase in the investment account if it uses the cost method or the equity method of accounting?

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

**CPA-00325 Explanation**
Choice "a" is correct, No - No.

Under the cost method, receipt of a dividend is recorded as income and does not affect the investment account.

Under the equity method, receipt of a dividend is recorded as a decrease in the investment account.

**CPA-00326 Type1 M/C A-D Corr Ans: C PM#14 F 3-04**

25. CPA-00326 Nov 93 I #14 Page 19

Pare, Inc. purchased 10% of Tot Co.'s 100,000 outstanding shares of common stock on January 2, 1992, for $50,000. On December 31, 1992, Pare purchased an additional 20,000 shares of Tot for $150,000. There was no goodwill as a result of either acquisition, and Tot had not issued any additional stock during 1992. Tot reported earnings of $300,000 for 1992. What amount should Pare report in its December 31, 1992, balance sheet as investment in Tot?

a. $170,000
b. $200,000
c. $230,000
d. $290,000

**CPA-00326 Explanation**
Choice "c" is correct, $230,000 investment in Tot at 12/31/92.

**Rule:** When two or more purchases of stock cause ownership in an investee to go from less than 20% to more than 20%, the equity method should be used.

| | | *Total shares* | | | *Investment in Tot Co.* | |
|---|---|---|---|---|---|---|
| | *Date* | *outstanding* | *%* | | *shares* | *amnt* |
| 1st step | 1/2/92 | 100,000 × | 10% | = | 10,000 | $ 50,000 |
| 2nd step | 12/31/92 | 100,000 × | 20% | = | 20,000 | 150,000 |
| Total purchase | | | 30% | | 30,000 | 200,000 |
| Share of earnings (equity method): | | | | | | |
| ($300,000 earnings × 10%) | | | | = | | 30,000 |
| Investment account at 12/31/92 | | | | | | $ 230,000 |

Note: Although the equity method is used, the actual ownership percentage (10%) is used for 1992 since the additional 20% was not purchased until 12/31/92 in 1993, 30% of Tot's earnings would be recorded in the investor's investment account.

**CPA-00334 Type1 M/C A-D Corr Ans: D PM#15 F 3-04**

26. CPA-00334 PI May 93 #5 Page 14


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Pear Co.'s income statement for the year ended December 31, 1992, as prepared by Pear's controller, reported income before taxes of $125,000. The auditor questioned the following amounts that had been included in income before taxes:

| | |
|---|---|
| Equity in earnings of Cinn Co. | $ 40,000 |
| Dividends received from Cinn | 8,000 |
| Adjustments to profits of prior years for arithmetical errors in depreciation | (35,000) |

Pear owns 40% of Cinn's common stock. Pear's December 31, 1992, income statement should report income before taxes of:

a. $85,000
b. $117,000
c. $120,000
d. $152,000

**CPA-00334 Explanation**

Choice "d" is correct. The $40,000 equity in earnings of Cinn is properly included in income. Pear owns 40% of Cinn and uses the equity method. Thus, equity in earnings is included in the income statement while dividends received are not. The $35,000 is a prior period adjustment and should be reported as an adjustment to the opening balance of retained earnings, not on the current period income.

| | |
|---|---|
| Income as reported | $ 125,000 |
| Dividends received | (8,000) |
| Prior period adjustment | 35,000 |
| Income before taxes | $ 152,000 |

APB 18 para. 19

**CPA-00335 Type1 M/C A-D Corr Ans: B PM#16 F 3-04**

27. CPA-00335 May 93 I #43 Page 14

On July 1, 1992, Denver Corp. purchased 3,000 shares of Eagle Co.'s 10,000 outstanding shares of common stock for $20 per share. On December 15, 1992, Eagle paid $40,000 in dividends to its common stockholders. Eagle's net income for the year ended December 31, 1992, was $120,000, earned evenly throughout the year. In its 1992 income statement, what amount of income from this investment should Denver report?

a. $36,000
b. $18,000
c. $12,000
d. $6,000

**CPA-00335 Explanation**

| | |
|---|---|
| Eagle's 1992 income | $ 120,000 |
| Percentage owned – | |
| 3,000 out of 10,000 shares | × 30% |
| | 36,000 |
| Owned for 6 months (7/1/92 to 12/31/92) | × 6/12 |
| Income from investment in Eagle | $ 18,000 |

Choice "b" is correct, $18,000 income from investment in Eagle Co. for 1992.

Notes:
1. In a purchase, income from an investee is recognized only from date of purchase (in a pooling, it is the whole year).
2. The dividends received reduce the investment account, but do not affect the income.
3. With 30% ownership, significant influence is assumed and the equity method is used.


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**CPA-00336 Type1 M/C A-D Corr Ans: B PM#17 F 3-04**

28. CPA-00336 May 92 I #40 (Adapted) Page 16

Sage, Inc. bought 40% of Adams Corp.'s outstanding common stock on January 2, 1991, for $400,000. The carrying amount of Adams' net assets at the purchase date totaled $900,000. Fair values and carrying amounts were the same for all items except for plant and inventory, for which fair values exceeded their carrying amounts by $90,000 and $10,000, respectively. The plant has an 18-year life. All inventory was sold during 1991. During 1991, Adams reported net income of $120,000 and paid a $20,000 cash dividend. What amount should Sage report in its income statement from its investment in Adams for the year ended December 31, 1991?

a. $48,000
b. $42,000
c. $36,000
d. $32,000

**CPA-00336 Explanation**
Choice "b" is correct, $42,000 should be reported in the income statement.

| *Investment in Adams Corp.* | |
|---|---|
| Carrying amount on Adams' books | $ 900,000 |
| Increase in value for: | |
| Plant | 90,000 |
| Inventory | 10,000 |
| Fair market value of Adams | 1,000,000 |
| Percent purchased | 40% |
| FV of 40% purchased (no goodwill) | $ 400,000 |
| *Income earned from investment* | |
| Net income for 1991 | $ 120,000 |
| Percent owned | 40% |
| Share of income before adjustment | 48,000 |
| Amortization of higher plant value ($90,000 × 40% ÷ 18 years) | (2,000) |
| Write off extra value of inventory (10,000 × 40%) | (4,000) |
| Equity in income of 40% investee | $ 42,000 |

**CPA-00338 Type1 M/C A-D Corr Ans: C PM#18 F 3-04**

29. CPA-00338 May 92 I #42 Page 14

Green Corp. owns 30% of the outstanding common stock and 100% of the outstanding noncumulative nonvoting preferred stock of Axel Corp. In 1991, Axel declared dividends of $100,000 on its common stock and $60,000 on its preferred stock. Green exercises significant influence over Axel's operations. What amount of dividend revenue should Green report in its income statement for the year ended December 31, 1991?

a. $0
b. $30,000
c. $60,000
d. $90,000

**CPA-00338 Explanation**
Choice "c" is correct, $60,000

| *Ownership* | | *Dividend Paid* | *Dividend Revenue* | |
|---|---|---|---|---|
| | | | *Cost Method* | *Equity Method* |
| 30% | × | $100,000 com stk. = | 30,000 | na 0 |


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| | | | | |
|---|---|---|---|---|
| 100% | × | 60,000 prf stk. | 60,000 | 60,000 |
| Total dividends under cost method | | | 90,000 | |
| Total dividends under equity method | | | | $60,000 |

Because Green the investor exercises significant influence over the investee corporation, it must use the equity method for recording common stock dividends which are treated as return of capital. Preferred stock dividends are the same under both methods.

**CPA-00341 Type1 M/C A-D Corr Ans: D PM#19 F 3-04**

30. CPA-00341 Nov 91 T #14 (Adapted) Page 16

When the equity method is used to account for investments in common stock, which of the following affects the investor's reported investment income?

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

**CPA-00341 Explanation**
Choice "d" is correct, under the equity method undervalued asset amortization will decrease the investor's reported investment income, but cash dividends received will only affect the balance sheet investment account.

**Rule:** Undervalued asset amortization affects both the investment account (an asset) and the investment income account (a revenue), while cash dividends affect the investment account but not the investment income account.

*Journal entries:*
For undervalued asset amortization:

| | | |
|---|---|---|
| **Dr** Equity revenue (I/S) | $XXX | |
| **Cr** Investment acct (B/S) | | $XXX |

For cash dividends:

| | | |
|---|---|---|
| **Dr** Cash (B/S) | $XXX | |
| **Cr** Investment acct (B/S) | | $XXX |

**CPA-00344 Type1 M/C A-D Corr Ans: C PM#20 F 3-04**

31. CPA-00344 Nov 91 I #41 Page 19

On January 1, 1989, Mega Corp. acquired 10% of the outstanding voting stock of Penny, Inc. On January 2, 1990, Mega gained the ability to exercise significant influence over financial and operating control of Penny by acquiring an additional 20% of Penny's outstanding stock. The two purchases were made at prices proportionate to the value assigned to Penny's net assets, which equaled their carrying amounts. For the years ended December 31, 1989 and 1990, Penny reported the following:

| | *1989* | *1990* |
|---|---|---|
| Dividends paid | $200,000 | $300,000 |
| Net income | 600,000 | 650,000 |

In 1990, what amounts should Mega report as current year investment income and as an adjustment, before income taxes, to 1989 investment income?

| *1990 investment income* | *Adjustment 1989 investment income* |
|---|---|


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a. $195,000 $160,000
b. $195,000 $100,000
c. $195,000 $40,000
d. $105,000 $40,000

**CPA-00344 Explanation**
Choice "c" is correct, 1990 investment income of $195,000 and an adjustment to 1989 investment income of $40,000.

**Rule:** When two or more purchases of stock cause ownership to go from less than 20% to more than 20%, the equity method should be used and the periods during which the cost method was used are retroactively restated.

1990 investment income = 30% × $650,000 = $195,000

1990 adjustment to 1989 investment income:

| | |
|---|---|
| 10% × $600,000 net income = | $ 60,000 |
| 10% × $200,000 dividends paid = | (20,000) |
| adjustment to 1989 | $ 40,000 |

**CPA-00346 Type1 M/C A-D Corr Ans: A PM#21 F 3-04**

32. CPA-00346 Nov 91 I #44 Page 14

In 1990, Neil Co. held the following investments in common stock:

- 25,000 shares of B & K, Inc.'s 100,000 outstanding shares. Neil's level of ownership gives it the ability to exercise significant influence over the financial and operating policies of B & K.
- 6,000 shares of Amal Corp.'s 309,000 outstanding shares.

During 1990, Neil received the following distributions from its common stock investments:

November 6 – $30,000 cash dividend from B & K.
November 11 – $1,500 cash dividend from Amal.
December 26 – 3% common stock dividend from Amal.
The closing price of this stock on a national exchange was $15 per share.

What amount of dividend revenue should Neil report for 1990?

a. $1,500
b. $4,200
c. $31,500
d. $34,200

**CPA-00346 Explanation**
Choice "a" is correct, $1,500 dividend revenue should be reported for 1990, representing the cash dividend from Amal.

The $30,000 cash dividend from B & K is a return of capital as is any dividend under the equity method, since the investment account is reduced.

The 3% stock dividend from Amal means more shares, representing the same proportional piece of the pie. It is not income.

**CPA-00349 Type1 M/C A-D Corr Ans: D PM#23 F 3-04**

33. CPA-00349 Nov 90 I #36 Page 14

Day Co. received dividends from its common stock investments during the year ended December 31, 1989 as follows:


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- A stock dividend of 400 shares from Parr Corp. on July 25, 1989 when the market price of Parr's shares was $20 per share. Day owns less than 1% of Parr's common stock.
- A cash dividend of $15,000 from Lark Corp. in which Day owns a 25% interest. A majority of Lark's directors are also directors of Day.

What amount of dividend revenue should Day report in its 1989 income statement?

a. $23,000
b. $15,000
c. $8,000
d. $0

**CPA-00349 Explanation**
Choice "d" is correct, $0 dividend revenue.

**Rules:**

1. Stock dividend (more shares of stock) is not reported as revenue, only a memo entry is made.
2. Cash dividend (under the equity method) reduces the investment account but does not affect revenue.

**CPA-00350 Type1 M/C A-D Corr Ans: C PM#24 F 3-04**

34. CPA-00350 May 90 I #6 Page 14

Lee, Inc. acquired 30% of Polk Corp.'s voting stock on January 1, 1988 for $100,000. During 1988, Polk earned $40,000 and paid dividends of $25,000. Lee's 30% interest in Polk gives Lee the ability to exercise significant influence over Polk's operating and financial policies. During 1989, Polk earned $50,000 and paid dividends of $15,000 on April 1, and $15,000 October 1. On July 1, 1989, Lee sold half its stock in Polk for $66,000 cash.

Before income taxes, what amount should Lee include in its 1988 income statement as a result of the investment?

a. $40,000
b. $25,000
c. $12,000
d. $7,500

**CPA-00350 Explanation**
Choice "c" is correct, $12,000 income in 1988 income statement.

| | | | *Investment 30% equity interest* | *Account* |
|---|---|---|---|---|
| | 100% × 30% | = | | |
| Purchase price 1/1/88 | | | $100,000 | |
| Add: 1988 income | $ 40,000 × 30% | = | 12,000 | |
| Less: 1988 dividends | 25,000 × 30% | = | (7,500) | |
| Balance at 12/31/88 | | | 104,500 | |
| Add: 1989 income - 1/2 yr | 50,000 × 30% | = | 7,500 | |
| Less: 4/1/89 dividend | 15,000 × 30% | = | (4,500) | |
| Balance at 6/30/89 | | | 107,500 | |
| Percentage sold | | | × 50% | |
| Cost of half sold | | | 53,750 | |
| Selling price | | | 66,000 | |
| Gain on sale | | | $ 12,250 | |

**CPA-00351 Type1 M/C A-D Corr Ans: B PM#25 F 3-04**

35. CPA-00351 May 90 I #7 Page 14


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Lee, Inc. acquired 30% of Polk Corp.'s voting stock on January 1, 1988 for $100,000. During 1988, Polk earned $40,000 and paid dividends of $25,000. Lee's 30% interest in Polk gives Lee the ability to exercise significant influence over Polk's operating and financial policies. During 1989, Polk earned $50,000 and paid dividends of $15,000 on April 1, and $15,000 October 1. On July 1, 1989, Lee sold half its stock in Polk for $66,000 cash.

The carrying amount of this investment in Lee's December 31, 1988 balance sheet should be:

a. $100,000
b. $104,500
c. $112,000
d. $115,000

**CPA-00351 Explanation**
Choice "b" is correct, $104,500 carrying amount of investment in 12/31/88 balance sheet.

| | | | *Investment 30% equity interest* | *Account* |
|---|---|---|---|---|
| | 100% × 30% | = | | |
| Purchase price 1/1/88 | | | $100,000 | |
| Add: 1988 income | $ 40,000 × 30% | = | 12,000 | |
| Less: 1988 dividends | 25,000 × 30% | = | (7,500) | |
| Balance at 12/31/88 | | | 104,500 | |
| Add: 1989 income - 1/2 yr | 50,000 × 30% | = | 7,500 | |
| Less: 4/1/89 dividend | 15,000 × 30% | = | (4,500) | |
| Balance at 6/30/89 | | | 107,500 | |
| Percentage sold | | | × 50% | |
| Cost of half sold | | | 53,750 | |
| Selling price | | | 66,000 | |
| Gain on sale | | | $ 12,250 | |

**CPA-00352 Type1 M/C A-D Corr Ans: C PM#26 F 3-04**

36. CPA-00352 May 90 I #8 Page 14

Lee, Inc. acquired 30% of Polk Corp.'s voting stock on January 1, 1988 for $100,000. During 1988, Polk earned $40,000 and paid dividends of $25,000. Lee's 30% interest in Polk gives Lee the ability to exercise significant influence over Polk's operating and financial policies. During 1989, Polk earned $50,000 and paid dividends of $15,000 on April 1, and $15,000 October 1. On July 1, 1989, Lee sold half its stock in Polk for $66,000 cash.

What should be the gain on sale of this investment in Lee's 1989 income statement?

a. $16,000
b. $13,750
c. $12,250
d. $10,000

**CPA-00352 Explanation**
Choice "c" is correct, $12,250 gain on sale of investment.

| | | | *Investment 30% equity interest* | *Account* |
|---|---|---|---|---|
| | 100% × 30% | = | | |
| Purchase price 1/1/88 | | | $100,000 | |
| Add: 1988 income | $ 40,000 × 30% | = | 12,000 | |
| Less: 1988 dividends | 25,000 × 30% | = | (7,500) | |
| Balance at 12/31/88 | | | 104,500 | |
| Add: 1989 income - 1/2 yr | 50,000 × 30% | = | 7,500 | |
| Less: 4/1/89 dividend | 15,000 × 30% | = | (4,500) | |
| Balance at 6/30/89 | | | 107,500 | |


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| | |
|---|---|
| Percentage sold | × 50% |
| Cost of half sold | 53,750 |
| Selling price | 66,000 |
| Gain on sale | $ 12,250 |

**CPA-00353 Type1 M/C A-D Corr Ans: D PM#27 F 3-04**

37. CPA-00353 Nov 89 T #4 Page 14

An investor in common stock received dividends in excess of the investor's share of investee's earnings subsequent to the date of the investment. How will the investor's investment account be affected by those dividends under each of the following accounting methods?

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

**CPA-00353 Explanation**
Choice "d" is correct, "decrease - decrease."

**Rule:** Under both the cost and equity methods, liquidating dividends reduce the carrying amount of the investment account.

**CPA-05616 Type1 M/C A-D Corr Ans: B PM#28 F 3-04**

38. CPA-05616 Page 19

On January 1, 20X8, Parker Inc. acquired 30% of Smith Inc.'s outstanding common stock for $400,000. During 20X8, Smith had net income of $100,000 and paid dividends of $30,000. On January 1, 20X9, Parker acquired an additional 45% interest on Smith for $1,012,000. The fair value of Smith on January 1, 20X9 was $2,250,000. What amount of gain from this transaction will Parker record in 20X9?

a. $0
b. $254,000
c. $275,000
d. $675,000

**CPA-05616 Explanation**
Choice "b" is correct. When an investor goes from non-control to control of a subsidiary through a step acquisition, the previously held equity investment must be adjusted to fair value. The fair value adjustment is recognized as a gain or loss by the investor in the period of the additional acquisition.

To compute the adjustment made on January 1, 20X9, the carrying amount of Parker's investment in Smith on that date must first be calculated. Because Parker previously owned 30% of Smith, the investment would have been accounted for using the equity method:

| | |
|---|---|
| Investment in Smith, 1/1/X8 | $400,000 |
| + 30% share of Smith's 20X8 earnings | 30,000 |
| - 30% share of Smith's 20X8 dividends | (9,000) |
| Investment in Smith, 12/31/X8 | $421,000 |

| | Original Interest 30% | Acquired Interest 45% | Noncontrolling Interest 25% | Total Fair Value |
|---|---|---|---|---|
| Beg. Carrying Amount | $421,000 | $1,012,000 | | |
| Adjustment | 254,000 | | 562,500 | |
| New Carrying Amount | $675,000 | $1,012,000 | $562,000 | $2,250,000 |


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The $254,000 adjustment necessary to adjust the original investment to its July 1, 20X9 fair value is recorded by Parker as a gain in 20X9.

Choice "a" is incorrect. A gain must be recorded to adjust the investment to fair value on 1/1/X9.

Choice "c" is incorrect. This calculation assumes that the 30% interest is reported at $400,000 on 1/1/X9. Parker would use the equity method to account for its investment in Smith during 20X8 and the ending value of the investment would be $421,000 on 12/31/X8 (see the calculation above).

Choice "d" is incorrect. This is the total fair value of the original 30% interest on July 1, 20X9.

**Consolidated Financial Statements**

**CPA-00372 Type1 M/C A-D Corr Ans: A PM#1 F 3-05**

39. CPA-00372 FARE C03 #1 Page 48

Assume Kiwi, Inc.'s planned combination with Mori Co. on December 31, 2000, can be structured either as an acquisition or a pooling of interests. Both Kiwi and Mori were incorporated and began business on January 1, 1999. Both Kiwi and Mori reported net income for 1999 and 2000. Consolidated retained earnings for Kiwi, Inc. and Subsidiary as of December 31, 2000 will include the net income of Mori Co., from what date?

| | *Purchase* | *Pooling* |
|---|---|---|
| a. | It will not include the net income of Mori Co. | January 1, 1999 |
| b. | It will not include the net Income of Mori Co. | January 1, 2000 |
| c. | January 1, 1999 | January 1, 1999 |
| d. | January 1, 2000 | January 1, 1999 |

**CPA-00372 Explanation**
Choice "a" is correct. A pooling is considered a retroactive combining together of stockholder interests. In a pooling, consolidated retained earnings includes the retained earnings of all pooled subsidiaries. Consolidated retained earnings would include Mori's net income from its inception. In acquisition accounting, the earnings of a subsidiary are only included in consolidated retained earnings from the date of acquisition.

**CPA-00373 Type1 M/C A-D Corr Ans: C PM#2 F 3-05**

40. CPA-00373 FARE Nov 95 #52 Page 48

In a business combination, how should long-term debt of the acquired company generally be reported under each of the following methods?

| | *Pooling of interest* | *Acquisition* |
|---|---|---|
| a. | Fair value | Carrying amount |
| b. | Fair value | Fair value |
| c. | Carrying amount | Fair value |
| d. | Carrying amount | Carrying amount |

**CPA-00373 Explanation**
Choice "c" is correct. In the pooling of interest method, all assets and liabilities are reported at their carrying value, since no acquisition is recognized. In the acquisition method, all assets and liabilities are reported at their fair values (as if the net assets had been purchased separately).

**CPA-00381 Type1 M/C A-D Corr Ans: A PM#3 F 3-05**

41. CPA-00381 FARE May 95 #54 Page 48

Poe, Inc. acquired 100% of Shaw Co. in a business combination on September 30, 1994. During 1994, Poe declared quarterly dividends of $25,000 and Shaw declared quarterly dividends of $10,000. Under


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each of the following methods of accounting for the business combination, what amount should be reported as dividends declared in the December 31, 1994, consolidated statement of retained earnings?

| | *Acquisition* | *Pooling of interests* |
|---|---|---|
| a. | $100,000 | $130,000 |
| b. | $100,000 | $140,000 |
| c. | $130,000 | $130,000 |
| d. | $130,000 | $140,000 |

**CPA-00381 Explanation**

Choice "a" is correct, $100,000 – $130,000.

**Rule:** In an "acquisition," net income and dividends declared of a newly acquired sub will only be included in the consolidated statements from the date of acquisition. In a "pooling" net income and dividends declared of a newly acquired sub are included in the consolidated statements for the entire period regardless of the date of pooling. In both cases, any intercompany profits or dividends are eliminated.

| | | | *Acquisition* | *Pooling* |
|---|---|---|---|---|
| Dividends declared | | | | |
| By parent (Poe) | 1 | Q | $ 25,000 | $ 25,000 |
| | 2 | Q | $ 25,000 | $ 25,000 |
| | 3 | Q | $ 25,000 | $ 25,000 |
| | 4 | Q | $ 25,000 | $ 25,000 |
| Dividends declared | | | | |
| By subsidiary | | | | |
| (Shaw) | 1 | Q | $ 0 | $ 10,000 |
| | 2 | Q | $ 0 | $ 10,000 |
| | 3 | Q | $ 0 | $ 10,000 |
| Acquired 9/30/94 | 4 | Q | $ 10,000 | $ 10,000 |
| Sub-total | | | $110,000 | $140,000 |
| Less intercompany | | | (10,000) | (10,000) |
| | | | $100,000 | $130,000 |

**CPA-00382 Type1 M/C A-D Corr Ans: D PM#4 F 3-05**

42. CPA-00382 FARE May 94 #52 Page 48

A business combination occurs in the middle of the year. Results of operations for the year of combination would include the combined results of operations of the separate companies for the entire year if the business combination is a:

| | *Acquisition* | *Pooling of interests* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | No |
| d. | No | Yes |

**CPA-00382 Explanation**

Choice "d" is correct. Acquisition accounting includes results of operations from the acquisition date forward. Pooling of interests combines the results of operations from the beginning of the fiscal year, and if comparative financial statements are presented, retroactively restates the results of operations as if the companies were always one entity.

**CPA-00386 Type1 M/C A-D Corr Ans: D PM#5 F 3-05**

43. CPA-00386 PI May 93 #8 Page 22


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On June 30, 1992, Pane Corp. exchanged 150,000 shares of its $20 par value common stock for all of Sky Corp.'s common stock. At that date, the fair value of Pane's common stock issued was equal to the book value of Sky's net assets. Both corporations continued to operate as separate businesses, maintaining accounting records with years ending December 31. Information from separate company operations follows:

| | *Pane* | *Sky* |
|---|---|---|
| Retained earnings-12/31/91 | $3,200,000 | $925,000 |
| Net income-six months ended 6/30/92 | 800,000 | 275,000 |
| Dividends paid-3/25/92 | 750,000 | - |

If the business combination is accounted for as an acquisition, what amount of retained earnings would Pane report, in its June 30, 1992, consolidated balance sheet?

a. $5,200,000
b. $3,525,000
c. $4,450,000
d. $3,250,000

**CPA-00386 Explanation**
Choice "d" is correct, $3,250,000 consolidated retained earnings in 6/30/92 balance sheet (acquisition method).

| | *Pane* | *Sky* | *Total* |
|---|---|---|---|
| Retained earnings (12/31/91) | $3,200,000 | N/A | $3,200,000 |
| Net income (12/1/91-6/30/92) | 800,000 | N/A | 800,000 |
| Less div paid (3/25/92) | (750,000) | N/A | (750,000) |
| | $3,250,000 | N/A | $3,250,000 |

**CPA-00388 Type1 M/C A-D Corr Ans: B PM#6 F 3-05**

44. CPA-00388 Nov 92 T #31 Page 21

Penn, Inc., a manufacturing company, owns 75% of the common stock of Sell, Inc., an investment company. Sell owns 60% of the common stock of Vane, Inc., an insurance company. In Penn's consolidated financial statements, should consolidation accounting or equity method accounting be used for Sell and Vane?

a. Consolidation used for Sell and equity method used for Vane.
b. Consolidation used for both Sell and Vane.
c. Equity method used for Sell and consolidation used for Vane.
d. Equity method used for both Sell and Vane.

**CPA-00388 Explanation**
Choice "b" is correct, in Penn's consolidated financial statements, consolidation accounting should be used for both Sell and Vane.

**Rule:** In a vertical chain, where parent co. owns more than 50% of subsidiary co., and subsidiary owns more than 50% of a third company, consolidate:

1. Third co. into subsidiary co.
2. Subsidiary co. (now consolidated with third co.) into parent co.

**Acquisition Method (external reporting)**

**CPA-00416 Type1 M/C A-D Corr Ans: D PM#3 F 3-06**

45. CPA-00416 FARE R96 #3 (Adapted) Page 22

Mega, Inc. was organized to consolidate the resources of Lone Co. and Small Co. in a business combination accounted for by the acquisition method. Mega issued 31,000 shares of its $10 par voting


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stock with a fair value of $15 per share, in exchange for all the outstanding capital stock of Lone and Small. The equity accounts of Lone and Small on the date of the exchange were:

| | *Lone* | *Small* | *Total* |
|---|---|---|---|
| Common stock, at par | $100,000 | $200,000 | $300,000 |
| Additional paid-in capital | 12,500 | 17,500 | 30,000 |
| Retained earnings | 60,000 | 105,000 | 165,000 |
| | $172,500 | $322,500 | $495,000 |

What is the balance in Mega's additional paid-in capital account immediately after the business combination?

a. $12,500
b. $17,500
c. $30,000
d. $155,000

**CPA-00416 Explanation**
Choice "d" is correct. The transaction is recorded at the fair market value of the stock issued. The journal entry would be:

| | | | |
|---|---|---|---|
| **DR:** | Investment in sub | $465,000 | |
| **CR:** | Common stock (par) | | $310,000 |
| **CR:** | APIC | | $155,000 |

Choice "a" is incorrect. Lone's APIC is not the correct amount.

Choice "b" is incorrect. Small's APIC is not the correct amount.

Choice "c" is incorrect. The combined APIC of Lone and Small is not the correct amount.

**CPA-00418 Type1 M/C A-D Corr Ans: C PM#4 F 3-06**

46. CPA-00418 FARE Nov 95 #53 (Adapted) Page 22

In a business combination accounted for as a purchase, the appraised values of the identifiable assets acquired exceeded the acquisition price. How should the excess appraised value be reported?

a. As negative goodwill.
b. As an extraordinary gain.
c. As a reduction of the values assigned to noncurrent assets and an extraordinary gain for any unallocated portion.
d. As positive goodwill.

**CPA-00418 Explanation**
Choice "c" is correct. When the appraised values of the identifiable net assets exceed the acquisition price (i.e., a "bargain" purchase), the noncurrent assets must be written down on a relative value basis with any unallocated portion of the excess value being recorded as an extraordinary gain. FASB 141 para. 62

Choice "a" is incorrect. Negative goodwill is not recorded. Instead, the noncurrent assets must be written down on a relative value basis with any unallocated portion of the excess value being recorded as an extraordinary gain.

Choice "b" is incorrect. An extraordinary gain is recognized only after the noncurrent assets have been written down.

Choice "d" is incorrect. Positive goodwill results, and is recorded, only if the acquisition price exceeds the fair values of the identifiable net assets.

**CPA-00420 Type1 M/C A-D Corr Ans: C PM#5 F 3-06**


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47. CPA-00420 FARE May 95 #53 Page 26

A business combination is accounted for properly as an acquisition. Direct costs of combination, other than registration and issuance costs of equity securities, should be:

a. Capitalized as a deferred charge and amortized.
b. Deducted directly from the retained earnings of the combined corporation.
c. Deducted in determining the net income of the combined corporation for the period in which the costs were incurred.
d. Included in the acquisition cost to be allocated to identifiable assets according to their fair values.

**CPA-00420 Explanation**
Choice "c" is correct. Direct costs are expensed in the period incurred.

**CPA-00421 Type1 M/C A-D Corr Ans: B PM#6 F 3-06**

48. CPA-00421 Th May 93 #6 Page 28

On September 1, 1990, Phillips, Inc. issued common stock in exchange for 20% of Sago, Inc.'s outstanding common stock. On July 1, 1992, Phillips issued common stock for an additional 75% of Sago's outstanding common stock. Sago continues in existence as Phillips' subsidiary. How much of Sago's 1992 net income should be reported as accruing to Phillips?

a. 20% of Sago's net income to June 30 and all of Sago's net income from July 1 to December 31.
b. 20% of Sago's net income to June 30 and 95% of Sago's net income from July 1 to December 31.
c. 95% of Sago's net income.
d. All of Sago's net income.

**CPA-00421 Explanation**
Choice "b" is correct, 20% of Sago's net income to June 30 and 95% of Sago's net income from July 1 to December 31.

**Rule:** In an acquisition, the net income of a newly acquired subsidiary will only be included in consolidated net income from the date of acquisition. Therefore, only 20% of Sago net income is included in consolidated earnings until June 30 and 95% thereafter.

**CPA-00422 Type1 M/C A-D Corr Ans: D PM#7 F 3-06**

49. CPA-00422 Th May 93 #7 Page 28

PDX Corp. acquired 100% of the outstanding common stock of Sea Corp. in an acquisition transaction. The cost of the acquisition exceeded the fair value of the identifiable assets and assumed liabilities. The general guidelines for assigning amounts to the inventories acquired provide for:

a. Raw materials to be valued at original cost.
b. Work in process to be valued at the estimated selling prices of finished goods, less both costs to complete and costs of disposal.
c. Finished goods to be valued at replacement cost.
d. Finished goods to be valued at estimated selling prices, less both costs of disposal and a reasonable profit allowance.

**CPA-00422 Explanation**
Choice "d" is correct. With acquisition accounting the net assets acquired are based on fair market value. The fair value of finished goods and merchandise inventory are based upon selling price less disposal costs and a reasonable profit allowance.

Choice "a" is incorrect. The fair value of raw materials should be based upon replacement costs.

Choice "b" is incorrect. The fair value of work in process should be based upon the estimated selling price of finished goods less the costs to complete and dispose and a reasonable profit allowance.


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Choice "c" is incorrect. Replacement costs are an appropriate measure of fair market value for raw materials inventory, but not finished goods.

**CPA-00426 Type1 M/C A-D Corr Ans: C PM#9 F 3-06**

50. CPA-00426 May 92 I #6 (Adapted) Page 28

On January 1, 1991, Dallas, Inc. acquired 80% of Style, Inc.'s outstanding common stock for $120,000. On that date, the carrying amounts of Style's assets and liabilities approximated their fair values. During 1991, Style paid $5,000 cash dividends to its stockholders. Summarized balance sheet information for the two companies follows:

| | *Dallas* | *Style* | |
|---|---|---|---|
| | 12/31/91 | 12/31/91 | 1/1/91 |
| Investment in Style (equity method) | $132,000 | | |
| Other assets | 138,000 | $115,000 | $100,000 |
| | $270,000 | $115,000 | $100,000 |
| Common stock | $ 50,000 | $ 20,000 | $ 20,000 |
| Additional paid-in capital | 80,250 | 44,000 | 44,000 |
| Retained earnings | 139,750 | 51,000 | 36,000 |
| | $270,000 | $115,000 | $100,000 |

What amount should Dallas report as earnings from subsidiary, in its 1991 income statement?

a. $12,000
b. $15,000
c. $16,000
d. $20,000

**CPA-00426 Explanation**
Choice "c" is correct, $16,000 earnings from subsidiary.

| *Subsidiary's retained earnings statement* | | |
|---|---|---|
| 1/1/91 balance | | $36,000 |
| Income | squeeze | 20,000 |
| | | 56,000 |
| Dividend paid | | (5,000) |
| 12/31/91 balance | | 51,000 |

| *Earnings from subsidiary* | |
|---|---|
| 1991 income | 20,000 |
| Percent owned | x 80% |
| Dallas' share | $16,000 |

**CPA-00427 Type1 M/C A-D Corr Ans: A PM#10 F 3-06**

51. CPA-00427 May 92 I #7 Page 28

On January 1, 1991, Dallas, Inc. acquired 80% of Style, Inc.'s outstanding common stock for $120,000. On that date, the carrying amounts of Style's assets and liabilities approximated their fair values. During 1991, Style paid $5,000 cash dividends to its stockholders. Summarized balance sheet information for the two companies follows:

| | *Dallas* | *Style* | |
|---|---|---|---|
| | 12/31/91 | 12/31/91 | 1/1/91 |
| Investment in Style (equity method) | $132,000 | | |
| Other assets | 138,000 | $115,000 | $100,000 |
| | $270,000 | $115,000 | $100,000 |
| Common stock | $ 50,000 | $ 20,000 | $ 20,000 |
| Additional paid-in capital | 80,250 | 44,000 | 44,000 |


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| | | | |
|---|---|---|---|
| Retained earnings | 139,750 | 51,000 | 36,000 |
| | $270,000 | $115,000 | $100,000 |

What amount of total stockholders' equity should be reported in Dallas' December 31, 1991, consolidated balance sheet?

a. $270,000
b. $286,000
c. $362,000
d. $385,000

**CPA-00427 Explanation**
Choice "a" is correct, $270,000 total consolidated stockholders' equity.

Dallas' consolidated stockholders' equity will be the same as the parent company stockholders' equity:

| | |
|---|---|
| Common stock | $50,000 |
| Additional paid in | 80,250 |
| Retained earnings | 139,750 |
| | $270,000 |

**CPA-00429 Type1 M/C A-D Corr Ans: D PM#11 F 3-06**

52. CPA-00429 Nov 91 II #10 Page 28

Beni Corp. purchased 100% of Carr Corp.'s outstanding capital stock for $430,000 cash. Immediately before the acquisition, the balance sheets of both corporations reported the following:

| | *Beni* | *Carr* |
|---|---|---|
| Assets | $2,000,000 | $750,000 |
| Liabilities | $ 750,000 | $400,000 |
| Common stock | 1,000,000 | 310,000 |
| Retained earnings | 250,000 | 40,000 |
| Liabilities and stockholders' equity | $2,000,000 | $750,000 |

At the date of purchase, the fair value of Carr's assets was $50,000 more than the aggregate carrying amounts. In the consolidated balance sheet prepared immediately after the acquisition, the consolidated stockholders' equity should amount to:

a. $1,680,000
b. $1,650,000
c. $1,600,000
d. $1,250,000

**CPA-00429 Explanation**
Choice "d" is correct, $1,250,000 consolidated stockholders' equity (the same as the parent company).

**Rule:** At date of acquisition, the consolidated equity will be the same as the parent company's equity. The subsidiary company's equity accounts are eliminated.

**CPA-00486 Type1 M/C A-D Corr Ans: A PM#13 F 3-06**

53. CPA-00486 May 91 I #13 (Adapted) Page 29

The separate condensed balance sheets and income statements of Purl Corp. and its wholly-owned subsidiary, Scott Corp., are as follows:

**BALANCE SHEETS**
**December 31, 1990**

| | *Purl* | *Scott* |
|---|---|---|
| *Assets* | | |


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| | | |
|---|---|---|
| Current assets | | |
| Cash | $ 80,000 | $ 60,000 |
| Accounts receivable (net) | 140,000 | 25,000 |
| Inventories | 90,000 | 50,000 |
| Total current assets | 310,000 | 135,000 |
| Property, plant, and equipment (net) | 625,000 | 280,000 |
| Investment in Scott (equity method) | 400,000 | - |
| Total assets | $1,335,000 | $415,000 |
| | *Liabilities and Stockholders' Equity* | |
| Current liabilities | | |
| Accounts payable | $ 160,000 | $ 95,000 |
| Accrued liabilities | 110,000 | 30,000 |
| Total current liabilities | 270,000 | 125,000 |
| Stockholders' equity | | |
| Common stock ($10 par) | 300,000 | 50,000 |
| Additional paid-in capital | - | 10,000 |
| Retained earnings | 765,000 | 230,000 |
| Total stockholders' equity | 1,065,000 | 290,000 |
| Total liabilities and stockholders' equity | $1,335,000 | $415,000 |

**INCOME STATEMENTS**
For the Year Ended December 31, 1990

| | *Purl* | *Scott* |
|---|---|---|
| Sales | $2,000,000 | $750,000 |
| Cost of goods sold | 1,540,000 | 500,000 |
| Gross margin | 460,000 | 250,000 |
| Operating expenses | 260,000 | 150,000 |
| Operating income | 200,000 | 100,000 |
| Equity in earnings of Scott | 70,000 | - |
| Income before income taxes | 270,000 | 100,000 |
| Provision for income taxes | 60,000 | 30,000 |
| Net income | $ 210,000 | $ 70,000 |

Additional information:

- On January 1, 1990, Purl purchased for $360,000 all of Scott's $10 par, voting common stock. On January 1, 1990, the fair value of Scott's assets and liabilities equaled their carrying amount of $395,000 and $145,000, respectively, except that the fair values of certain items identifiable in Scott's inventory were $10,000 more than their carrying amounts. These items were still on hand at December 31, 1990.
- During 1990, Purl and Scott paid cash dividends of $100,000 and $30,000, respectively. For tax purposes, Purl receives the 100% exclusion for dividends received from Scott.
- There were no intercompany transactions, except for Purl's receipt of dividends from Scott and Purl's recording of its share of Scott's earnings.
- Both Purl and Scott paid income taxes at the rate of 30%.
- During Year X, there was no impairment of goodwill.

In the December 31, 1990, consolidated financial statements of Purl and its subsidiary:

Total current assets should be:

a. $455,000
b. $445,000


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c. $310,000
d. $135,000

**CPA-00486 Explanation**
Choice "a" is correct, $455,000 total current assets.

| | |
|---|---|
| Purl | $310,000 |
| Scott | 135,000 |
| Inventory adjust to FMV | 10,000 |
| | $455,000 |

**CPA-00492 Type1 M/C A-D Corr Ans: D PM#14 F 3-06**

54. CPA-00492 May 91 I #15 (Adapted) Page 22

The separate condensed balance sheets and income statements of Purl Corp. and its wholly-owned subsidiary, Scott Corp., are as follows:

**BALANCE SHEETS**
**December 31, 1990**

| | *Purl* | *Scott* |
|---|---|---|
| *Assets* | | |
| Current assets | | |
| Cash | $ 80,000 | $ 60,000 |
| Accounts receivable (net) | 140,000 | 25,000 |
| Inventories | 90,000 | 50,000 |
| Total current assets | 310,000 | 135,000 |
| Property, plant, and equipment (net) | 625,000 | 280,000 |
| Investment in Scott (equity method) | 400,000 | - |
| Total assets | $1,335,000 | $415,000 |
| | *Liabilities and Stockholders' Equity* | |
| Current liabilities | | |
| Accounts payable | $ 160,000 | $ 95,000 |
| Accrued liabilities | 110,000 | 30,000 |
| Total current liabilities | 270,000 | 125,000 |
| Stockholders' equity | | |
| Common stock ($10 par) | 300,000 | 50,000 |
| Additional paid-in capital | - | 10,000 |
| Retained earnings | 765,000 | 230,000 |
| Total stockholders' equity | 1,065,000 | 290,000 |
| Total liabilities and stockholders' equity | $1,335,000 | $415,000 |

**INCOME STATEMENTS**
For the Year Ended December 31, 1990

| | *Purl* | *Scott* |
|---|---|---|
| Sales | $2,000,000 | $750,000 |
| Cost of goods sold | 1,540,000 | 500,000 |
| Gross margin | 460,000 | 250,000 |
| Operating expenses | 260,000 | 150,000 |
| Operating income | 200,000 | 100,000 |
| Equity in earnings of Scott | 70,000 | - |
| Income before income taxes | 270,000 | 100,000 |
| Provision for income taxes | 60,000 | 30,000 |
| Net income | $ 210,000 | $ 70,000 |


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Additional information:

- On January 1, 1990, Purl purchased for $360,000 all of Scott's $10 par, voting common stock. On January 1, 1990, the fair value of Scott's assets and liabilities equaled their carrying amount of $395,000 and $145,000, respectively, except that the fair values of certain items identifiable in Scott's inventory were $10,000 more than their carrying amounts. These items were still on hand at December 31, 1990.
- During 1990, Purl and Scott paid cash dividends of $100,000 and $30,000, respectively. For tax purposes, Purl receives the 100% exclusion for dividends received from Scott.
- There were no intercompany transactions, except for Purl's receipt of dividends from Scott and Purl's recording of its share of Scott's earnings.
- Both Purl and Scott paid income taxes at the rate of 30%.
- During Year X, there was no impairment of goodwill.

In the December 31, 1990, consolidated financial statements of Purl and its subsidiary:

Total retained earnings should be:

a. $985,000
b. $825,000
c. $795,000
d. $765,000

**CPA-00492 Explanation**
Choice "d" is correct, $765,000 total retained earnings. Consolidated retained earnings are the same as the parent company retained earnings, when financial statements are consolidated under the acquisition method.

**CPA-00494 Type1 M/C A-D Corr Ans: B PM#15 F 3-06**

55. CPA-00494 May 91 I #16 (Adapted) Page 22

The separate condensed balance sheets and income statements of Purl Corp. and its wholly-owned subsidiary, Scott Corp., are as follows:

**BALANCE SHEETS**
**December 31, 1990**

| | *Purl* | *Scott* |
|---|---|---|
| *Assets* | | |
| Current assets | | |
| Cash | $ 80,000 | $ 60,000 |
| Accounts receivable (net) | 140,000 | 25,000 |
| Inventories | 90,000 | 50,000 |
| Total current assets | 310,000 | 135,000 |
| Property, plant, and equipment (net) | 625,000 | 280,000 |
| Investment in Scott (equity method) | 400,000 | - |
| Total assets | $1,335,000 | $415,000 |
| | *Liabilities and Stockholders' Equity* | |
| Current liabilities | | |
| Accounts payable | $ 160,000 | $ 95,000 |
| Accrued liabilities | 110,000 | 30,000 |
| Total current liabilities | 270,000 | 125,000 |
| Stockholders' equity | | |
| Common stock ($10 par) | 300,000 | 50,000 |
| Additional paid-in capital | - | 10,000 |


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| | | |
|---|---|---|
| Retained earnings | 765,000 | 230,000 |
| Total stockholders' equity | 1,065,000 | 290,000 |
| Total liabilities and stockholders' equity | $1,335,000 | $415,000 |

**INCOME STATEMENTS**
For the Year Ended December 31, 1990

| | *Purl* | *Scott* |
|---|---|---|
| Sales | $2,000,000 | $750,000 |
| Cost of goods sold | 1,540,000 | 500,000 |
| Gross margin | 460,000 | 250,000 |
| Operating expenses | 260,000 | 150,000 |
| Operating income | 200,000 | 100,000 |
| Equity in earnings of Scott | 70,000 | - |
| Income before income taxes | 270,000 | 100,000 |
| Provision for income taxes | 60,000 | 30,000 |
| Net income | $ 210,000 | $ 70,000 |

Additional information:

- On January 1, 1990, Purl purchased for $360,000 all of Scott's $10 par, voting common stock. On January 1, 1990, the fair value of Scott's assets and liabilities equaled their carrying amount of $395,000 and $145,000, respectively, except that the fair values of certain items identifiable in Scott's inventory were $10,000 more than their carrying amounts. These items were still on hand at December 31, 1990.
- During 1990, Purl and Scott paid cash dividends of $100,000 and $30,000, respectively. For tax purposes, Purl receives the 100% exclusion for dividends received from Scott.
- There were no intercompany transactions, except for Purl's receipt of dividends from Scott and Purl's recording of its share of Scott's earnings.
- Both Purl and Scott paid income taxes at the rate of 30%.
- During Year X, there was no impairment of goodwill.

In the December 31, 1990, consolidated financial statements of Purl and its subsidiary:

Net income should be:

a. $270,000
b. $210,000
c. $190,000
d. $170,000

**CPA-00494 Explanation**
Choice "b" is correct, $210,000 net income. Consolidated net income is the same as parent company net income, when the equity method is used.

**CPA-00590 Type1 M/C A-D Corr Ans: C PM#16 F 3-06**

56. CPA-00590 PI May 93 #25 Page 16

On November 30, 1992, Parlor, Inc. purchased for cash at $15 per share all 250,000 shares of the outstanding common stock of Shaw Co. At November 30, 1992, Shaw's balance sheet showed a carrying amount of net assets of $3,000,000. At that date, the fair value of Shaw's property, plant and equipment exceeded its carrying amount by $400,000. In its November 30, 1992, consolidated balance sheet, what amount should Parlor report as goodwill?

a. $750,000
b. $400,000


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c. $350,000
d. $0

**CPA-00590 Explanation**
Choice "c" is correct. Goodwill is the difference between the fair value of the subsidiary of $3,750,000 ($15 x $250,000) and fair market value of the net assets acquired, $3,400,000. $3,750,000 - $3,400,000 = $350,000. APB 16 para. 87

Choice "a" is incorrect. Goodwill is the difference between the fair value of the subsidiary and the fair market value of the net assets acquired, not the carrying amount.

Choice "b" is incorrect. Goodwill is the difference between the fair value of the subsidiary and fair market value of the net assets acquired, not the difference between carrying value and the fair market value of the assets acquired.

Choice "d" is incorrect. Goodwill is recorded in the acquisition. It is the fair value of the subsidiary less the fair market value of the net assets acquired.

**CPA-05617 Type1 M/C A-D Corr Ans: D PM#17 F 3-06**

57. CPA-05617 Page 27

On January 1, 20X5, Placid Company acquired 80% of Serene Company's 100,000 shares of common stock for $1,600,000. Placid accounts for the investment internally using the cost method. On January 1, 20X9, Placid sold 50,000 shares of Serene for $25 per share. What is the total gain to be reported on Placid's 20X9 income statement?

a. $0
b. $150,000
c. $250,000
d. $400,000

**CPA-05617 Explanation**
Choice "d" is correct. When an investor sells shares and goes from control to non-control, the investor must recognize a gain or loss from the sale of the stock and then remeasure the remaining non-consolidating interest to fair value. The fair value adjustment is recognized as an additional gain or loss on the income statement.

In 20X5, Placid purchased 80,000 shares (80% x 100,000) for $1,600,000 or $20 per share ($1,600,000 / 80,000 shares = $20/share). When Placid sells 50,000 shares on 1/1/X9, the company will recognize a gain on the sale, which will be recorded as follows:

| | | | | |
|---|---|---|---|---|
| Dr. | Cash | $1,250,000 | | (50,000 shares x $25/share sale price) |
| Cr. | Investment in Serene | | $1,000,000 | (50,000 shares x $20/share cost) |
| Cr. | Gain | | 250,000 | |

The remaining 30,000 shares must be remeasured to fair value on 1/1/X9 by recording a gain due to the increase in the price per share from $20 cost on 1/1/X5 to the $25 fair value on 1/1/X9:

| | | | | |
|---|---|---|---|---|
| Dr. | Investment in Serene | $150,000 | | (30,000 shares x ($25 - $20)) |
| Cr. | Gain | | $150,000 | |

The total gain related to the sale and remeasurement is $400,000 ($250,000 gain on sale + $150,000 gain on remeasurement).

Choice "a" is incorrect. A gain must be reported from the partial sale of the investment and the remeasurement of the remaining shares.

Choice "b" is incorrect. This is the gain from the remeasurement of the remaining shares only, not the total gain.

Choice "c" is incorrect. This is the gain from the sale of the 50,000 shares only, not the total gain.


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**CPA-05618 Type1 M/C A-D Corr Ans: D PM#18 F 3-06**

58. CPA-05618 Page 34

On January 1, 20X9, Paul Corporation acquired 80% of Saul Corporation's 200,000 shares of the outstanding common stock of for $5,000,000. Paul did not pay a control premium in the acquisition. On the date of acquisition, the $6,000,000 book value of Saul's net assets equaled fair value. During 20X9, Saul reported net income of $550,000 and paid dividends of $165,000. What is the noncontrolling interest that will be reported on Paul Corporation's December 31, 20X9 consolidated balance sheet?

a. $1,200,000
b. $1,250,000
c. $1,277,000
d. $1,327,000

**CPA-05618 Explanation**

Choice "d" is correct. The noncontrolling interest to be reported on the December 31, 20X9 balance sheet is equal to the noncontrolling interest on January 1, 20X9, adjusted for the noncontrolling shareholders' share of Saul's 20X9 income and dividends.

Noncontrolling interest on January 1, 20X9 is the fair value of the portion of Saul Corporation that was not acquired by Paul Corporation. Because no control premium was paid by Paul, the fair value of Saul can be calculated using the acquisition price:

Fair Value of Saul x 80% = Acquisition Price
Fair Value of Saul x 80% = $5,000,000
Fair Value of Saul = $5,000,000 / 80% = $6,250,000

Using the total fair value of Saul, the noncontrolling interest in Saul on the acquisition date can be calculated:

$6,250,000 x 20% = $1,250,000

The noncontrolling interest in Saul on December 31, 20X9 is:

| | |
|---|---|
| Beginning Noncontrolling Interest | $1,250,000 |
| + 20% of Saul's Net Income | 110,000 |
| - 20% of Saul's Dividends | (33,000) |
| Ending Noncontrolling Interest | $1,327,000 |

Choice "a" is incorrect. This is the book value of the noncontrolling interest on January 1, 20X9. The noncontrolling interest is recognized at fair value.

Choice "b" is incorrect. This is the fair value of the noncontrolling interest on January 1, 20X9. The question asks for the year end value.

Choice "c" is incorrect. This is the book value of the noncontrolling interest on January 1, 20X9, adjusted for the noncontrolling shareholders' share of Saul's 20X9 income and dividends. Noncontrolling interest is recognized at fair value, not at book value.

**CPA-05619 Type1 M/C A-D Corr Ans: B PM#19 F 3-06**

59. CPA-05619 Page 35

During 20X8, Poppy Inc. acquired 100% of Seed Inc. by issuing 250,000 shares of its common stock. The acquisition was announced on March 31, 20X8, when Poppy's common stock was selling for $45 per share, and finalized on October 15, 20X8, when the market price of Poppy's common stock was $50 per share. On October 15, 20X8, Seed's net assets had a book value of $10,750,000. Book value equaled fair value for all recognized assets and liabilities, expect land, which had a fair value $500,000 higher than book value. Seed also had unpatented technology with a fair value of $225,000 and in-process research and development with a fair value of $365,000. What is the goodwill to be reported on Poppy Inc.'s December 31, 20X8 balance sheet?


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a. $500,000
b. $660,000
c. $1,250,000
d. $1,750,000

**CPA-05619 Explanation**
Choice "b" is correct. The acquisition price paid by Poppy is calculated on the date the acquisition is finalized:

Acquisition Price on 10/15/X8 = 250,000 shares x $50/share = $12,500,000

The difference between the $12,500,000 acquisition price (the fair value of Seed Inc.) and the $10,750,000 book value of the net assets acquired must be allocated first to adjusting 100% of the existing balance sheet from book value to fair value, second recognizing 100% of the fair value of all identifiable intangible assets and finally recognizing any excess as goodwill:

| | |
|---|---|
| FV of Seed Inc. | $12,500,000 |
| - Balance Sheet of Seed at BV | (10,750,000) |
| - Adjust Balance Sheet to FV | (500,000) |
| - Recognize Identifiable Intangibles at FV | (590,000) |
| Excess is Goodwill | $ 660,000 |

The acquisition date eliminating journal entry would be:

| | | | |
|---|---|---|---|
| Dr. | Equity - Seed (CAR) | $10,750,000 | |
| Cr. | Investment in Seed | | $12,500,000 |
| Cr. | Noncontrolling Interest | | $ 0 |
| Dr. | Balance Sheet Adjusted to FV | $ 500,000 | |
| Dr. | Identifiable Intangible Assets at FV | $ 590,000 | |
| Dr. | Goodwill | $ 660,000 | |

Choice "a" is incorrect. The $500,000 balance sheet fair value adjustment for land is not recognized as goodwill.

Choice "c" is incorrect. The fair value of the identifiable intangible assets must be recognized before calculating goodwill.

Choice "d" is incorrect. Goodwill is not the difference between the acquisition price and the book value of the net assets acquired.

**CPA-05620 Type1 M/C A-D Corr Ans: A PM#20 F 3-06**

60. CPA-05620 Page 24

On January 1, 20X9, Pacific Corporation acquired 75% of Sand Corporation's 200,000 outstanding common shares for $2,850,000. The remaining shares traded at $18.50 per share on the acquisition date. On January 1, the book value of Sand's net assets was $3,000,000. Book value equaled fair value for all of Sand's assets and liabilities except land, which had a fair value $200,000 greater than book value, and equipment, which had a fair value $150,000 greater than book value. On January 1, 20X9, Sand had a noncompete agreement with a fair value of $300,000. What is the goodwill to be reported on Pacific Corporation's December 31, 20X9 balance sheet?

a. $125,000
b. $287,500
c. $337,500
d. $425,000

**CPA-05620 Explanation**
Choice "a" is correct. On the acquisition date, the fair value of the subsidiary is the total of the acquisition price paid by the parent and the fair value of the noncontrolling interest:

| | |
|---|---|
| Acquisition Price | $2,850,000 |


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| | | |
|---|---|---|
| + FV of Noncontrolling Interest | 925,000 | [(200,000 shares x 25%) x $18.50 per share] |
| FV of Sand Corporation | $3,775,000 | |

The difference between the $3,775,000 fair value of the subsidiary and the $3,000,000 book value of Sand's net assets acquired must be allocated first to adjusting 100% of the existing balance sheet from book value to fair value, second recognizing 100% of the fair value of all identifiable intangible assets and finally recognizing any excess as goodwill:

| | |
|---|---|
| FV of Sand Corporation | $3,775,000 |
| - Balance Sheet of Sand at BV | (3,000,000) |
| - Adjust Balance Sheet to FV | (350,000) |
| - Recognize Identifiable Intangibles at FV | (300,000) |
| Excess is Goodwill | $ 125,000 |

The acquisition date eliminating journal entry would be:

| | | | |
|---|---|---|---|
| Dr. | Equity - Sand (CAR) | $3,000,000 | |
| Cr. | Investment in Sand | | $2,850,000 |
| Cr. | Noncontrolling Interest | | $ 925,000 |
| Dr. | Balance Sheet Adjusted to FV | $ 350,000 | |
| Dr. | Identifiable Intangible Assets at FV | $ 300,000 | |
| Dr. | Goodwill | $ 125,000 | |

Choice "b" is incorrect. This answer is calculated by incorrectly recognizing 75% of the balance sheet fair value adjustment and 75% of the fair value of the identifiable intangible assets. The acquisition method required that 100% of the fair value of the balance sheet, including identifiable intangible assets, be reported in the consolidated financial statements.

Choice "c" is incorrect. This answer is calculated by incorrectly recognizing the noncontrolling interest at book value, recognizing only 75% of the balance sheet fair value adjustment and recognizing no identifiable intangible assets. This methodology is not correct under the acquisition method.

Choice "d" is incorrect. This answer is calculated by failing to recognize the fair value of the identifiable intangible assets.

**CPA-05621 Type1 M/C A-D Corr Ans: D PM#21 F 3-06**

61. CPA-05621 Page 38

On October 1, 20X8, Pepper Inc. acquired 100% of Salt Inc. for $275,000. On that date, the carrying values of Salt Inc.'s assets and liabilities were $450,000 and $200,000, respectively. The fair values of Salt's assets and liabilities were $550,000 and $200,000, respectively. Additionally, Salt had identifiable intangible assets at the time of acquisition with a fair value of $60,000. What is the gain to be reported on Pepper's December 31, 20X8 consolidated income statement?

a. $0
b. $25,000
c. $75,000
d. $135,000

**CPA-05621 Explanation**

Choice "d" is correct. When acquiring a corporation with an acquisition cost that is less than the fair value of 100% of the underlying net assets acquired, the balance sheet, including any identifiable intangible assets, must be adjusted to fair value. This creates a negative balance in the acquisition cost account, which is recorded as a gain.

| | |
|---|---|
| Investment in subsidiary | $275,000 |
| Liabilities assumed | 200,000 |
| Acquisition cost | $475,000 |
| Adjust balance sheet to FV | (550,000) |
| Record identifiable intangibles at FV | (60,000) |


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| | |
|---|---|
| Gain | $(135,000) |

The eliminating journal entry on the date of acquisition would be:

| | | | |
|---|---|---|---|
| Dr. | Equity - subsidiary (CAR) | $250,000 | |
| Cr. | Investment in subsidiary | | $275,000 |
| Cr. | Noncontrolling interest | | $ 0 |
| Dr. | Balance sheet adjustment | $100,000 | |
| Dr. | Intangible assets | $ 60,000 | |
| Cr. | Gain | | $135,000 |

Choice "a" is incorrect. A gain must be recorded because the fair value of the underlying net assets acquired is greater than the acquisition price.

Choice "b" is incorrect. The gain is not the difference between the purchase price and the book value of the net assets acquired.

Choice "c" is incorrect. The fair value of the identifiable intangible assets must be recognized at the time of acquisition.

**Intercompany Transactions**

**CPA-00432 Type1 M/C A-D Corr Ans: B PM#1 F 3-07**

62. CPA-00432 FARE Nov 95 #49 Page 34

On January 2, 1994, Pare Co. acquired 75% of Kidd Co.'s outstanding common stock. Selected balance sheet data at December 31, 1994, is as follows:

| | *Pare* | *Kidd* |
|---|---|---|
| Total assets | $420,000 | $180,000 |
| Liabilities | 120,000 | 60,000 |
| Common stock | 100,000 | 50,000 |
| Retained earnings | 200,000 | 70,000 |
| | $420,000 | $180,000 |

During 1994, Pare and Kidd paid cash dividends of $25,000 and $5,000, respectively, to their shareholders. There were no other intercompany transactions.

In its December 31, 1994, consolidated statement of retained earnings, what amount should Pare report as dividends paid?

a. $5,000
b. $25,000
c. $26,250
d. $30,000

**CPA-00432 Explanation**
Choice "b" is correct, $25,000 consolidated dividends paid (same as parent dividends paid) since dividends paid by sub (Kidd) are 100% eliminated in consolidation.

Interco. dividends paid by Kidd to Pare (5,000 x .75 = 3,750) should be eliminated.

The dividends paid to the noncontrolling shareholders (5,000 x .25 = 1,250) would decrease their noncontrolling interest.

| Eliminating Entry: | *Dr* | *Cr* |
|---|---|---|
| Investment in Kidd | 3,750 | |
| Noncontrolling interest | 1,250 | |
| Dividends paid/retained earnings | | 5,000 |

**CPA-00433 Type1 M/C A-D Corr Ans: B PM#2 F 3-07**


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63. CPA-00433 FARE Nov 95 #50 Page 27

On January 2, 1994, Pare Co. acquired 75% of Kidd Co.'s outstanding common stock. On the acquisition date, the book value of Kidd's assets and liabilities equaled their fair values. Selected balance sheet data at December 31, 1994, is as follows:

| | *Pare* | *Kidd* |
|---|---|---|
| Total assets | $420,000 | $180,000 |
| Liabilities | 120,000 | 60,000 |
| Common stock | 100,000 | 50,000 |
| Retained earnings | 200,000 | 70,000 |
| | $420,000 | $180,000 |

During 1994, Pare and Kidd paid cash dividends of $25,000 and $5,000, respectively, to their shareholders. There were no other intercompany transactions.

In Pare's December 31, 1994, consolidated balance sheet, what amount should be reported as noncontrolling interest in net assets?

a. $0
b. $30,000
c. $45,000
d. $105,000

**CPA-00433 Explanation**
Choice "b" is correct, $30,000 noncontrolling interest in net assets at 12/31/94.

| | |
|---|---|
| Total assets @ fair value - Kidd | $180,000 |
| Total liabilities @ fair value - Kidd | (60,000) |
| Fair value of net assets - Kidd (com stk 50,000 + re 70,000) | 120,000 |
| Noncontrolling interest percentage (100% - 75%) | 25% |
| Amount to report as noncontrolling interest | $ 30,000 |

**CPA-00435 Type1 M/C A-D Corr Ans: B PM#3 F 3-07**

64. CPA-00435 FARE Nov 95 #51 Page 23

On January 2, 1994, Pare Co. purchased 75% of Kidd Co.'s outstanding common stock. Selected balance sheet data at December 31, 1994, is as follows:

| | *Pare* | *Kidd* |
|---|---|---|
| Total assets | $420,000 | $180,000 |
| Liabilities | 120,000 | 60,000 |
| Common stock | 100,000 | 50,000 |
| Retained earnings | 200,000 | 70,000 |
| | $420,000 | $180,000 |

During 1994, Pare and Kidd paid cash dividends of $25,000 and $5,000, respectively, to their shareholders. There were no other intercompany transactions.

In its December 31, 1994, consolidated balance sheet, what amount should Pare report as common stock?

a. $50,000
b. $100,000
c. $137,500
d. $150,000

**CPA-00435 Explanation**
Choice "b" is correct, $100,000 consolidated common stock at 12/31/94 (same as parent).

**Rule:** 100% of a purchased subsidiary's shareholders' equity (including common stock) as of the date of acquisition is eliminated in consolidation.


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**CPA-00436 Type1 M/C A-D Corr Ans: D PM#4 F 3-07**

65. CPA-00436 FARE May 95 #50 Page 34

Selected information from the separate and consolidated balance sheets and income statements of Pare, Inc. and its subsidiary, Shel Co., as of December 31, 1994, and for the year then ended is as follows:

| | *Pare* | *Shel* | *Consolidated* |
|---|---|---|---|
| Balance sheet accounts | | | |
| Accounts receivable | $ 52,000 | $ 38,000 | $ 78,000 |
| Inventory | 60,000 | 50,000 | 104,000 |
| Income statement accounts | | | |
| Revenues | $400,000 | $280,000 | $616,000 |
| Cost of goods sold | 300,000 | 220,000 | 462,000 |
| Gross profit | $100,000 | $ 60,000 | $154,000 |

Additional information:

During 1994, Pare sold goods to Shel at the same markup on cost that Pare uses for all sales.

What was the amount of intercompany sales from Pare to Shel during 1994?

a. $ 6,000
b. $12,000
c. $58,000
d. $64,000

**CPA-00436 Explanation**
Choice "d" is correct, $64,000 interco sales.

| | |
|---|---|
| Revenues - Pare | $ 400,000 |
| Revenues - Shel | 280,000 |
| | 680,000 |
| Revenues - consolidated | (616,000) |
| Interco sales | $ 64,000 |

**CPA-00437 Type1 M/C A-D Corr Ans: B PM#5 F 3-07**

66. CPA-00437 FARE May 95 #51 Page 34

Selected information from the separate and consolidated balance sheets and income statements of Pare, Inc. and its subsidiary, Shel Co., as of December 31, 1994, and for the year then ended is as follows:

| | *Pare* | *Shel* | *Consolidated* |
|---|---|---|---|
| Balance sheet accounts | | | |
| Accounts receivable | $ 52,000 | $ 38,000 | $ 78,000 |
| Inventory | 60,000 | 50,000 | 104,000 |
| Income statement accounts | | | |
| Revenues | $400,000 | $280,000 | $616,000 |
| Cost of goods sold | 300,000 | 220,000 | 462,000 |
| Gross profit | $100,000 | $ 60,000 | $154,000 |

Additional information:

During 1994, Pare sold goods to Shel at the same markup on cost that Pare uses for all sales.

At December 31, 1994, what was the amount of Shel's payable to Pare for intercompany sales?

a. $6,000
b. $12,000
c. $58,000


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d. $64,000

**CPA-00437 Explanation**
Choice "b" is correct, $12,000 interco payable.

The interco receivable/payable due from Shel to Pare should equal the interco receivable from Pare to Shel

| | |
|---|---|
| Accounts receivable – Pare | $52,000 |
| Accounts receivable – Shel | 38,000 |
| | 90,000 |
| Receivables – consolidated | 78,000 |
| Interco payable | $12,000 |

**CPA-00440 Type1 M/C A-D Corr Ans: A PM#6 F 3-07**

67. CPA-00440 FARE May 95 #52 Page 34

Selected information from the separate and consolidated balance sheets and income statements of Pare, Inc. and its subsidiary, Shel Co., as of December 31, 1994, and for the year then ended is as follows:

| | *Pare* | *Shel* | *Consolidated* |
|---|---|---|---|
| Balance sheet accounts | | | |
| Accounts receivable | $ 52,000 | $ 38,000 | $ 78,000 |
| Inventory | 60,000 | 50,000 | 104,000 |
| Income statement accounts | | | |
| Revenues | $400,000 | $280,000 | $616,000 |
| Cost of goods sold | 300,000 | 220,000 | 462,000 |
| Gross profit | $100,000 | $ 60,000 | $154,000 |

Additional information:

During 1994, Pare sold goods to Shel at the same markup on cost that Pare uses for all sales.

In Pare's consolidating worksheet, what amount of unrealized intercompany profit was eliminated?

a. $6,000
b. $12,000
c. $58,000
d. $64,000

**CPA-00440 Explanation**
Choice "a" is correct, $6,000 unrealized interco profit eliminated.

| | |
|---|---|
| Inventory - Pare | $ 60,000 |
| Inventory - Shel | 50,000 |
| | 110,000 |
| Inventory - consolidated | 104,000 |
| Unrealized interco profit eliminated | $ 6,000 |

**CPA-00442 Type1 M/C A-D Corr Ans: A PM#7 F 3-07**

68. CPA-00442 Nov 94 #56 Page 34

Sun, Inc. is a wholly owned subsidiary of Patton, Inc. On June 1, 1993, Patton declared and paid a $1 per share cash dividend to stockholders of record on May 15, 1993. On May 1, 1993, Sun bought 10,000 shares of Patton's common stock for $700,000 on the open market, when the book value per share was $30. What amount of gain should Patton report from this transaction in its consolidated income statement for the year ended December 31,1993?

a. $0


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b. $390,000
c. $400,000
d. $410,000

**CPA-00442 Explanation**
Choice "a" is correct, $0 gain from the purchase of Patton's (parent) stock by Sun (subsidiary). The purchase by the member of a consolidated group of stock of another member of the consolidated group is treated as a treasury stock transaction. This follows the theory of consolidated financial statements presenting one economic entity. (You cannot make money selling stock to yourself.)

**CPA-00443 Type1 M/C A-D Corr Ans: A PM#8 F 3-07**

69. CPA-00443 FARE May 94 #16 Page 35

In its financial statements, Pare, Inc. uses the fair value method of accounting for its 15% ownership of Sabe Co. At December 31, 1993, Pare has a receivable from Sabe. How should the receivable be reported in Pare's December 31, 1993, balance sheet?

a. The total receivable should be reported separately.
b. The total receivable should be included as part of the investment in Sabe, without separate disclosure.
c. Eighty-five percent of the receivable should be reported separately, with the balance offset against Sabe's payable to Pare.
d. The total receivable should be offset against Sabe's payable to Pare, without separate disclosure.

**CPA-00443 Explanation**
Choice "a" is correct; the total receivable should be reported separately.

**Rule:** When a company owns less than 50% of the common stock of an investee corporation, the investment account can be reported under the cost or equity method, depending on whether significant influence is exercised. Receivables and payables to the investee are reported separately on the balance sheet.

Choice "b" is incorrect. The receivable is not part of the investment.

Choice "c" is incorrect. 100% must be disclosed and there can be no elimination.

Choice "d" is incorrect. Receivables and payables must be presented separately with separate disclosure made in the footnotes.

**CPA-00446 Type1 M/C A-D Corr Ans: A PM#9 F 3-07**

70. CPA-00446 FARE May 94 #56 (Adapted) Page 23

On January 1, 1993, Owen Corp. acquired all of Sharp Corp.'s common stock for $1,200,000. On that date, the fair values of Sharp's assets and liabilities equaled their carrying amounts of $1,320,000 and $320,000, respectively. During 1993, Sharp paid cash dividends of $20,000.

Selected information from the separate balance sheets and income statements of Owen and Sharp as of December 31, 1993, and for the year then ended follows:

| | *Owen* | *Sharp* |
|---|---|---|
| Balance sheet accounts | | |
| Investment in subsidiary | $1,300,000 | - |
| Retained earnings | 1,240,000 | 540,000 |
| Total stockholders' equity | 2,620,000 | 1,100,000 |
| | | |
| Income statement accounts | | |
| Operating income | 420,000 | 200,000 |
| Equity in earnings of Sharp | 120,000 | - |
| Net income | 400,000 | 120,000 |


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In Owen's December 31, 1993, consolidated balance sheet, what amount should be reported as total retained earnings?

a. $1,240,000
b. $1,360,000
c. $1,380,000
d. $1,800,000

**CPA-00446 Explanation**
Choice "a" is correct, $1,240,000 consolidated retained earnings. The parent company equity account at 12/31/93 (per the facts of the question) becomes the consolidated equity account when the acquisition method is used.

**Note:** When using the acquisition method, 100% of the subsidiary equity accounts are eliminated in consolidation.

**CPA-00450 Type1 M/C A-D Corr Ans: B PM#11 F 3-07**

71. CPA-00450 May 93 T #4 Page 39

Port, Inc. owns 100% of Salem Inc. On January 1, 1992, Port sold Salem delivery equipment at a gain. Port had owned the equipment for two years and used a five-year straight-line depreciation rate with no residual value. Salem is using a three-year straight-line depreciation rate with no residual value for the equipment. In the consolidated income statement, Salem's recorded depreciation expense on the equipment for 1992 will be decreased by:

a. 20% of the gain on sale.
b. 33 1/3% of the gain on sale.
c. 50% of the gain on sale.
d. 100% of the gain on sale.

**CPA-00450 Explanation**
Choice "b" is correct; depreciation expense will be decreased by 33 1/3% of the gain on sale, the amount that depreciation expense has been overstated.

Example:

| | |
|---|---|
| Original purchase price by Port | $100 |
| Two years' depreciation ($100 ÷ 5 = $20 per year × 2) | (40) |
| Net book value at date of sale | 60 |
| Sale price to Salem | 75 |
| Gain on sale | $ 15 |
| | |
| Depreciation expense recorded by Salem ($75 ÷ 3 year life) | $ 25 |
| Consolidated depreciation expense ($100 ÷ 5 year life) | 20 |
| Elimination of excess depreciation ($15 gain x 1/3) | 5 |

**CPA-00452 Type1 M/C A-D Corr Ans: C PM#12 F 3-07**

72. CPA-00452 May 93 I #9 Page 36

Clark Co. had the following transactions with affiliated parties during 1992:

- Sales of $60,000 to Dean, Inc., with $20,000 gross profit. Dean had $15,000 of inventory on hand at year-end. Clark owns a 15% interest in Dean and does not exert significant influence.
- Purchases of raw materials totaling $240,000 from Kent Corp., a wholly-owned subsidiary. Kent's gross profit on the sale was $48,000. Clark had $60,000 of this inventory remaining on December 31,1992.

Before eliminating entries, Clark had consolidated current assets of $320,000. What amount should Clark report in its December 31,1992, consolidated balance sheet for current assets?


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a. $320,000
b. $317,000
c. $308,000
d. $303,000

**CPA-00452 Explanation**
Choice "c" is correct, $308,000 current assets in the 12/31/92 consolidated balance sheet ($320,000 less 12,000 unrealized profit in inventory).

| | |
|---|---|
| Inventory on hand at year end | $ 60,000 |
| Gross profit percentage (48,000 ÷ 240,000) | 20% |
| Amount to eliminate from ending inventory | $ 12,000 |

**Note:** No elimination is made related to the transaction with Dean, Inc. because Dean (owned less than 50%) is not consolidated.

**CPA-00459 Type1 M/C A-D Corr Ans: D PM#14 F 3-07**

73. CPA-00459 Nov 92 I #14 (Adapted) Page 36

Selected information from the separate and consolidated balance sheets and income statements of Pard, Inc. and its subsidiary, Spin Co., as of December 31, 1991, and for the year then ended is as follows:

| | *Pard* | *Spin* | *Consolidated* |
|---|---|---|---|
| Balance sheet accounts | | | |
| Accounts receivable | $ 26,000 | $ 19,000 | $ 39,000 |
| Inventory | 30,000 | 25,000 | 52,000 |
| Investment in Spin | 67,000 | - | - |
| Goodwill | - | - | 30,000 |
| Noncontrolling interest | - | - | 10,000 |
| Stockholders, equity | 154,000 | 50,000 | 154,000 |

| | *Pard* | *Spin* | *Consolidated* |
|---|---|---|---|
| Income statement accounts | | | |
| Revenues | $200,000 | $140,000 | $308,000 |
| Cost of goods sold | 150,000 | 110,000 | 231,000 |
| Gross profit | 50,000 | 30,000 | 77,000 |
| Equity in earnings of Spin | 11,000 | - | - |
| Net income | 36,000 | 20,000 | 40,000 |

Additional information:

- During 1991, Pard sold goods to Spin at the same markup on cost that Pard uses for all sales. At December 31, 1991, Spin had not paid for all of these goods and still held 37.5% of them in inventory.
- Pard acquired its interest in Spin on January 2, 1988.

What was the amount of intercompany sales from Pard to Spin during 1991?

a. $3,000
b. $6,000
c. $29,000
d. $32,000

**CPA-00459 Explanation**
Choice "d" is correct, $32,000 of intercompany sales from Pard to Spin during 1991.

| | |
|---|---|
| Revenue - Pard | $200,000 |
| Revenue - Spin | 140,000 |
| Total before elim. | 340,000 |
| Consolidated revenue | (308,000) |
| Interco sales elim. | $ 32,000 |


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**CPA-00462 Type1 M/C A-D Corr Ans: B PM#15 F 3-07**

74. CPA-00462 Nov 92 I #15 (Adapted) Page 34

Selected information from the separate and consolidated balance sheets and income statements of Pard, Inc. and its subsidiary, Spin Co., as of December 31, 1991, and for the year then ended is as follows:

| | *Pard* | *Spin* | *Consolidated* |
|---|---|---|---|
| Balance sheet accounts | | | |
| Accounts receivable | $ 26,000 | $ 19,000 | $ 39,000 |
| Inventory | 30,000 | 25,000 | 52,000 |
| Investment in Spin | 67,000 | - | - |
| Goodwill | - | - | 30,000 |
| Noncontrolling interest | - | - | 10,000 |
| Stockholders, equity | 154,000 | 50,000 | 154,000 |

| | *Pard* | *Spin* | *Consolidated* |
|---|---|---|---|
| Income statement accounts | | | |
| Revenues | $200,000 | $140,000 | $308,000 |
| Cost of goods sold | 150,000 | 110,000 | 231,000 |
| Gross profit | 50,000 | 30,000 | 77,000 |
| Equity in earnings of Spin | 11,000 | - | - |
| Net income | 36,000 | 20,000 | 40,000 |

Additional information:

- During 1991, Pard sold goods to Spin at the same markup on cost that Pard uses for all sales. At December 31, 1991, Spin had not paid for all of these goods and still held 37.5% of them in inventory.
- Pard acquired its interest in Spin on January 2, 1988.

At December 31, 1991, what was the amount of Spin's payable to Pard for intercompany sales?

a. $3,000
b. $6,000
c. $29,000
d. $32,000

**CPA-00462 Explanation**
Choice "b" is correct, $6,000 payable.

| | |
|---|---|
| Accts rec - Pard | $26,000 |
| Accts rec - Spin | 19,000 |
| | 45,000 |
| Accts rec consol | (39,000) |
| Interco rec/pay eliminated | $ 6,000 |

**CPA-00464 Type1 M/C A-D Corr Ans: C PM#16 F 3-07**

75. CPA-00464 Nov 92 I #16 (Adapted) Page 36

Selected information from the separate and consolidated balance sheets and income statements of Pard, Inc. and its subsidiary, Spin Co., as of December 31, 1991, and for the year then ended is as follows:

| | *Pard* | *Spin* | *Consolidated* |
|---|---|---|---|
| Balance sheet accounts | | | |
| Accounts receivable | $ 26,000 | $ 19,000 | $ 39,000 |
| Inventory | 30,000 | 25,000 | 52,000 |
| Investment in Spin | 67,000 | - | - |
| Goodwill | - | - | 30,000 |
| Noncontrolling interest | - | - | 10,000 |


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| | | | |
|---|---|---|---|
| Stockholders, equity | 154,000 | 50,000 | 154,000 |

| | *Pard* | *Spin* | *Consolidated* |
|---|---|---|---|
| Income statement accounts | | | |
| Revenues | $200,000 | $140,000 | $308,000 |
| Cost of goods sold | 150,000 | 110,000 | 231,000 |
| Gross profit | 50,000 | 30,000 | 77,000 |
| Equity in earnings of Spin | 11,000 | - | - |
| Net income | 36,000 | 20,000 | 40,000 |

Additional information:

- During 1991, Pard sold goods to Spin at the same markup on cost that Pard uses for all sales. At December 31, 1991, Spin had not paid for all of these goods and still held 37.5% of them in inventory.
- Pard acquired its interest in Spin on January 2, 1988.

In Pard's consolidated balance sheet, what was the carrying amount of the inventory that Spin purchased from Pard?

a. $3,000
b. $6,000
c. $9,000
d. $12,000

**CPA-00464 Explanation**
Choice "c" is correct, $9,000.

| | |
|---|---|
| Inventory - Pard | $30,000 |
| Inventory - Spin | 25,000 |
| Total before interco eliminations | 55,000 |
| Inventory - consolidated | (52,000) |
| Interco profit in end inv - eliminated | $ 3,000 |
| Gross profit margin (50,000 ÷ 200,000) | ÷ 25% |
| Interco inv in end balance sheet | 12,000 |
| Less profit in end inv | (3,000) |
| Carrying amount of interco inventory | $ 9,000 |

**CPA-00466 Type1 M/C A-D Corr Ans: B PM#17 F 3-07**

76. CPA-00466 Nov 92 I #17 (Adapted) Page 27

Selected information from the separate and consolidated balance sheets and income statements of Pard, Inc. and its subsidiary, Spin Co., as of December 31, 1991, and for the year then ended is as follows:

| | *Pard* | *Spin* | *Consolidated* |
|---|---|---|---|
| Balance sheet accounts | | | |
| Accounts receivable | $ 26,000 | $ 19,000 | $ 39,000 |
| Inventory | 30,000 | 25,000 | 52,000 |
| Investment in Spin | 67,000 | - | - |
| Goodwill | - | - | 30,000 |
| Noncontrolling interest | - | - | 10,000 |
| Stockholders, equity | 154,000 | 50,000 | 154,000 |

| | *Pard* | *Spin* | *Consolidated* |
|---|---|---|---|
| Income statement accounts | | | |
| Revenues | $200,000 | $140,000 | $308,000 |
| Cost of goods sold | 150,000 | 110,000 | 231,000 |
| Gross profit | 50,000 | 30,000 | 77,000 |


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| | | | |
|---|---|---|---|
| Equity in earnings of Spin | 11,000 | - | - |
| Net income | 36,000 | 20,000 | 40,000 |

Additional information:

- During 1991, Pard sold goods to Spin at the same markup on cost that Pard uses for all sales. At December 31, 1991, Spin had not paid for all of these goods and still held 37.5% of them in inventory.
- Pard acquired its interest in Spin on January 2, 1988.

What is the percent of noncontrolling interest ownership in Spin?

a. 10%
b. 20%
c. 25%
d. 45%

**CPA-00466 Explanation**
Choice "b" is correct, 20% noncontrolling interest.

| | |
|---|---|
| Minority interest | 10,000 |
| Spin's Equity | 50,000 |

**CPA-00467 Type1 M/C A-D Corr Ans: B PM#18 F 3-07**

77. CPA-00467 Nov 92 T #34 Page 27

A 70%-owned subsidiary company declares and pays a cash dividend. What effect does the dividend have on the retained earnings and noncontrolling interest balances in the parent company's consolidated balance sheet?

a. No effect on either retained earnings or noncontrolling interest.
b. No effect on retained earnings and a decrease in noncontrolling interest.
c. Decreases in both retained earnings and noncontrolling interest.
d. A decrease in retained earnings and no effect on noncontrolling interest.

**CPA-00467 Explanation**
Choice "b" is correct, no effect on retained earnings and a decrease in noncontrolling interest. The parent's balance sheet would reflect 70% of the sub's earnings. Receipt of 70% of the dividends would simply transfer cash from one company to another. The dividend would be eliminated in consolidation. However, 30% of the dividend would be paid to the noncontrolling shareholders and would reduce noncontrolling interest on the consolidated balance sheet.

Choice "a" is incorrect. The dividend affects noncontrolling interest but not retained earnings.

Choice "c" is incorrect. The dividend does not affect retained earnings.

Choice "d" is incorrect. The dividend reduces noncontrolling interest.

**CPA-00468 Type1 M/C A-D Corr Ans: A PM#19 F 3-07**

78. CPA-00468 Nov 92 II #60 Page 34

The following information pertains to shipments of merchandise from Home Office to Branch during 1991:

| | |
|---|---|
| Home Office's cost of merchandise | $160,000 |
| Intracompany billing | 200,000 |
| Sales by Branch | 250,000 |
| Unsold merchandise at Branch on December 31, 1991 | 20,000 |

In the combined income statement of Home Office and Branch for the year ended December 31, 1991, what amount of the above transactions should be included in sales?

a. $250,000
b. $230,000


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c. $200,000
d. $180,000

**CPA-00468 Explanation**
**Rule:** All intercompany billings are eliminated in consolidation.

Choice "a" is correct, $250,000. Sales by the branch are to outside parties and are not eliminated.

Choices "b", "c", and "d" are incorrect, per the above explanation.

**CPA-00478 Type1 M/C A-D Corr Ans: A PM#20 F 3-07**

79. CPA-00478 May 92 I #4 Page 37

Wagner, a holder of a $1,000,000 Palmer, Inc. bond, collected the interest due on March 31, 1992, and then sold the bond to Seal, Inc. for $975,000. On that date, Palmer, a 75% owner of Seal, had a $1,075,000 carrying amount for this bond. What was the effect of Seal's purchase of Palmer's bond on the retained earnings and noncontrolling interest amounts reported in Palmer's March 31, 1992, consolidated balance sheet?

| | *Retained earnings* | *Noncontrolling interest* |
|---|---|---|
| a. | $100,000 increase | $0 |
| b. | $75,000 increase | $25,000 increase |
| c. | $0 | $25,000 increase |
| d. | $0 | $100,000 increase |

**CPA-00478 Explanation**
Choice "a" is correct, $100,000 increase in consolidated earnings. $0 effect on noncontrolling interest. The purchase of the parent company bond by the subsidiary is treated as if the bond were retired when the financial statements are consolidated. Because the bond had a book value of $1,075,000, but was "retired" for $975,000, a gain is recorded upon consolidation.

*Journal entry on consolidated ws*

| Bond Premium | Dr | Cr |
|---|---|---|
| Bond premium (Palmer's books) | 75,000 | |
| Bond payable (Palmer's books) | 1,000,000 | |
| Bond investment (Seal's books) | | 975,000 |
| Retained earnings - consolidated | | 100,000 |
| Noncontrolling interest | | 0 |

**CPA-00479 Type1 M/C A-D Corr Ans: C PM#21 F 3-07**

80. CPA-00479 May 92 I #11 Page 36

Parker Corp. owns 80% of Smith Inc.'s common stock. During 1991, Parker sold Smith $250,000 of inventory on the same terms as sales made to third parties. Smith sold all of the inventory purchased from Parker in 1991. The following information pertains to Smith and Parker's sales for 1991:

| | *Parker* | *Smith* |
|---|---|---|
| Sales | $1,000,000 | $700,000 |
| Cost of sales | 400,000 | 350,000 |
| | $ 600,000 | $350,000 |

What amount should Parker report as cost of sales in its 1991 consolidated income statement?

a. $750,000
b. $680,000
c. $500,000
d. $430,000


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**CPA-00479 Explanation**
Choice "c" is correct, $500,000 cost of sales in consolidated income statement.

| | |
|---|---|
| Unadjusted cost of sales: | |
| Parker | $ 400,000 |
| Smith | 350,000 |
| | 750,000 |
| Adjustment for interco sales | (250,000) |
| Adjusted cost of sales | $ 500,000 |

**CPA-00481 Type1 M/C A-D Corr Ans: B PM#22 F 3-07**

81. CPA-00481 May 92 II #20 Page 36

Ahm Corp. owns 90% of Bee Corp.'s common stock and 80% of Cee Corp.'s common stock. The remaining common shares of Bee and Cee are owned by their respective employees. Bee sells exclusively to Cee, Cee buys exclusively from Bee, and Cee sells exclusively to unrelated companies. Selected 1991 information for Bee and Cee follows:

| | *Bee Corp.* | *Cee Corp.* |
|---|---|---|
| Sales | $130,000 | $91,000 |
| Cost of sales | 100,000 | 65,000 |
| Beginning inventory | None | None |
| Ending inventory | None | 65,000 |

What amount should be reported as gross profit in Bee and Cee's combined income statement for the year ended December 31, 1991?

a. $26,000
b. $41,000
c. $47,800
d. $56,000

**CPA-00481 Explanation**
Choice "b" is correct, $41,000 gross profit in combined income statement.

**Rule:** "Combined financial statements" do not eliminate "equity" accounts (they are all added across); however, all other intercompany "transactions" and "balances" are eliminated in combined financial statements just as they are in consolidated financial statements.

| *Income Statement* | *Bee* | *Cee* | Dr(Cr) *Elims* | *Combined* |
|---|---|---|---|---|
| Sales | 130 | 91 | 130* | 91 |
| Cost of sales | 100 | 65 | (100)*<br>(15)† | 50 |
| Gross profit | 30 | 26 | (15) | 41 |
| *Balance Sheet* | | | | |
| Inventory | 0 | 65 | (15)† | 50 |

* Eliminate interco sales and interco cost of sales.
† Eliminate interco profit in Cee's Cost of Sales and Ending Inventory.

$$\text{Interco gross profit \%} = \frac{\text{Gross Profit}}{\text{Sales}} = \frac{30}{130} = .23077$$

$$.23077 \times \text{Cee's Cost of Sales } \$65{,}000 = \$15{,}000$$

$$.23077 \times \text{Cee's Ending Inventory } \$65{,}000 = \$15{,}000$$


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**CPA-00483 Type1 M/C A-D Corr Ans: C PM#23 F 3-07**

82. CPA-00483 May 92 T #41 Page 34

In its financial statements, Pulham Corp. uses the equity method of accounting for its 30% ownership of Angles Corp. At December 31, l991, Pulham has a receivable from Angles. How should the receivable be reported in Pulham's 1991 financial statements?

a. The receivable should be eliminated.
b. Seventy percent of the receivable should be separately reported, with the balance eliminated.
c. The total receivable should be disclosed separately.
d. The total receivable should be included as part of the investment in Angles, without separate disclosure.

**CPA-00483 Explanation**
Choice "c" is correct. The total receivable should be disclosed separately.

Choice "a" is incorrect. There can be no elimination as there is no consolidation.

Choice "b" is incorrect. 100% must be disclosed and there can be no elimination.

Choice "d" is incorrect. The receivable is not part of the investment.

**CPA-00495 Type1 M/C A-D Corr Ans: C PM#25 F 3-07**

83. CPA-00495 May 91 II #19 Page 36

Nolan owns 100% of the capital stock of both Twill Corp. and Webb Corp. Twill purchases merchandise inventory from Webb at 140% of Webb's cost. During 1990, merchandise that cost Webb $40,000 was sold to Twill. Twill sold all of this merchandise to unrelated customers for $81,200 during 1990. In preparing combined financial statements for 1990, Nolan's bookkeeper disregarded the common ownership of Twill and Webb.

By what amount was unadjusted revenue overstated in the combined income statement for 1990?

a. $16,000
b. $40,000
c. $56,000
d. $81,200

**CPA-00495 Explanation**
Choice "c" is correct, $56,000. Merchandise that cost Twill $40,000 was sold to Webb at 140% of Twill's cost ($56,000) and must be eliminated.

**CPA-00496 Type1 M/C A-D Corr Ans: A PM#26 F 3-07**

84. CPA-00496 May 91 II #20 Page 36

Nolan owns 100% of the capital stock of both Twill Corp. and Webb Corp. Twill purchases merchandise inventory from Webb at 140% of Webb's cost. During 1990, merchandise that cost Webb $40,000 was sold to Twill. Twill sold all of this merchandise to unrelated customers for $81,200 during 1990. In preparing combined financial statements for 1990, Nolan's bookkeeper disregarded the common ownership of Twill and Webb.

What amount should be eliminated from cost of goods sold in the combined income statement for 1990?

a. $56,000
b. $40,000
c. $24,000
d. $16,000


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**CPA-00496 Explanation**
Choice "a" is correct, $56,000 elimination from cost of goods sold.

| | |
|---|---|
| Webb's cost of sales to Twill | $40,000 |
| Markup percentage | x 140% |
| Revenue from intercompany sales (including profit) | $56,000 |

**Rule:** The sales and cost of sales elimination is always the same amount if no inventory related to intercompany sales is on hand at the end of the year. Interco profit elimination is based on the amount of inventory remaining on the ending balance sheet.

**Note:** In this question, there is no interco profit to eliminate from ending inventory because everything had been sold to outside parties.

**CPA-00497 Type1 M/C A-D Corr Ans: C PM#27 F 3-07**

85. CPA-00497 Nov 90 T #2 Page 39

Water Co. owns 80% of the outstanding common stock of Fire Co. On December 31, 1989, Fire sold equipment to Water at a price in excess of Fire's carrying amount, but less than its original cost. On a consolidated balance sheet at December 31, 1989, the carrying amount of the (cost less accumulated depreciation) equipment should be reported at:

a. Water's original cost.
b. Fire's original cost.
c. Water's original cost less Fire's recorded gain.
d. Water's original cost less 80% of Fire's recorded gain.

**CPA-00497 Explanation**
Choice "c" is correct, on the consolidated balance sheet at 12/31/89, equipment should be reported at Water's original cost less Fire's recorded gain (which equals Fire's carrying value prior to sale).

Illustrative example:

| | |
|---|---|
| Fire's original cost | 100 |
| Accum depr prior to sale | (40) |
| Net carrying value to Fire | 60 |
| Sale price to Water | 75 |
| Gain to Fire | 15 |
| Water's "original" cost | 75 |
| Less Fire's gain | 15 |
| Carrying value on consolidated financial statements | 60 |

**Rule:** Fixed asset cost is based on original cost from the outside world and remains the same on the consolidated financial statements.

**CPA-00498 Type1 M/C A-D Corr Ans: A PM#28 F 3-07**

86. CPA-00498 May 90 T #2 Page 35

P Co. purchased term bonds at a premium on the open market. These bonds represented 20 percent of the outstanding class of bonds issued at a discount by S Co., P's wholly owned subsidiary. P intends to hold the bonds until maturity. In a consolidated balance sheet, the difference between the bond carrying amounts in the two companies would be:

a. Included as a decrease to retained earnings.
b. Included as an increase to retained earnings.
c. Reported as a deferred debit to be amortized over the remaining life of the bonds.
d. Reported as a deferred credit to be amortized over the remaining life of the bonds.

**CPA-00498 Explanation**


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Choice "a" is correct, in a consolidated balance sheet, the difference between the bond carrying amounts would be included as a decrease to retained earnings.

**Rule:** When members of a consolidated group have intercompany bond holdings, the bonds are eliminated in consolidation and the difference (gain or loss) between the discounted issue price and the premium on reacquisition would be included in retained earnings.

**CPA-00499 Type1 M/C A-D Corr Ans: D PM#29 F 3-07**

87. CPA-00499 May 90 I #11 Page 34

At December 31, 1989, Grey, Inc. owned 90% of Winn Corp., a consolidated subsidiary, and 20% of Carr Corp., an investee in which Grey cannot exercise significant influence. On the same date, Grey had receivables of $300,000 from Winn and $200,000 from Carr. In its December 31, 1989 consolidated balance sheet, Grey should report accounts receivable from affiliates of:

a. $500,000
b. $340,000
c. $230,000
d. $200,000

**CPA-00499 Explanation**
Choice "d" is correct, $200,000.

The receivable from Winn will be eliminated in the consolidation. The receivable from Carr will not be eliminated (Carr is not a subsidiary), thus, it remains. Grey reports accounts receivable from affiliates (Carr) of $200,000 in its consolidated balance sheet.

**CPA-00500 Type1 M/C A-D Corr Ans: C PM#30 F 3-07**

88. CPA-00500 Nov 89 I #55 Page 36

Selected data for two subsidiaries of Dunn Corp. taken from December 31, 1988 pre-closing trial balances are as follows:

| | *Banks Co.* *Debit* | *Lamm Co.* *Credit* |
|---|---|---|
| Shipments to Banks | $ - | $ 150,000 |
| Shipments from Lamm | 200,000 | - |
| Intercompany inventory profit on total shipments | - | 50,000 |

Additional data relating to the December 31, 1988 inventory are as follows:

| | | |
|---|---|---|
| Inventory acquired from outside parties | $175,000 | $ 250,000 |
| Inventory acquired from Lamm | 60,000 | - |

At December 31, 1988, the inventory reported on the combined balance sheet of the two subsidiaries should be:

a. $425,000
b. $435,000
c. $470,000
d. $485,000

**CPA-00500 Explanation**
Choice "c" is correct, $470,000.

| | *Banks* | *Lamm* | *Combined* |
|---|---|---|---|
| Inventory acquired from outside parties | 175,000 | 250,000 | 425,000 |
| Inventory acquired from Lamm (intercompany) | 60,000 | | 60,000 |
| Less unrealized gross margin (25% of 60,000)* | (15,000) | | (15,000) |
| Inventory on combined balance sheet | 220,000 | 250,000 | 470,000 |


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*Gross Margin % calculated as ($200,000 –150,000)/200,000

**CPA-05451 Type1 M/C A-D Corr Ans: B PM#31 F 3-07**

89. CPA-05451 Released 2007 Page 39

Zest Co. owns 100% of Cinn, Inc. On January 2, 1999, Zest sold equipment with an original cost of $80,000 and a carrying amount of $48,000 to Cinn for $72,000. Zest had been depreciating the equipment over a five-year period using straight-line depreciation with no residual value. Cinn is using straight-line depreciation over three years with no residual value. In Zest's December 31, 1999, consolidating worksheet, by what amount should depreciation expense be decreased?

a. $0
b. $8,000
c. $16,000
d. $24,000

**CPA-05451 Explanation**
Choice "b" is correct. Depreciation expense should be decreased by the difference between the depreciation expense calculated by Cinn and the depreciation that would have been calculated by Zest had Zest not sold the asset in an intercompany transaction:

| | |
|---|---|
| Depreciation expense after intercompany sale | $24,000 = $72,000/3 |
| Depreciation expense if no intercompany sale | 16,000 = $80,000/5 |
| Difference | $ 8,000 |

Note that this $8,000 depreciation expense adjustment can also be calculated by dividing the difference between the pre-intercompany-sale asset book value and post-intercompany-sale asset book value by the useful life to be used by the new owner:

($72,000 - $48,000) / 3 = $8,000

Choice "a" is incorrect. In all intercompany sales of depreciable assets, depreciation expense must be adjusted back to what the expense would have been if the sale had not taken place. This adjustment is made at the time of consolidation.

Choice "c" is incorrect. This is the annual depreciation recorded by Zest before selling the asset to Cinn.

Choice "d" is incorrect. This is the annual depreciation recorded by Cinn after acquiring the asset from Zest.

**Combined Financial Statements / Push Down Accounting**

**CPA-00506 Type1 M/C A-D Corr Ans: D PM#1 F 3-08**

90. CPA-00506 May 93 T #8 Page 41

Combined statements may be used to present the results of operations of:

| | *Companies under common management* | *Commonly controlled companies* |
|---|---|---|
| a. | No | Yes |
| b. | Yes | No |
| c. | No | No |
| d. | Yes | Yes |

**CPA-00506 Explanation**
Choice "d" is correct, Yes - Yes. Combined statements may be used for companies under common management or commonly controlled companies (e.g., individual owns many companies).


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Procedure:

1. All intercompany transactions and balances among the related companies are eliminated.
2. Minority interests are treated as in consolidated financial statements.
3. Equity accounts are added across, not eliminated.
4. Income statement accounts are added across.

**CPA-00507 Type1 M/C A-D Corr Ans: D PM#2 F 3-08**

91. CPA-00507 Nov 91 T #8 Page 41

For which of the following reporting units is the preparation of combined financial statements most appropriate?

a. A corporation and a majority-owned subsidiary with nonhomogeneous operations.
b. A corporation and a foreign subsidiary with nonintegrated homogeneous operations.
c. Several corporations with related operations with some common individual owners.
d. Several corporations with related operations owned by one individual.

**CPA-00507 Explanation**
Choice "d" is correct, combined financial statements would be most appropriate for several corporations owned by one individual.

Choices "a" and "b" are incorrect. As consolidated statements are appropriate for a parent and subsidiary.

Choice "c" is incorrect. There are only "some common owners."

**CPA-00508 Type1 M/C A-D Corr Ans: A PM#3 F 3-08**

92. CPA-00508 Nov 90 T #3 Page 41

Combined statements may be used to present the results of operations of:

| | *Unconsolidated subsidiaries* | *Companies under common management* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |

**CPA-00508 Explanation**
Choice "a" is correct, Yes - Yes.

**Rule:** Combined financial statements may be prepared for:

1. Many companies owned by one individual.
2. Many companies under common management.
3. Unconsolidated subsidiaries (rare since SFAS 94).

**CPA-00509 Type1 M/C A-D Corr Ans: C PM#4 F 3-08**

93. CPA-00509 Nov 90 I #60 Page 41

Mr. Cord owns four corporations. Combined financial statements are being prepared for these corporations, which have intercompany loans of $200,000 and intercompany profits of $500,000. What amount of these intercompany loans and profits should be included in the combined financial statements?

| | *Intercompany* | |
|---|---|---|
| | *Loans* | *Profits* |
| a. | $200,000 | $0 |
| b. | $200,000 | $500,000 |


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| | | |
|---|---|---|
| c. | $0 | $0 |
| d. | $0 | $500,000 |

**CPA-00509 Explanation**
Choice "c" is correct, loans, $0; profits, $0. (All of the $200,000 interco loans and $500,000 interco profits should be eliminated.)

**Rule:** "Combined financial statements" do not eliminate "equity" accounts (they are all added across). However, all other intercompany "transactions" and "balances" are eliminated in combined financial statements just as they are in consolidated financial statements.

**Note:** The question is tricky because it asks what should be "included" rather than "eliminated."

**CPA-00510 Type1 M/C A-D Corr Ans: C PM#5 F 3-08**

94. CPA-00510 Nov 89 T #40 Page 41

Which of the following items should be treated in the same manner in both combined financial statements and consolidated statements?

| | *Different fiscal periods* | *Foreign operations* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | Yes |
| d. | Yes | No |

**CPA-00510 Explanation**
Choice "c" is correct, Yes - Yes. Different fiscal periods and foreign operations are treated in the same manner in both combined financial statements and consolidated statements.

Combined financial statements are prepared in the same manner as consolidated financial statements except there is no parent company. Therefore, there is no investment in sub account to eliminate against sub equity accounts.

**Supplemental Questions**

**CPA-00502 Type1 M/C A-D Corr Ans: B PM#1 F 3-99**

95. CPA-00502 Th Nov 93 #12 Page 48

In a business combination accounted for as a pooling:

a. Income is combined only from date of combination, not for prior periods presented.
b. Income is combined for all periods presented.
c. After the combination, balance sheet amounts are carried at fair market value.
d. Direct acquisition costs are recorded as part of the cost of the investment.

**CPA-00502 Explanation**
Choice "b" is correct. In a business combination accounted for as a pooling, all accounts are combined as if the combination had occurred at the beginning of the year. All prior periods presented are also retroactively adjusted as if the companies had always been one entity.

Choice "a" is incorrect. In a business combination accounted for as a pooling, all accounts are combined as if the combination had occurred at the beginning of the year and all prior periods presented are restated.

Choice "c" is incorrect. Under a pooling of interests, all account balances are reflected at the original book value of the combined entities.

Choice "d" is incorrect. Under a pooling, direct acquisition costs are expenses of the combined corporation.


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**CPA-00504 Type1 M/C A-D Corr Ans: B PM#2 F 3-99**

96. CPA-00504 Th Nov 93 #13 Page 48

Which of the following statements is supportive of the pooling-of-interests method in accounting for a business combination?

a. Bargaining between the parties is based on current values for assets and liabilities.
b. Stockholder groups remain intact but combine.
c. Goodwill is generally a part of any acquisition.
d. A portion of the total cost is assigned to individual assets acquired on the basis of their fair value.

**CPA-00504 Explanation**
Choice "b" is correct, the "pooling-of-interests" method of accounting for a business combination assumes that stockholder groups remain intact but combine.

Choice "a" is incorrect. The purchase method uses bargaining between the parties based on current values for assets and liabilities.

Choice "c" is incorrect. The purchase method generally results in goodwill not the pooling method.

Choice "d" is incorrect. In a pooling "net book values" of the newly "pooled companies" remain the same while in a purchase, net book values of a newly acquired company are adjusted (generally upward due to inflation) to acquisition date "fair value."

**CPA-00511 Type1 M/C A-D Corr Ans: D PM#3 F 3-99**

97. CPA-00511 Nov 89 II #3 Page 4

Lee Corp. reported the following available-for-sale marketable equity security on its December 31, 1994, balance sheet:

| | |
|---|---|
| Neu Corp. common stock, at cost | $100,000 |
| Less: Allowance for decline in market value | (20,000) |
| Balance | $ 80,000 |

At December 31, 1995, the market value of Lee's investment in the Neu Corp. stock was $85,000. As a result of the 1995 increase in this stock's market value, Lee's 1995 income statement should report:

a. An unrealized gain of $5,000.
b. A realized gain of $5,000.
c. An unrealized loss of $15,000.
d. No gain or loss.

**CPA-00511 Explanation**
Choice "d" is correct. No gain or loss should be reported in the income statement.

**Rule:** Available-for-sale marketable securities are carried at market value.

Any unrealized loss is charged to other comprehensive income. The valuation account ("allowance for unrealized losses") and accumulated OCI are adjusted each year-end to reflect the current cumulative difference between aggregate cost and aggregate market.

In this example, the valuation account and accumulated OCI account (both balance sheet accounts) would be reduced by $5,000 (from $20,000 to $15,000).

Choices "a", "b", and "c" are incorrect. The income statement is only affected by gains or losses from trading securities, or on available-for-sale securities if the unrealized loss is considered permanent.

**CPA-00514 Type1 M/C A-D Corr Ans: D PM#4 F 3-99**

98. CPA-00514 Nov 89 #2 Page 4


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Robin Co. has a marketable equity securities portfolio classified as available-for-sale. None of the holdings enables Robin to exercise significant influence over an investee. The aggregate cost exceeds its aggregate market value. The decline is considered temporary and should be reported as a (an):

a. Unrealized loss in the income statement.
b. Realized loss in the income statement.
c. Valuation allowance in the noncurrent liability section of the balance sheet.
d. Valuation allowance in the asset section of the balance sheet.

**CPA-00514 Explanation**
Choice "d" is correct. The temporary decline of an available-for-sale marketable equity securities portfolio below aggregate cost should be reported as a valuation allowance in the asset section of the balance sheet.

**Rule:** Temporary losses on available-for-sale securities (where aggregate cost exceeds aggregate market) should be credited to an asset valuation account and debited direct to other comprehensive income.

Choices "a" and "b" are incorrect. There is no income statement effect for an available-for-sale portfolio unless the loss is permanent.

Choice "c" is incorrect. The valuation account is a "contra-asset" (valuation account) and not a liability.

**CPA-00518 Type1 M/C A-D Corr Ans: D PM#5 F 3-99**

99. CPA-00518 May 90 I #2 Page 4

During 1994, Scott Corp. purchased marketable equity securities as available-for-sale investments. Pertinent data follow:

| | | *Market Value* |
|---|---|---|
| *Security* | *Cost* | *at 12/31/94* |
| D | $ 36,000 | $ 40,000 |
| E | 80,000 | 60,000 |
| F | 180,000 | 186,000 |
| | $296,000 | $286,000 |

Scott appropriately carries these securities at market value. The amount of unrealized loss on these securities in Scott's 1994 income statement should be:

a. $20,000
b. $14,000
c. $10,000
d. $0

**CPA-00518 Explanation**
Choice "d" is correct. $0 unrealized loss should be in the income statement.

**Rule:** If unrealized loss on available-for-sale marketable equity securities:

If Temporary -
1. Do not record loss in the income statement.
2. Record (debit) difference in other comprehensive income.
3. Record (credit) difference in a valuation (contra) account (a component of the noncurrent asset section of the balance sheet).
4. Subsequent recoveries in market value are debited to the valuation account and credited to other comprehensive income.

If Permanent -
1. Record realized loss (debit) in the income statement.
2. Credit the cost of the individual security account.

**CPA-00521 Type1 M/C A-D Corr Ans: A PM#6 F 3-99**

100. CPA-00521 May 90 I #57 Page 6


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During 1994, Wall Co. purchased 2,000 shares of Hemp Corp. common stock for $31,500 as a trading investment. The market value of this investment was $29,500 at December 31, 1994. Wall sold all of the Hemp common stock for $14 per share on December 15, 1995, incurring $1,400 in brokerage commissions and taxes. On the sale, Wall should report a realized loss in its income statement of:

a. $2,900
b. $3,500
c. $4,900
d. $1,500

**CPA-00521 Explanation**
Choice "a" is correct. $2,900 realized loss in 1995 income statement on sale of stock.

**Rule:** Trading securities are reported at fair value with unrealized gains and losses included in earnings. Fair value becomes the new basis (revalued cost) for computing realized gains or losses upon sale.

| | | Trading Investment |
|---|---|---|
| Original cost in 1994 | | $ 31,500 |
| Unrealized loss charged to income in 1994, as if realized | | (2,000) |
| Fair value at 12-31-94 (revalued cost) | | 29,500 |
| Sales proceeds ($14 × 2,000 SH) | $28,000 | |
| Less brokerage commissions & taxes | (1,400) | 26,600 |
| realized loss in 1995 income statement | | $ 2,900 |

**CPA-00523 Type1 M/C A-D Corr Ans: B PM#7 F 3-99**

101. CPA-00523 May 91 I #18 Page 4

Data regarding Ball Corp.'s available-for-sale marketable equity securities follow:

| | *Cost* | *Market Value* |
|---|---|---|
| December 31, 1994 | $150,000 | $130,000 |
| December 31, 1995 | 150,000 | 160,000 |

Differences between cost and market values are considered temporary. The decline in market value was considered temporary and was properly accounted for at December 31, 1994. Ball's 1995 statement of changes in stockholders' equity would report an increase of:

a. $20,000
b. $30,000
c. $10,000
d. $0

**CPA-00523 Explanation**
Choice "b" is correct. $30,000 increase in Accumulated Other Comprehensive Income.

**Rule:** Temporary declines in aggregate market values of available-for-sale securities are charged to (decrease) Stockholders' Equity.

Subsequent recoveries and/or advances in aggregate market values are credited to (increase) other comprehensive income to reflect fair value.

| | |
|---|---|
| Original cost | $150,000 |
| Market value 12/31/94 | (130,000) |
| 1994 decrease in accumulated OCI | $ 20,000 |
| | |
| Market value 12/31/95 | $160,000 |
| Prior fair value | (130,000) |
| 1995 increase in accumulated OCI | $ 30,000 |


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**CPA-00525 Type1 M/C A-D Corr Ans: C PM#8 F 3-99**

102. CPA-00525 May 92 I #13 Page 4

Reed, Inc. began operations on January 1, 1994. The following information pertains to Reed's December 31, 1994, portfolio of marketable equity securities:

| | *Trading* | *Available-for-Sale* |
|---|---|---|
| Aggregate cost | $360,000 | $550,000 |
| Market value | 320,000 | 450,000 |

If the market declines are judged to be temporary, what amounts should Reed report as valuation allowances for its trading and available-for-sale marketable equity securities in its December 31, 1994 balance sheet?

| | *Trading* | *Available-for-Sale* |
|---|---|---|
| a. | $40,000 | $0 |
| b. | $0 | $100,000 |
| c. | $40,000 | $100,000 |
| d. | $56,000 | $130,000 |

**CPA-00525 Explanation**
Choice "c" is correct. $40,000 and $100,000.

**Rule:** Unrealized gains or losses on trading and available-for-sale marketable equity securities (e.g., stocks) are based on fair values.

| | | Trading | Available-for-Sale |
|---|---|---|---|
| Aggregate cost | | $360,000 | $ 550,000 |
| Market value | | (320,000) | (450,000) |
| Valuation allowance | - Cr | $ 40,000 | $ 100,000 |
| | - Dr | Income Statement | Other Comprehensive Income |

**CPA-00527 Type1 M/C A-D Corr Ans: D PM#9 F 3-99**

103. CPA-00527 May 92 I #14 Page 3

The following information pertains to Smoke, Inc.'s investment in marketable equity securities:

- On December 31, 1995, Smoke reclassified a security with a $70,000 cost and a $50,000 fair value from trading to available-for-sale.
- An available-for-sale marketable equity security costing $75,000, written down to $30,000 in 1994, had a $60,000 fair value on December 31, 1995. Smoke believes the recovery is permanent.

What is the net effect of the above items on Smoke's valuation allowance for available-for-sale marketable equity securities as of December 31, 1995?

a. $10,000 decrease.
b. No effect.
c. $20,000 increase.
d. $30,000 decrease.

**CPA-00527 Explanation**
**Rule:** The transfer of a security between categories of investments shall be accounted for at fair value. At the date of the transfer, the security's unrealized holding gain or loss shall be accounted for as follows:

a. For a security transferred from the trading category, the unrealized holding gain or loss at the date of the transfer will have already been recognized in earnings and shall not be reversed.


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b. For a security transferred into the trading category, the unrealized holding gain or loss at the date of the transfer shall be recognized in earnings immediately.

Choice "d" is correct. The reclassified security is transferred in at fair market value and thus, has no effect on the valuation allowance. The adjustment for the existing available for sale security would be as follows:

| | Dec. 31, 1994 | Dec. 31, 1995 | Net Change |
|---|---|---|---|
| Cost | 75,000 | 75,000 | 0 |
| FMV | (30,000) | (60,000) | (30,000) |
| Val. Allowance | 45,000 | 15,000 | (30,000) |

**CPA-00529 Type1 M/C A-D Corr Ans: D PM#10 F 3-99**

104. CPA-00529 Nov 89 #33 Page 48

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. A portion of the total cost is assigned to individual assets acquired on the basis of their fair value.
d. It was developed within the boundaries of the historical-cost system and is compatible with it.

**CPA-00529 Explanation**
Choice "d" is correct. The pooling of interests method of accounting for a business combination was developed within the boundaries of the historical-cost system and is compatible with it.

Choice "a" is incorrect. The purchase method of accounting is generally used for a business combination where one company is clearly the dominant and continuing entity.

Choice "b" is incorrect. Goodwill is not reported under the pooling method since pooling creates no goodwill - only the purchase method could produce goodwill.

Choice "c" is incorrect. In a pooling "net book values" of the newly "pooled companies" remain the same while in a purchase, net book values of a newly acquired company are adjusted (generally upwards due to inflation) to acquisition date "fair value."

**CPA-00530 Type1 M/C A-D Corr Ans: C PM#11 F 3-99**

105. CPA-00530 May 90 #32 Page 48

In order to report a business combination as a pooling of interests, the minimum amount of an investee's common stock that must be acquired during the combination period in exchange for the investor's common stock is:

a. 51 percent.
b. 80 percent.
c. 90 percent.
d. 100 percent.

**CPA-00530 Explanation**
Choice "c" is correct. 90 percent of an investee's common stock must be acquired during the combination period in exchange for the investor's common stock in order to report a business combination as a pooling of interests.

**CPA-00531 Type1 M/C A-D Corr Ans: B PM#12 F 3-99**

106. CPA-00531 Nov 90 #5 Page 49


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A business combination is accounted for as a pooling of interests. In the consolidated balance sheet, the following component(s) of stockholders' equity may be less than the sum of those same components of the merging companies:

| | *Retained earnings* | *Contributed capital* |
|---|---|---|
| a. | No | No |
| b. | Yes | No |
| c. | No | Yes |
| d. | Yes | Yes |

**CPA-00531 Explanation**

Choice "b" is correct. In the consolidated BS following a pooling:

Yes - Retained earnings may be less than the sum of the merging companies due to pooling expenses.

No - Contributed capital (capital stock at par or stated value, plus additional paid-in capital, less treasury stock) would be the same as (not less than) the sum of the merging companies.

**Rules:** In a pooling almost all of the acquired retained earnings of the subsidiary will be added to the consolidated retained earnings.

Net income of the subsidiary for the entire year is added to consolidated net income regardless of the date of "pooling." Thus, a pooling consummated on the last day of the year will result in additional consolidated net income from the newly pooled company for the entire year.

Expenses related to combination (e.g., costs of registering and issuing equity securities, including finders, consultants, legal and accounting fees) are expenses in determining net income of the resulting combined corporation for the period incurred.

When new stock is issued for a newly acquired "pooled" corporation, the "shareholders equity" is increased by the total net book value of the newly pooled corporation. "Net book values" of the newly "pooled companies" remain the same. Thus, it remains within the boundaries of the "historical cost" system.

**CPA-00533 Type1 M/C A-D Corr Ans: D PM#13 F 3-99**

107. CPA-00533 Nov 92 I #44 Page 13

Information pertaining to dividends from Wray Corp.'s common stock investments for the year ended December 31, 1991, follows:

- On September 8, 1991, Wray received a $50,000 cash dividend from Seco, Inc., in which Wray owns a 30% interest. A majority of Wray's directors are also directors of Seco.
- On October 15, 1991, Wray received a $6,000 liquidating dividend from King Co. Wray owns a 5% interest in King Co.
- Wray owns a 2% interest in Bow Corp., which declared a $200,000 cash dividend on November 27, 1991, to stockholders of record on December 15, 1991, payable on January 5, 1992.

What amount should Wray report as dividend income in its income statement for the year ended December 31, 1991?

a. $60,000
b. $56,000
c. $10,000
d. $4,000

**CPA-00533 Explanation**

| | Dividend income in income statement | Reduction of investments in balance sheet |
|---|---|---|
| Seco dividend (equity method) | | $ 50,000 |
| King Co. liquidating dividend | | 6,000 |


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| | | |
|---|---|---|
| Bow Corp. Dividend receivable ($200,000 × .02) | $4,000 | |
| | $4,000 | $ 56,000 |
| | **D** | Not **B** |

Choice "d" is correct. $4,000 dividend income should be reported in income statement.

**CPA-04347 Type1 M/C H,T,A Corr Ans: T PM#14 F 3-99**

108. CPA-04347 FARE Nov 95 PR 2 1 Page 3

Camp Co. purchased various securities during 1994 to be classified as held-to-maturity securities, trading securities, or available-for-sale securities.

This question describes a security purchased by Camp. Select from the following list the appropriate category for the security.

- Debt securities bought and held for the purpose of selling in the near term.

*Categories*

[A] Available-for-sale.
[H] Held-to-maturity.
[T] Trading.

**CPA-04347 Explanation**
**Choice "T" is correct.** Trading securities are those marketable securities [debt and equity], which will be sold in the near term.

**CPA-04348 Type1 M/C H,T,A Corr Ans: H PM#15 F 3-99**

109. CPA-04348 FARE Nov 95 PR 2 2 Page 3

Camp Co. purchased various securities during 1994 to be classified as held-to-maturity securities, trading securities, or available-for-sale securities.

This question describes a security purchased by Camp. Select from the following list the appropriate category for the security.

- U.S. Treasury bonds that Camp has both the positive intent and the ability to hold to maturity.

*Categories*

[A] Available-for-sale.
[H] Held-to-maturity.
[T] Trading.

**CPA-04348 Explanation**
**Choice "H" is correct.** Held-to-maturity securities are investments in bonds that will be held until the maturity date. Camp has both the intent and the ability to do so.

**CPA-04350 Type1 M/C H,T,A Corr Ans: A PM#16 F 3-99**

110. CPA-04350 FARE Nov 95 PR 2 3 Page 3

Camp Co. purchased various securities during 1994 to be classified as held-to-maturity securities, trading securities, or available-for-sale securities.

This question describes a security purchased by Camp. Select from the following list the appropriate category for the security.

- $3 million debt security bought and held for the purpose of selling in three years to finance payment of Camp's $2 million long-term note payable when it matures.


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*Categories*

[A] Available-for-sale.
[H] Held-to-maturity.
[T] Trading.

**CPA-04350 Explanation**
**Choice "A" is correct.** Available-for-sale securities are those marketable securities [debt and equity], which will be held longer than a year or operating cycle before disposal. These debt securities will not be held until maturity.

**CPA-04353 Type1 M/C H,T,A Corr Ans: A PM#17 F 3-99**

111. CPA-04353 FARE Nov 95 PR 2 4 Page 3

Camp Co. purchased various securities during 1994 to be classified as held-to-maturity securities, trading securities, or available-for-sale securities.

This question describes a security purchased by Camp. Select from the following list the appropriate category for the security.

- Convertible preferred stock that Camp does not intend to sell in the near term.

*Categories*

[A] Available-for-sale.
[H] Held-to-maturity.
[T] Trading.

**CPA-04353 Explanation**
**Choice "A" is correct.** Available-for-sale securities are those marketable securities (debt and equity), which are not classified as trading securities or held-to-maturity securities.

**CPA-04355 Type1 M/C A-K Corr Ans: G PM#18 F 3-99**

112. CPA-04355 FARE Nov 95 PR 2 5 Page 3

The following information pertains to Dayle, Inc.'s portfolio of marketable investments for the year ended December 31, 1994:

| | Cost | Fair value 12/31/93 | 1994 activity Purchases | Sales | Fair value 12/31/94 |
|---|---|---|---|---|---|
| Held-to-maturity securities | | | | | |
| Security ABC | | | $100,000 | | $95,000 |
| Trading securities | | | | | |
| Security DEF | $150,000 | $160,000 | | | 155,000 |
| Available-for-sale securities | | | | | |
| Security GHI | 190,000 | 165,000 | | $175,000 | |
| Security JKL | 170,000 | 175,000 | | | 160,000 |

Security ABC was purchased at par. All declines in fair value are considered to be temporary.

This question describes an amount to be reported in Dayle's 1994 financial statements. Select from the following list the correct numerical response. Ignore income tax considerations.

- Carrying amount of security ABC at December 31, 1994.

*Answer List*

[A] $0
[B] $5,000


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[C] $10,000
[D] $15,000
[E] $25,000
[F] $95,000
[G] $100,000
[H] $150,000
[I] $155,000
[J] $160,000
[K] $170,000

**CPA-04355 Explanation**
**Choice "G" is correct.** At year end, held-to-maturity investments are reported at their carrying value (amortized cost), not fair value. Carrying value of security ABC is the purchase price of $100,000.

**CPA-04357 Type1 M/C A-K Corr Ans: I PM#19 F 3-99**

113. CPA-04357 FARE Nov 95 PR 2 6 Page 3

The following information pertains to Dayle, Inc.'s portfolio of marketable investments for the year ended December 31, 1994:

| | Cost | Fair value 12/31/93 | 1994 activity Purchases | Sales | Fair value 12/31/94 |
|---|---|---|---|---|---|
| Held-to-maturity securities | | | | | |
| Security ABC | | | $100,000 | | $95,000 |
| Trading securities | | | | | |
| Security DEF | $150,000 | $160,000 | | | 155,000 |
| Available-for-sale securities | | | | | |
| Security GHI | 190,000 | 165,000 | | $175,000 | |
| Security JKL | 170,000 | 175,000 | | | 160,000 |

Security ABC was purchased at par. All declines in fair value are considered to be temporary.

This question describes an amount to be reported in Dayle's 1994 financial statements. Select from the following list the correct numerical response. Ignore income tax considerations.

- Carrying amount of security DEF at December 31, 1994.

*Answer List*

[A] $0
[B] $5,000
[C] $10,000
[D] $15,000
[E] $25,000
[F] $95,000
[G] $100,000
[H] $150,000
[I] $155,000
[J] $160,000
[K] $170,000

**CPA-04357 Explanation**
**Choice "I" is correct.** The year-end carrying amount of trading investments is the fair value at year-end. Fair value of security DEF is $155,000.

**CPA-04358 Type1 M/C A-K Corr Ans: J PM#20 F 3-99**


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114. CPA-04358 FARE Nov 95 PR 2 7 Page 3

The following information pertains to Dayle, Inc.'s portfolio of marketable investments for the year ended December 31, 1994:

| | Cost | Fair value 12/31/93 | 1994 activity Purchases | Sales | Fair value 12/31/94 |
|---|---|---|---|---|---|
| Held-to-maturity securities | | | | | |
| Security ABC | | | $100,000 | | $95,000 |
| Trading securities | | | | | |
| Security DEF | $150,000 | $160,000 | | | 155,000 |
| Available-for-sale securities | | | | | |
| Security GHI | 190,000 | 165,000 | | $175,000 | |
| Security JKL | 170,000 | 175,000 | | | 160,000 |

Security ABC was purchased at par. All declines in fair value are considered to be temporary.

This question describes an amount to be reported in Dayle's 1994 financial statements. Select from the following list the correct numerical response. Ignore income tax considerations.

- Carrying amount of security JKL at December 31, 1994.

*Answer List*

[A] $0
[B] $5,000
[C] $10,000
[D] $15,000
[E] $25,000
[F] $95,000
[G] $100,000
[H] $150,000
[I] $155,000
[J] $160,000
[K] $170,000

**CPA-04358 Explanation**
**Choice "J" is correct.** The year-end carrying amount of available for sale investments is the fair value at year end. Fair value of security JKL is $160,000.

**CPA-04359 Type1 M/C A-K Corr Ans: D PM#21 F 3-99**

115. CPA-04359 FARE Nov 95 PR 2 8 Page 3

The following information pertains to Dayle, Inc.'s portfolio of marketable investments for the year ended December 31, 1994:

| | Cost | Fair value 12/31/93 | 1994 activity Purchases | Sales | Fair value 12/31/94 |
|---|---|---|---|---|---|
| Held-to-maturity securities | | | | | |
| Security ABC | | | $100,000 | | $95,000 |
| Trading securities | | | | | |
| Security DEF | $150,000 | $160,000 | | | 155,000 |
| Available-for-sale securities | | | | | |
| Security GHI | 190,000 | 165,000 | | $175,000 | |
| Security JKL | 170,000 | 175,000 | | | 160,000 |


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Security ABC was purchased at par. All declines in fair value are considered to be temporary.

This question describes an amount to be reported in Dayle's 1994 financial statements. Select from the following list the correct numerical response. Ignore income tax considerations.

- Recognized gain or loss on sale of security GHI.

*Answer List*
[A] $0
[B] $5,000
[C] $10,000
[D] $15,000
[E] $25,000
[F] $95,000
[G] $100,000
[H] $150,000
[I] $155,000
[J] $160,000
[K] $170,000

**CPA-04359 Explanation**
**Choice "D" is correct.** The $175,000 sales proceeds less the $190,000 cost yields a realized loss of $15,000.

**CPA-04360 Type1 M/C A-K Corr Ans: B PM#22 F 3-99**

116. CPA-04360 FARE Nov 95 PR 2 9 Page 3

The following information pertains to Dayle, Inc.'s portfolio of marketable investments for the year ended December 31, 1994:

| | Cost | Fair value 12/31/93 | 1994 activity Purchases | Sales | Fair value 12/31/94 |
|---|---|---|---|---|---|
| Held-to-maturity securities | | | | | |
| Security ABC | | | $100,000 | | $95,000 |
| Trading securities | | | | | |
| Security DEF | $150,000 | $160,000 | | | 155,000 |
| Available-for-sale securities | | | | | |
| Security GHI | 190,000 | 165,000 | | $175,000 | |
| Security JKL | 170,000 | 175,000 | | | 160,000 |

Security ABC was purchased at par. All declines in fair value are considered to be temporary.

This question describes an amount to be reported in Dayle's 1994 financial statements. Select from the following list the correct numerical response. Ignore income tax considerations.

- Unrealized gain or loss to be reported in 1994 income statement.

*Answer List*
[A] $0
[B] $5,000
[C] $10,000
[D] $15,000
[E] $25,000
[F] $95,000
[G] $100,000
[H] $150,000


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[I] $155,000
[J] $160,000
[K] $170,000

**CPA-04360 Explanation**
**Choice "B" is correct.** Only adjustments to trading securities valuations are reported on the income statement. The $160,000 carrying value of the trading securities must be reduced to the $155,000 fair value and an income statement unrealized loss of $5,000 is recognized.

**CPA-04361 Type1 M/C A-K Corr Ans: C PM#23 F 3-99**

117. CPA-04361 FARE Nov 95 PR 2 10 Page 3

The following information pertains to Dayle, Inc.'s portfolio of marketable investments for the year ended December 31, 1994:

| | Cost | Fair value 12/31/93 | 1994 activity Purchases | Sales | Fair value 12/31/94 |
|---|---|---|---|---|---|
| Held-to-maturity securities | | | | | |
| Security ABC | | | $100,000 | | $95,000 |
| Trading securities | | | | | |
| Security DEF | $150,000 | $160,000 | | | 155,000 |
| Available-for-sale securities | | | | | |
| Security GHI | 190,000 | 165,000 | | $175,000 | |
| Security JKL | 170,000 | 175,000 | | | 160,000 |

Security ABC was purchased at par. All declines in fair value are considered to be temporary.

This question describes an amount to be reported in Dayle's 1994 financial statements. Select from the following list the correct numerical response. Ignore income tax considerations.

- Unrealized gain or loss to be reported at December 31, 1994, as other comprehensive income.

*Answer List*
[A] $0
[B] $5,000
[C] $10,000
[D] $15,000
[E] $25,000
[F] $95,000
[G] $100,000
[H] $150,000
[I] $155,000
[J] $160,000
[K] $170,000

**CPA-04361 Explanation**
**Choice "C" is correct.** Adjustments to available-for-sale securities are reported as other comprehensive income. The $175,000 fair value/carrying value of the available-for-sale JKL securities must be reduced to the $160,000 fair value for an unrealized loss of $15,000, and that unrealized loss is reported in other comprehensive income. The accumulated other comprehensive income amount on the balance sheet for that security, which was a debit balance of $5,000 due to 12/31/93's increase to $175,000, is thus adjusted to a credit balance of $10,000 ($15,000 - $5,000) and now reflects the $10,000 difference between the original cost and the 12/31/94 fair value. Using a valuation account, the security would be presented as follows:

| | |
|---|---|
| Cost | $170,000 |
| Allowance to adjust available-for-sale securities to market | (10,000) |


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$160,000

However, in addition to security JKL, security GHI also had an impact on other comprehensive income. That security was sold during 1994 when it had a valuation allowance and an amount in accumulated comprehensive income of $25,000 ($190,000 - $165,000). When the security is sold, the security and the valuation allowance both had to be removed from the accounts. That entry would have produced an adjustment of $25,000 to accumulated other comprehensive income. This adjustment of $25,000 (an increase to OCI, or a "gain") from security GHI combined with the unrealized loss adjustment of $15,000 (a decrease to OCI, or a "loss") from security JKL would mean a total effect for the year on other comprehensive income of an increase to OCI in the amount of $10,000 (a "gain").


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# CPA PassMaster Questions–Financial 3
# Export Date: 10/30/08


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**Marketable Securities**

**CPA-00263 Type1 M/C A-D Corr Ans: B PM#1 F 3-01**

1. CPA-00263 FARE R96 #6 Page 3

When the fair value of an investment in debt securities exceeds its amortized cost, how should each of the following debt securities be reported at the end of the year?

| | *Debt securities classified as* | |
|---|---|---|
| | *Held-to-maturity* | *Available-for-sale* |
| a. | Amortized cost | Amortized cost |
| b. | Amortized cost | Fair value |
| c. | Fair value | Fair value |
| d. | Fair value | Amortized cost |

**CPA-00263 Explanation**
Choice "b" is correct. According to SFAS 115, debt securities (bonds) classified as held-to-maturity are reported at amortized cost (that is, cost adjusted for amortization of premium or discount; approaches face value). Debt securities classified as available-for-sale are reported at fair value. Note that SFAS 130 changes the treatment of unrealized holding gains and losses from available-for-sale securities. Such gain/loss is excluded from earnings (per SFAS 115), however, per SFAS 130, it is reported as a component of accumulated other comprehensive income.

Choice "a" is incorrect. While amortized cost is the appropriate treatment for debt securities classified as held-to-maturity, this is not the correct treatment for securities classified as available-for-sale.

Choice "c" is incorrect. Fair value is not the appropriate treatment for debt securities classified as held-to-maturity.

Choice "d" is incorrect. Fair value is not the appropriate treatment for debt securities classified as held-to-maturity. Nor is amortized cost the appropriate treatment for debt securities classified as available-for-sale.

**CPA-00266 Type1 M/C A-D Corr Ans: B PM#3 F 3-01**

2. CPA-00266 FARE Nov 94 #10 Page 3

Kale Co. has adopted Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities.* Kale purchased bonds at a discount on the open market as an investment and intends to hold these bonds to maturity. Kale should account for these bonds at:

a. Cost.
b. Amortized cost.
c. Fair value.
d. Lower of cost or market.

**CPA-00266 Explanation**
Choice "b" is correct. Bond investments which are intended to be held until the maturity date are classified as held-to-maturity securities and are reported at their amortized cost.

Choice "a" is incorrect. Investments in marketable securities are reported at fair value or at their amortized cost, depending on their classification.

Choice "c" is incorrect. Trading securities and available-for-sale securities are reported at their fair value.

Choice "d" is incorrect. The lower of cost or market method has been superseded by the methods specified in SFAS 115.

**CPA-00267 Type1 M/C A-D Corr Ans: B PM#4 F 3-01**

3. CPA-00267 FARE May 94 #14 Page 3


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Nola Co. has adopted Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities.* Nola has a portfolio of marketable equity securities which it does not intend to sell in the near term. How should Nola classify these securities, and how should it report unrealized gains and losses from these securities?

| | *Classify as* | *Report as a* |
|---|---|---|
| a. | Trading securities | Component of income from continuing operations |
| b. | Available-for-sale securities | Component of other comprehensive income |
| c. | Trading securities | Component of other comprehensive income |
| d. | Available-for-sale securities | Component of income from continuing operations |

**CPA-00267 Explanation**
Choice "b" is correct. Investments in marketable equity securities which the company does not intend to sell in the near term should be classified as available-for-sale. Unrealized gains and losses on available-for-sale securities should be reported as a separate component of other comprehensive income.

**CPA-00268 Type1 M/C A-D Corr Ans: A PM#5 F 3-01**

4. CPA-00268 PI Nov 93 #2 (Adapted) Page 3

The following data pertains to Tyne Co.'s investments in marketable equity securities:

| | | *Market value* | |
|---|---|---|---|
| | *Cost* | *12/31/X2* | *12/31/X1* |
| Trading | $150,000 | $155,000 | $100,000 |
| Available-for-sale | 150,000 | 130,000 | 120,000 |

What amount should Tyne report as unrealized gain (loss) in its 20X2 income statement?

a. $55,000
b. $50,000
c. $60,000
d. $65,000

**CPA-00268 Explanation**
Choice "a" is correct, $55,000 unrealized holding gain on trading securities reported in 1995 income statement:

| *Trading Portfolio* | *Fair Value* |
|---|---|
| 12/31/X2 | $155,000 |
| 12/31/X1 | (100,000) |
| Unrealized gain, reflected in income | $ 55,000 |

**Rule:** Unrealized gains and losses are reported as follows: trading securities-reported at fair value with unrealized gains and losses included in earnings (along with "realized" gains and losses, if any).

Available-for-sale securities-reported at fair value with unrealized gains and losses reported as a separate component of other comprehensive income until realized.

**CPA-00270 Type1 M/C A-D Corr Ans: D PM#6 F 3-01**

5. CPA-00270 PI Nov 93 #3 (Adapted) Page 3

The following data pertains to Tyne Co.'s investments in marketable equity securities:

| | *Market value* | |
|---|---|---|
| *Cost* | *12/31/X2* | *12/31/X1* |


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| | | | |
|---|---|---|---|
| Trading | $150,000 | $155,000 | $100,000 |
| Available-for-sale | 150,000 | 130,000 | 120,000 |

What amount should Tyne report as net unrealized loss on available-for-sale marketable equity securities at December 31, 20X2, in accumulated other comprehensive income on the balance sheet?

a. $0
b. $10,000
c. $15,000
d. $20,000

**CPA-00270 Explanation**
Choice "d" is correct, $20,000 net unrealized loss on available-for-sale securities reported as a separate component of other comprehensive income on the statement of comprehensive income and as a separate component of accumulated other comprehensive income on the balance sheet:

| *Available-for-Sale Portfolio* | |
|---|---|
| Cost | $150,000 |
| 12/31/X2 fair value | (130,000) |
| Net unrealized loss at 12/31/X2 | $ 20,000 |

**CPA-00272 Type1 M/C A-D Corr Ans: C PM#7 F 3-01**

6. CPA-00272 Th Nov 93 #7 (Adapted) Page 5

On January 10, 20X2, Box, Inc. purchased marketable equity securities of Knox, Inc. and Scot, Inc. Box classified both securities as available-for-sale assets over which it could not exercise significant influence. At December 31, 20X2, the cost of each investment was greater than its fair market value. The loss on the Knox investment was considered permanent and that on Scot was considered temporary. How should Box report the effects of these investing activities in its 20X2 income statement?

I. Excess of cost of Knox stock over its market value.
II. Excess of cost of Scot stock over its market value.

a. An unrealized loss equal to I plus II.
b. An unrealized loss equal to I only.
c. A realized loss equal to I only.
d. No income statement effect.

**CPA-00272 Explanation**
**Rule:** "Available-for-sale equity" securities are carried at fair value. Permanent impairment in value results in a writedown and a charge to income as if the loss was realized.

Choice "c" is correct, record a realized loss on the Knox stock because the loss is considered permanent.

Choices "a" and "b" are incorrect. The loss on Knox is permanent and therefore a realized loss. The loss on Scot is not permanent and should not be reported on the income statement.

Choice "d" is incorrect. Realized losses are reflected in current year income.

**CPA-00275 Type1 M/C A-D Corr Ans: C PM#9 F 3-01**

7. CPA-00275 PI Nov 93 #13 (Adapted) Page 3

On July 2, 19X2, Wynn, Inc., purchased as an available-for-sale security a $1,000,000 face value Kean Co. 8% bond for $910,000 plus accrued interest to yield 10%. The bonds mature on January 1, 19X9, and pay interest annually on January 1. On December 31, 19X2, the bonds had a market value of $945,000. On February 13, 19X3, Wynn sold the bonds for $920,000. In its December 31, 19X2, balance sheet, what amount should Wynn report for available-for-sale investments in debt securities?

a. $910,000
b. $920,000


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c. $945,000
d. $950,000

**CPA-00275 Explanation**
Choice "c" is correct. The security would be recorded at fair value on July 2, 19X2, or $910,000. Accrued interest is a receivable and does not affect cost. The $90,000 discount is not amortized on short-term investments. On December 31, 19X2, the investment would be adjusted to fair value, $945,000. The unrealized holding gain of $35,000 would be reported as a separate component of other comprehensive income. SFAS 115 para. 12,13 as amended by SFAS 130 para. 33

Choice "a" is incorrect. The investment would be recorded at cost on July 2, 19X2 or $910,000. However, the investment would reflect fair value as of December 31, 19X2.

Choice "b" is incorrect. $920,000 reflects the fair value of the investment on the date it was sold, not 12/31/X2. The investment is short-term.

Choice "d" is incorrect. The accrued interest of $40,000 at 12/31/X2 would be recorded as interest receivable, not as part of the investment account.

**CPA-00277 Type1 M/C A-D Corr Ans: A PM#10 F 3-01**

8. CPA-00277 PI May 93 #3 (Adapted) Page 5

Sun Corp. had investments in marketable equity securities costing $650,000. On June 30, 20X2, Sun decided to hold the investments indefinitely and accordingly reclassified them from trading to available-for-sale on that date. The investments' market value was $575,000 at December 31, 20X1, $530,000 at June 30, 20X2, and $490,000 at December 31, 20X2.

What amount of loss from investments should Sun report in its 20X2 income statement?

a. $45,000
b. $85,000
c. $120,000
d. $160,000

**CPA-00277 Explanation**
Choice "a" is correct, $45,000 loss should be reported in the 20X2 income statement.

**Rule:** When marketable equity securities are transferred between trading and available-for-sale, the transfer is made at fair value, and the difference (if any) is recorded as unrealized loss and charged to the income statement. The new carrying amount becomes the basis for any future gain or loss.

| | |
|---|---|
| Original cost | $650,000 |
| Unrealized I/S loss for 20X1 | (75,000) |
| FMV at 12/31/X1 | 575,000 |
| FMV at 6/30/X2 | (530,000) |
| Unrealized loss in 2002 I/S | $ 45,000 |

**CPA-00279 Type1 M/C A-D Corr Ans: A PM#11 F 3-01**

9. CPA-00279 PI May 93 #4 (Adapted) Page 5

Sun Corp. had investments in marketable equity securities costing $650,000. On June 30, 20X2, Sun decided to hold the investments indefinitely and accordingly reclassified them from trading to available-for-sale on that date. The investments' market value was $575,000 at December 31, 20X1, $530,000 at June 30, 20X2, and $490,000 at December 31, 20X2.

What amount should Sun report as net unrealized loss on available-for-sale marketable equity securities in its 20X2 statement of stockholders' equity?

a. $40,000
b. $45,000


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c. $85,000
d. $160,000

**CPA-00279 Explanation**
Choice "a" is correct, $40,000 "net unrealized loss on available-for-sale marketable equity securities" in the 20X2 statement of stockholders' equity.

**Rule:** Available-for-sale marketable equity securities are recorded at the fair value, and any temporary difference is reported as "net unrealized loss on available-for-sale marketable equity securities" in the statement of stockholders' equity.

| | |
|---|---|
| Carrying amount 6/30/X2 | $530,000 |
| FMV December 31, 20X2 | (490,000) |
| Net unrealized loss at 12/31/X2 | $ 40,000 |

**CPA-00281 Type1 M/C A-D Corr Ans: C PM#12 F 3-01**

10. CPA-00281Th May 93 #22 (Adapted) Page 3

When the market value of an investment in debt securities in which the company has a positive intent and ability to hold to maturity exceeds its carrying amount, how should each of the following assets be reported at the end of the year?

| | *Long-term marketable debt securities* | *Short-term marketable debt securities* |
|---|---|---|
| a. | Market value | Carrying amount |
| b. | Carrying amount | Market value |
| c. | Carrying amount | Carrying amount |
| d. | Market value | Market value |

**CPA-00281 Explanation**
Choice "c" is correct, carrying amount, carrying amount.

Marketable debt securities that the company has the intent and ability to hold to maturity, both "long" and "short" term, are reported at carrying amount (amortized cost) unless there is a permanent decline in market value.

**CPA-00282 Type1 M/C A-D Corr Ans: B PM#13 F 3-01**

11. CPA-00282Th May 93 #23 (Adapted) Page 5

On both December 31, 19X1, and December 31, 19X2, Kopp Co.'s only marketable equity security had the same market value, which was below cost. Kopp considered the decline in value to be temporary in 19X1 but other than temporary in 19X2. At the end of both years the security was classified as an available-for-sale asset. Kopp could not exercise significant influence over the investee. What should be the effects of the determination that the decline was other than temporary on Kopp's 19X2 net available-for-sale assets and net income?

a. No effect on both net available-for-sale assets and net income.
b. No effect on net available-for-sale assets and decrease in net income.
c. Decrease in net available-for-sale assets and no effect on net income.
d. Decrease in both net available-for-sale assets and net income.

**CPA-00282 Explanation**
Choice "b" is correct. In 19X1, the security would be written down to fair value. The unrealized holding loss would be reported in other comprehensive income. In 19X2, the unrealized holding loss would be removed from accumulated other comprehensive income and recognized in earnings as a realized loss since the decline is classified as other than temporary in 19X2. This 19X2 entry has no effect on


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available-for-sale assets and decreases net income by the amount of the realized loss. SFAS 115 para 13, 16, SFAS 130

Choice "a" is incorrect. In 19X2, the unrealized holding loss would be removed from accumulated other comprehensive income and recognized in earnings as a realized loss.

Choice "c" is incorrect. In 19X1, the security would be written down to fair value. The unrealized holding loss would be reported in other comprehensive income. In 19X2, the unrealized loss would be removed from accumulated other comprehensive income and recognized in earnings as a realized loss.

Choice "d" is incorrect. In 19X1, the security would be written down to fair value.

**CPA-04659 Type1 M/C A-D Corr Ans: D PM#14 F 3-01**

12. CPA-04659 Released 2005 Page 3

At year-end, Rim Co. held several investments with the intent of selling them in the near term. The investments consisted of $100,000, 8%, five-year bonds, purchased for $92,000, and equity securities purchased for $35,000. At year-end, the bonds were selling on the open market for $105,000 and the equity securities had a market value of $50,000. What amount should Rim report as trading securities in its year-end balance sheet?

a. $50,000
b. $127,000
c. $142,000
d. $155,000

**CPA-04659 Explanation**
Choice "d" is correct. Trading securities, both debt and equity, are to be reported at fair value at the end of the current reporting period.

| | |
|---|---|
| Bonds FMV at year end | $105,000 |
| Equities FMV at year end | 50,000 |
| Total reportable amount | $155,000 |

**CPA-05419 Type1 M/C A-D Corr Ans: B PM#25 F 3-01**

13. CPA-05419 Released 2007 Page 4

At the end of year 1, Lane Co. held trading securities that cost $86,000 and which had a year-end market value of $92,000. During year 2, all of these securities were sold for $104,500. At the end of year 2, Lane had acquired additional trading securities that cost $73,000 and which had a year-end market value of $71,000. What is the impact of these stock activities on Lane's year 2 income statement?

a. Loss of $2,000.
b. Gain of $10,500.
c. Gain of $16,500.
d. Gain of $18,500.

**CPA-05419 Explanation**
Choice "b" is correct. Because these are trading securities, the year 2 income statement will be affected by both the realized gain from the securities sold and the unrealized loss on the securities acquired in year 2:

Realized gain on securities sold = Sales price - Carrying value = $104,500 - 92,000 = $12,500

Unrealized loss in securities acquired = Year-end market value - Cost = $71,000 - 73,000 = (2,000)

Total income statement impact = Realized gain (loss) + Unrealized gain (loss) = $12,500 + (2,000) = $10,500 gain


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Choice "a" is incorrect. The gain on the securities sold will affect the year 2 income statement. Realized gains and losses are always reported on the income statement in the period incurred.

Choice "c" is incorrect. Because these are trading securities, the gain on the securities sold is not equal to the difference between the sales price and the original cost of the securities. In year 1, the difference between the cost of $86,000 and the ending fair value of $92,000 would have been recorded on the year 1 income statement as a $6,000 unrealized gain. Then, in year 2, the realized gain on the sale is calculated using the carrying value of $92,000 and the sales price of $104,500 ($104,500 - 92,000 = $12,500 realized gain).

Choice "d" is incorrect. Because these are trading securities, unrealized gains and losses are recorded on the income statement. Therefore, when the securities acquired in year 2 are adjusted to fair value at the end of the year, a $2000 unrealized loss is recorded on the income statement equal to the difference between the ending market value of the securities and their original cost ($71,000 - 73,000). Additionally, the gain on the trading securities sold is not equal to the difference between the sales price and the original cost of the securities. In year 1, the difference between the cost of $86,000 and the ending fair value of $92,000 would have been recorded on the year 1 income statement as a $6,000 unrealized gain. Then, in year 2, the realized gain on the sale is calculated using the carrying value of $92,000 and the sales price of $104,500 ($104,500 - 92,000 = $12,500 realized gain).

**CPA-05463 Type1 M/C A-D Corr Ans: B PM#26 F 3-01**

14. CPA-05463 Released 2007 Page 5

Beach Co. determined that the decline in the fair market value (FMV) of an investment was below the amortized cost and permanent in nature. The investment was classified as available-for-sale on Beach's books. The controller would properly record the decrease in FMV by including it in which of the following?

a. Other comprehensive income section of the income statement only.
b. Earnings section of the income statement and writing down the cost basis to FMV.
c. Extraordinary items section of the income statement, net of tax, and writing down the cost basis to FMV.
d. Other comprehensive income section of the income statement, and writing down the cost basis to FMV.

**CPA-05463 Explanation**

Choice "b" is correct. When an available-for-sale security is determined to be impaired because of a permanent decline in fair value below cost, the asset must be written down to the lower fair value by recording a loss that is recognized on the income statement.

Choice "a" is incorrect. The impairment of an available-for-sale security must be recorded on the income statement. Only gains and non-permanent losses on available-for-sale securities are reported in other comprehensive income.

Choice "c" is incorrect. The impairment of an available-for-sale security is reported as a component of income from continuing operations and is not considered an extraordinary item.

Choice "d" is incorrect. The impairment of an available-for-sale security must be recorded on the income statement. Only gains and non-permanent losses on available-for-sale securities are reported in other comprehensive income.

**Business Combinations / Consolidations**

**CPA-04697 Type1 M/C A-D Corr Ans: B PM#3 F 3-02**

15. CPA-04697 Releaed 2005 Page 10

Sun Co. is a wholly owned subsidiary of Star Co. Both companies have separate general ledgers, and prepare separate financial statements. Sun requires stand-alone financial statements. Which of the following statements is correct?


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a. Consolidated financial statements should be prepared for both Star and Sun.
b. Consolidated financial statements should only be prepared by Star and **not** by Sun.
c. After consolidation, the accounts of both Star and Sun should be changed to reflect the consolidated totals for future ease in reporting.
d. After consolidation, the accounts of both Star and Sun should be combined together into one general-ledger accounting system for future ease in reporting.

**CPA-04697 Explanation**
Choice "b" is correct. Consolidate ALL majority-owned subsidiaries to have one management and one economic entity. Per SFAS 94, this includes domestic, foreign, similar, and dissimilar subsidiaries. Consolidated financial statements are prepared when a parent-subsidiary relationship has been formed. An investor is considered to have parent status when control over an investee is established or more than 50% of the voting stock of the investee has been acquired.

Choices "a", "c", and "d" are incorrect, per the above.

**Cost Method (external reporting)**

**CPA-00286 Type1 M/C A-D Corr Ans: A PM#2 F 3-03**

16. CPA-00286 Nov 92 T #30 Page 12

Pal Corp.'s 1991 dividend income included only part of the dividend received from its Ima Corp. investment. The balance of the dividend reduced Pal's carrying amount for its Ima investment. This reflects that Pal accounts for its Ima investment by the:

a. Cost method, and only a portion of Ima's 1991 dividends represent Pal's earnings after Pal's acquisition.
b. Cost method, and its carrying amount exceeded the proportionate share of Ima's market value.
c. Equity method, and Ima incurred a loss in 1991.
d. Equity method, and its carrying amount exceeded the proportionate share of Ima's market value.

**CPA-00286 Explanation**
Choice "a" is correct. The facts indicate a portion of the dividends were considered income and a portion a return of capital. This implies the cost method and dividends in excess of earnings.

**Rule:** Under the cost method, dividends (not earnings) are reflected as income by the investor. The cost basis investment account is reduced only if:

1. Shares of stock are sold, or
2. Cumulative dividends exceed cumulative earnings (a return of capital), or
3. Subsidiary incurs losses that substantially reduced net worth.

Choice "b" is incorrect. Cost method investments are not adjusted for changes in market value but that does not explain the portion of the dividend not recognized in income.

Choice "c" is incorrect. Under the equity method, 100% of the dividends paid would reduce the investment account.

Choice "d" is incorrect. 100% of the dividends are considered a reduction of the investment account under all circumstances when using the equity method.

**Equity Method (external reporting)**

**CPA-00309 Type1 M/C A-D Corr Ans: D PM#4 F 3-04**

17. CPA-00309 FARE R96 #2 Page 15

When the equity method is used to account for investments in common stock, which of the following affect(s) the investor's reported investment income?

*A change*


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| | *in market value of investee's common stock* | *Cash dividends from investee* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |

**CPA-00309 Explanation**
Choice "d" is correct, No - No.

**Rule:** Investor records as revenue its "share of the investee's earnings" (not "dividends received") under the equity method.

Dividends from an investee company are recorded by the investor as a reduction in the carrying amount of the investment on the balance sheet of the investor.

Changes in the market value of investee's common stock are not considered income to the parent under the equity method.

Under the cost method, receipt of a dividend is recorded as income and does not affect the investment account.

**CPA-00310 Type1 M/C A-D Corr Ans: B PM#5 F 3-04**

18. CPA-00310 Nov 95 #26 Page 15

Grant, Inc. acquired 30% of South Co.'s voting stock for $200,000 on January 2, 1993. Grant's 30% interest in South gave Grant the ability to exercise significant influence over South's operating and financial policies. During 1993, South earned $80,000 and paid dividends of $50,000. South reported earnings of $100,000 for the six months ended June 30, 1994, and $200,000 for the year ended December 31, 1994. On July 1, 1994, Grant sold half of its stock in South for $150,000 cash. South paid dividends of $60,000 on October 1, 1994.

Before income taxes, what amount should Grant include in its 1993 income statement as a result of the investment?

a. $15,000
b. $24,000
c. $50,000
d. $80,000

**CPA-00310 Explanation**
Choice "b" is correct, $24,000 income in 1993 income statement.

| | | | | *Investment account* | |
|---|---|---|---|---|---|
| | 100% | × | 30% = | 30% | |
| | | | | *Equity interest* | |
| Purchase price 1/2/93 | | | | $ 200,000 | |
| Add: 1993 income | 80,000 | × | 30% = | 24,000 | #26 |
| Less: 1993 dividends | | | | | |
| | 50,000 | × | 30% = | (15,000) | |
| Balance at 12/31/93 | | | | 209,000 | #27 |
| Add: 1994 income - 1/2 yr | 100,000 | × | 30% = | 30,000 | |
| Balance at 6/30/94 | | | | 239,000 | |
| Percentage sold | | | | 50% | |
| Cost of half sold | | | | 119,500 | |


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| | | | | | |
|---|---|---|---|---|---|
| Selling price | | | | 150,000 | |
| Gain on sale | | | | $ 30,500 | #28 |

**CPA-00315 Type1 M/C A-D Corr Ans: B PM#6 F 3-04**

19. CPA-00315 Nov 95 #27 Page 15

Grant, Inc. acquired 30% of South Co.'s voting stock for $200,000 on January 2, 1993. Grant's 30% interest in South gave Grant the ability to exercise significant influence over South's operating and financial policies. During 1993, South earned $80,000 and paid dividends of $50,000. South reported earnings of $100,000 for the six months ended June 30, 1994, and $200,000 for the year ended December 31, 1994. On July 1, 1994, Grant sold half of its stock in South for $150,000 cash. South paid dividends of $60,000 on October 1, 1994.

In Grant's December 31, 1993, balance sheet, what should be the carrying amount of this investment?

a. $200,000
b. $209,000
c. $224,000
d. $230,000

**CPA-00315 Explanation**
Choice "b" is correct, $209,000 carrying amount of investment in 12/31/93 balance sheet.

| | | | | *Investment account* | |
|---|---|---|---|---|---|
| | 100% | × | 30% = | 30% | |
| | | | | *Equity interest* | |
| Purchase price 1/2/93 | | | | $ 200,000 | |
| Add: 1993 income | 80,000 | × | 30% = | 24,000 | #26 |
| Less: 1993 dividends | 50,000 | × | 30% = | (15,000) | |
| Balance at 12/31/93 | | | | 209,000 | #27 |
| Add: 1994 income - 1/2 yr | 100,000 | × | 30% = | 30,000 | |
| Balance at 6/30/94 | | | | 239,000 | |
| Percentage sold | | | | 50% | |
| Cost of half sold | | | | 119,500 | |
| Selling price | | | | 150,000 | |
| Gain on sale | | | | $ 30,500 | #28 |

**CPA-00317 Type1 M/C A-D Corr Ans: B PM#7 F 3-04**

20. CPA-00317 Nov 95 #28 Page 15

Grant, Inc. acquired 30% of South Co.'s voting stock for $200,000 on January 2, 1993. Grant's 30% interest in South gave Grant the ability to exercise significant influence over South's operating and financial policies. During 1993, South earned $80,000 and paid dividends of $50,000. South reported earnings of $100,000 for the six months ended June 30, 1994, and $200,000 for the year ended December 31, 1994. On July 1, 1994, Grant sold half of its stock in South for $150,000 cash. South paid dividends of $60,000 on October 1, 1994.

In its 1994 income statement, what amount should Grant report as gain from the sale of half of its investment?

a. $24,500
b. $30,500
c. $35,000


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d. $45,500

**CPA-00317 Explanation**
Choice "b" is correct, $30,500 gain on sale of half of its investment.

| | | | | *Investment account* | |
|---|---|---|---|---|---|
| | 100% | × | 30% = | 30% | |
| | | | | *Equity interest* | |
| Purchase price 1/2/93 | | | | $ 200,000 | |
| Add: 1993 income | 80,000 | × | 30% = | 24,000 | #26 |
| Less: 1993 dividends | 50,000 | × | 30% = | (15,000) | |
| Balance at 12/31/93 | | | | 209,000 | #27 |
| Add: 1994 income - 1/2 yr | 100,000 | × | 30% = | 30,000 | |
| Balance at 6/30/94 | | | | 239,000 | |
| Percentage sold | | | | 50% | |
| Cost of half sold | | | | 119,500 | |
| Selling price | | | | 150,000 | |
| Gain on sale | | | | $ 30,500 | #28 |

**CPA-00318 Type1 M/C A-D Corr Ans: A PM#8 F 3-04**

21. CPA-00318 FARE Nov 94 #15 Page 15

Moss Corp. owns 20% of Dubro Corp.'s preferred stock and 40% of its common stock. Dubro's stock outstanding at December 31, 1993, is as follows:

| | |
|---|---|
| 10% cumulative preferred stock | $100,000 |
| Common stock | 700,000 |

Dubro reported net income of $60,000 and paid dividends of $10,000 to its preferred shareholders for the year ended December 31, 1993. How much total revenue should Moss record due to its investment in Dubro?

a. $22,000
b. $20,000
c. $70,000
d. $50,000

**CPA-00318 Explanation**
Since Moss owns 40% of Dubro's common stock, the equity method is appropriate.

Preferred Stock:
$100,000 x 10% =
$10,000 dividends x 20% ownership = $2,000 dividends received

Common Stock:

| | | |
|---|---|---|
| net income | $60,000 | |
| less pref'd dividends | (10,000) | |
| net income available to common shareholders | 50,000 | |
| Moss' percentage owned | x 40% = | $20,000 equity in earnings |

Choice "a" is correct, $20,000 from equity in earnings plus $2,000 from dividend revenue.


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**CPA-00321 Type1 M/C A-D Corr Ans: D PM#10 F 3-04**

22. CPA-00321 FARE Nov 94 #39 Page 14

Stock dividends on common stock should be recorded at their fair market value by the investor when the related investment is accounted for under which of the following methods?

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

**CPA-00321 Explanation**
Choice "d" is correct, No - No.

**Rule:** Stock dividends and stock splits are not considered income to the recipient.

Therefore, investors do not record stock dividends at fair market value. They simply reallocate the investment account balance (under either method -- cost or equity) over more shares so that value per share decreases.

Choices "a", "b", and "c" are incorrect, per rule above.

**CPA-00322 Type1 M/C A-D Corr Ans: D PM#11 F 3-04**

23. CPA-00322 FARE May 94 #19 (Adapted) Page 14

On January 2, 2002, Kean Co. purchased a 30% interest in Pod Co. for $250,000. On this date, Pod's stockholders' equity was $500,000. The carrying amounts of Pod's identifiable net assets approximated their fair values, except for land whose fair value exceeded its carrying amount by $200,000. Pod reported net income of $100,000 for 2002, and paid no dividends. Kean accounts for this investment using the equity method. In its December 31, 2002, balance sheet, what amount should Kean report as investment in subsidiary?

a. $210,000
b. $220,000
c. $270,000
d. $280,000

**CPA-00322 Explanation**
Choice "d" is correct. Under the equity method, the investment account will be increased by the investor's share of investee's net income (30% × $100,000) and decreased by any dividends declared (none). Thus, the Investment in Pod, at December 31, 2002 is equal to $280,000: $250,000 + $30,000. In order to determine the amount of goodwill, the fair value of the net assets acquired must be determined and then compared with the purchase price:

| | |
|---|---|
| Stockholders' equity | $ 500,000 |
| Excess of FMV, land | 200,000 |
| Total FMV | 700,000 |
| Percentage acquired | 30% |
| FMV of net assets acquired | 210,000 |
| Purchase price | 250,000 |
| Goodwill | $ 40,000 |

Under the equity method, the investment account will be increased by the investor's share of investee's net income (30% × $100,000) and decreased by any dividends declared (none). Thus, the Investment in Pod, at December 31, 2002 is equal to $280,000: $250,000 + $30,000.


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**CPA-00325 Type1 M/C A-D Corr Ans: A PM#13 F 3-04**

24. CPA-00325 Nov 93 T #9 Page 14

Peel Co. received a cash dividend from a common stock investment. Should Peel report an increase in the investment account if it uses the cost method or the equity method of accounting?

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

**CPA-00325 Explanation**
Choice "a" is correct, No - No.

Under the cost method, receipt of a dividend is recorded as income and does not affect the investment account.

Under the equity method, receipt of a dividend is recorded as a decrease in the investment account.

**CPA-00326 Type1 M/C A-D Corr Ans: C PM#14 F 3-04**

25. CPA-00326 Nov 93 I #14 Page 19

Pare, Inc. purchased 10% of Tot Co.'s 100,000 outstanding shares of common stock on January 2, 1992, for $50,000. On December 31, 1992, Pare purchased an additional 20,000 shares of Tot for $150,000. There was no goodwill as a result of either acquisition, and Tot had not issued any additional stock during 1992. Tot reported earnings of $300,000 for 1992. What amount should Pare report in its December 31, 1992, balance sheet as investment in Tot?

a. $170,000
b. $200,000
c. $230,000
d. $290,000

**CPA-00326 Explanation**
Choice "c" is correct, $230,000 investment in Tot at 12/31/92.

**Rule:** When two or more purchases of stock cause ownership in an investee to go from less than 20% to more than 20%, the equity method should be used.

| | | *Total shares* | | | *Investment in Tot Co.* | |
|---|---|---|---|---|---|---|
| | *Date* | *outstanding* | *%* | | *shares* | *amnt* |
| 1st step | 1/2/92 | 100,000 × | 10% | = | 10,000 | $ 50,000 |
| 2nd step | 12/31/92 | 100,000 × | 20% | = | 20,000 | 150,000 |
| Total purchase | | | 30% | | 30,000 | 200,000 |
| Share of earnings (equity method): | | | | | | |
| ($300,000 earnings × 10%) | | | | = | | 30,000 |
| Investment account at 12/31/92 | | | | | | $ 230,000 |

Note: Although the equity method is used, the actual ownership percentage (10%) is used for 1992 since the additional 20% was not purchased until 12/31/92 in 1993, 30% of Tot's earnings would be recorded in the investor's investment account.

**CPA-00334 Type1 M/C A-D Corr Ans: D PM#15 F 3-04**

26. CPA-00334 PI May 93 #5 Page 14


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Pear Co.'s income statement for the year ended December 31, 1992, as prepared by Pear's controller, reported income before taxes of $125,000. The auditor questioned the following amounts that had been included in income before taxes:

| | |
|---|---|
| Equity in earnings of Cinn Co. | $ 40,000 |
| Dividends received from Cinn | 8,000 |
| Adjustments to profits of prior years for arithmetical errors in depreciation | (35,000) |

Pear owns 40% of Cinn's common stock. Pear's December 31, 1992, income statement should report income before taxes of:

a. $85,000
b. $117,000
c. $120,000
d. $152,000

**CPA-00334 Explanation**

Choice "d" is correct. The $40,000 equity in earnings of Cinn is properly included in income. Pear owns 40% of Cinn and uses the equity method. Thus, equity in earnings is included in the income statement while dividends received are not. The $35,000 is a prior period adjustment and should be reported as an adjustment to the opening balance of retained earnings, not on the current period income.

| | |
|---|---|
| Income as reported | $ 125,000 |
| Dividends received | (8,000) |
| Prior period adjustment | 35,000 |
| Income before taxes | $ 152,000 |

APB 18 para. 19

**CPA-00335 Type1 M/C A-D Corr Ans: B PM#16 F 3-04**

27. CPA-00335 May 93 I #43 Page 14

On July 1, 1992, Denver Corp. purchased 3,000 shares of Eagle Co.'s 10,000 outstanding shares of common stock for $20 per share. On December 15, 1992, Eagle paid $40,000 in dividends to its common stockholders. Eagle's net income for the year ended December 31, 1992, was $120,000, earned evenly throughout the year. In its 1992 income statement, what amount of income from this investment should Denver report?

a. $36,000
b. $18,000
c. $12,000
d. $6,000

**CPA-00335 Explanation**

| | |
|---|---|
| Eagle's 1992 income | $ 120,000 |
| Percentage owned – | |
| 3,000 out of 10,000 shares | × 30% |
| | 36,000 |
| Owned for 6 months (7/1/92 to 12/31/92) | × 6/12 |
| Income from investment in Eagle | $ 18,000 |

Choice "b" is correct, $18,000 income from investment in Eagle Co. for 1992.

Notes:
1. In a purchase, income from an investee is recognized only from date of purchase (in a pooling, it is the whole year).
2. The dividends received reduce the investment account, but do not affect the income.
3. With 30% ownership, significant influence is assumed and the equity method is used.


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**CPA-00336 Type1 M/C A-D Corr Ans: B PM#17 F 3-04**

28. CPA-00336 May 92 I #40 (Adapted) Page 16

Sage, Inc. bought 40% of Adams Corp.'s outstanding common stock on January 2, 1991, for $400,000. The carrying amount of Adams' net assets at the purchase date totaled $900,000. Fair values and carrying amounts were the same for all items except for plant and inventory, for which fair values exceeded their carrying amounts by $90,000 and $10,000, respectively. The plant has an 18-year life. All inventory was sold during 1991. During 1991, Adams reported net income of $120,000 and paid a $20,000 cash dividend. What amount should Sage report in its income statement from its investment in Adams for the year ended December 31, 1991?

a. $48,000
b. $42,000
c. $36,000
d. $32,000

**CPA-00336 Explanation**
Choice "b" is correct, $42,000 should be reported in the income statement.

| *Investment in Adams Corp.* | |
|---|---|
| Carrying amount on Adams' books | $ 900,000 |
| Increase in value for: | |
| Plant | 90,000 |
| Inventory | 10,000 |
| Fair market value of Adams | 1,000,000 |
| Percent purchased | 40% |
| FV of 40% purchased (no goodwill) | $ 400,000 |
| *Income earned from investment* | |
| Net income for 1991 | $ 120,000 |
| Percent owned | 40% |
| Share of income before adjustment | 48,000 |
| Amortization of higher plant value ($90,000 × 40% ÷ 18 years) | (2,000) |
| Write off extra value of inventory (10,000 × 40%) | (4,000) |
| Equity in income of 40% investee | $ 42,000 |

**CPA-00338 Type1 M/C A-D Corr Ans: C PM#18 F 3-04**

29. CPA-00338 May 92 I #42 Page 14

Green Corp. owns 30% of the outstanding common stock and 100% of the outstanding noncumulative nonvoting preferred stock of Axel Corp. In 1991, Axel declared dividends of $100,000 on its common stock and $60,000 on its preferred stock. Green exercises significant influence over Axel's operations. What amount of dividend revenue should Green report in its income statement for the year ended December 31, 1991?

a. $0
b. $30,000
c. $60,000
d. $90,000

**CPA-00338 Explanation**
Choice "c" is correct, $60,000

| *Ownership* | | *Dividend Paid* | *Dividend Revenue* | |
|---|---|---|---|---|
| | | | *Cost Method* | *Equity Method* |
| 30% | × | $100,000 com stk. = | 30,000 | na 0 |


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| | | | | |
|---|---|---|---|---|
| 100% | × | 60,000 prf stk. | 60,000 | 60,000 |
| Total dividends under cost method | | | 90,000 | |
| Total dividends under equity method | | | | $60,000 |

Because Green the investor exercises significant influence over the investee corporation, it must use the equity method for recording common stock dividends which are treated as return of capital. Preferred stock dividends are the same under both methods.

**CPA-00341 Type1 M/C A-D Corr Ans: D PM#19 F 3-04**

30. CPA-00341 Nov 91 T #14 (Adapted) Page 16

When the equity method is used to account for investments in common stock, which of the following affects the investor's reported investment income?

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

**CPA-00341 Explanation**
Choice "d" is correct, under the equity method undervalued asset amortization will decrease the investor's reported investment income, but cash dividends received will only affect the balance sheet investment account.

**Rule:** Undervalued asset amortization affects both the investment account (an asset) and the investment income account (a revenue), while cash dividends affect the investment account but not the investment income account.

*Journal entries:*
For undervalued asset amortization:

| | | |
|---|---|---|
| **Dr** Equity revenue (I/S) | $XXX | |
| **Cr** Investment acct (B/S) | | $XXX |

For cash dividends:

| | | |
|---|---|---|
| **Dr** Cash (B/S) | $XXX | |
| **Cr** Investment acct (B/S) | | $XXX |

**CPA-00344 Type1 M/C A-D Corr Ans: C PM#20 F 3-04**

31. CPA-00344 Nov 91 I #41 Page 19

On January 1, 1989, Mega Corp. acquired 10% of the outstanding voting stock of Penny, Inc. On January 2, 1990, Mega gained the ability to exercise significant influence over financial and operating control of Penny by acquiring an additional 20% of Penny's outstanding stock. The two purchases were made at prices proportionate to the value assigned to Penny's net assets, which equaled their carrying amounts. For the years ended December 31, 1989 and 1990, Penny reported the following:

| | *1989* | *1990* |
|---|---|---|
| Dividends paid | $200,000 | $300,000 |
| Net income | 600,000 | 650,000 |

In 1990, what amounts should Mega report as current year investment income and as an adjustment, before income taxes, to 1989 investment income?

| *1990 investment income* | *Adjustment 1989 investment income* |
|---|---|


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a. $195,000 $160,000
b. $195,000 $100,000
c. $195,000 $40,000
d. $105,000 $40,000

**CPA-00344 Explanation**
Choice "c" is correct, 1990 investment income of $195,000 and an adjustment to 1989 investment income of $40,000.

**Rule:** When two or more purchases of stock cause ownership to go from less than 20% to more than 20%, the equity method should be used and the periods during which the cost method was used are retroactively restated.

1990 investment income = 30% × $650,000 = $195,000

1990 adjustment to 1989 investment income:

| | |
|---|---|
| 10% × $600,000 net income = | $ 60,000 |
| 10% × $200,000 dividends paid = | (20,000) |
| adjustment to 1989 | $ 40,000 |

**CPA-00346 Type1 M/C A-D Corr Ans: A PM#21 F 3-04**

32. CPA-00346 Nov 91 I #44 Page 14

In 1990, Neil Co. held the following investments in common stock:

- 25,000 shares of B & K, Inc.'s 100,000 outstanding shares. Neil's level of ownership gives it the ability to exercise significant influence over the financial and operating policies of B & K.
- 6,000 shares of Amal Corp.'s 309,000 outstanding shares.

During 1990, Neil received the following distributions from its common stock investments:

November 6 – $30,000 cash dividend from B & K.
November 11 – $1,500 cash dividend from Amal.
December 26 – 3% common stock dividend from Amal.
The closing price of this stock on a national exchange was $15 per share.

What amount of dividend revenue should Neil report for 1990?

a. $1,500
b. $4,200
c. $31,500
d. $34,200

**CPA-00346 Explanation**
Choice "a" is correct, $1,500 dividend revenue should be reported for 1990, representing the cash dividend from Amal.

The $30,000 cash dividend from B & K is a return of capital as is any dividend under the equity method, since the investment account is reduced.

The 3% stock dividend from Amal means more shares, representing the same proportional piece of the pie. It is not income.

**CPA-00349 Type1 M/C A-D Corr Ans: D PM#23 F 3-04**

33. CPA-00349 Nov 90 I #36 Page 14

Day Co. received dividends from its common stock investments during the year ended December 31, 1989 as follows:


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- A stock dividend of 400 shares from Parr Corp. on July 25, 1989 when the market price of Parr's shares was $20 per share. Day owns less than 1% of Parr's common stock.
- A cash dividend of $15,000 from Lark Corp. in which Day owns a 25% interest. A majority of Lark's directors are also directors of Day.

What amount of dividend revenue should Day report in its 1989 income statement?

a. $23,000
b. $15,000
c. $8,000
d. $0

**CPA-00349 Explanation**
Choice "d" is correct, $0 dividend revenue.

**Rules:**

1. Stock dividend (more shares of stock) is not reported as revenue, only a memo entry is made.
2. Cash dividend (under the equity method) reduces the investment account but does not affect revenue.

**CPA-00350 Type1 M/C A-D Corr Ans: C PM#24 F 3-04**

34. CPA-00350 May 90 I #6 Page 14

Lee, Inc. acquired 30% of Polk Corp.'s voting stock on January 1, 1988 for $100,000. During 1988, Polk earned $40,000 and paid dividends of $25,000. Lee's 30% interest in Polk gives Lee the ability to exercise significant influence over Polk's operating and financial policies. During 1989, Polk earned $50,000 and paid dividends of $15,000 on April 1, and $15,000 October 1. On July 1, 1989, Lee sold half its stock in Polk for $66,000 cash.

Before income taxes, what amount should Lee include in its 1988 income statement as a result of the investment?

a. $40,000
b. $25,000
c. $12,000
d. $7,500

**CPA-00350 Explanation**
Choice "c" is correct, $12,000 income in 1988 income statement.

| | | | *Investment 30% equity interest* | *Account* |
|---|---|---|---|---|
| | 100% × 30% | = | | |
| Purchase price 1/1/88 | | | $100,000 | |
| Add: 1988 income | $ 40,000 × 30% | = | 12,000 | |
| Less: 1988 dividends | 25,000 × 30% | = | (7,500) | |
| Balance at 12/31/88 | | | 104,500 | |
| Add: 1989 income - 1/2 yr | 50,000 × 30% | = | 7,500 | |
| Less: 4/1/89 dividend | 15,000 × 30% | = | (4,500) | |
| Balance at 6/30/89 | | | 107,500 | |
| Percentage sold | | | × 50% | |
| Cost of half sold | | | 53,750 | |
| Selling price | | | 66,000 | |
| Gain on sale | | | $ 12,250 | |

**CPA-00351 Type1 M/C A-D Corr Ans: B PM#25 F 3-04**

35. CPA-00351 May 90 I #7 Page 14


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Lee, Inc. acquired 30% of Polk Corp.'s voting stock on January 1, 1988 for $100,000. During 1988, Polk earned $40,000 and paid dividends of $25,000. Lee's 30% interest in Polk gives Lee the ability to exercise significant influence over Polk's operating and financial policies. During 1989, Polk earned $50,000 and paid dividends of $15,000 on April 1, and $15,000 October 1. On July 1, 1989, Lee sold half its stock in Polk for $66,000 cash.

The carrying amount of this investment in Lee's December 31, 1988 balance sheet should be:

a. $100,000
b. $104,500
c. $112,000
d. $115,000

**CPA-00351 Explanation**
Choice "b" is correct, $104,500 carrying amount of investment in 12/31/88 balance sheet.

| | | | *Investment 30% equity interest* | *Account* |
|---|---|---|---|---|
| | 100% × 30% | = | | |
| Purchase price 1/1/88 | | | $100,000 | |
| Add: 1988 income | $ 40,000 × 30% | = | 12,000 | |
| Less: 1988 dividends | 25,000 × 30% | = | (7,500) | |
| Balance at 12/31/88 | | | 104,500 | |
| Add: 1989 income - 1/2 yr | 50,000 × 30% | = | 7,500 | |
| Less: 4/1/89 dividend | 15,000 × 30% | = | (4,500) | |
| Balance at 6/30/89 | | | 107,500 | |
| Percentage sold | | | × 50% | |
| Cost of half sold | | | 53,750 | |
| Selling price | | | 66,000 | |
| Gain on sale | | | $ 12,250 | |

**CPA-00352 Type1 M/C A-D Corr Ans: C PM#26 F 3-04**

36. CPA-00352 May 90 I #8 Page 14

Lee, Inc. acquired 30% of Polk Corp.'s voting stock on January 1, 1988 for $100,000. During 1988, Polk earned $40,000 and paid dividends of $25,000. Lee's 30% interest in Polk gives Lee the ability to exercise significant influence over Polk's operating and financial policies. During 1989, Polk earned $50,000 and paid dividends of $15,000 on April 1, and $15,000 October 1. On July 1, 1989, Lee sold half its stock in Polk for $66,000 cash.

What should be the gain on sale of this investment in Lee's 1989 income statement?

a. $16,000
b. $13,750
c. $12,250
d. $10,000

**CPA-00352 Explanation**
Choice "c" is correct, $12,250 gain on sale of investment.

| | | | *Investment 30% equity interest* | *Account* |
|---|---|---|---|---|
| | 100% × 30% | = | | |
| Purchase price 1/1/88 | | | $100,000 | |
| Add: 1988 income | $ 40,000 × 30% | = | 12,000 | |
| Less: 1988 dividends | 25,000 × 30% | = | (7,500) | |
| Balance at 12/31/88 | | | 104,500 | |
| Add: 1989 income - 1/2 yr | 50,000 × 30% | = | 7,500 | |
| Less: 4/1/89 dividend | 15,000 × 30% | = | (4,500) | |
| Balance at 6/30/89 | | | 107,500 | |


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| | |
|---|---|
| Percentage sold | × 50% |
| Cost of half sold | 53,750 |
| Selling price | 66,000 |
| Gain on sale | $ 12,250 |

**CPA-00353 Type1 M/C A-D Corr Ans: D PM#27 F 3-04**

37. CPA-00353 Nov 89 T #4 Page 14

An investor in common stock received dividends in excess of the investor's share of investee's earnings subsequent to the date of the investment. How will the investor's investment account be affected by those dividends under each of the following accounting methods?

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

**CPA-00353 Explanation**
Choice "d" is correct, "decrease - decrease."

**Rule:** Under both the cost and equity methods, liquidating dividends reduce the carrying amount of the investment account.

**CPA-05616 Type1 M/C A-D Corr Ans: B PM#28 F 3-04**

38. CPA-05616 Page 19

On January 1, 20X8, Parker Inc. acquired 30% of Smith Inc.'s outstanding common stock for $400,000. During 20X8, Smith had net income of $100,000 and paid dividends of $30,000. On January 1, 20X9, Parker acquired an additional 45% interest on Smith for $1,012,000. The fair value of Smith on January 1, 20X9 was $2,250,000. What amount of gain from this transaction will Parker record in 20X9?

a. $0
b. $254,000
c. $275,000
d. $675,000

**CPA-05616 Explanation**
Choice "b" is correct. When an investor goes from non-control to control of a subsidiary through a step acquisition, the previously held equity investment must be adjusted to fair value. The fair value adjustment is recognized as a gain or loss by the investor in the period of the additional acquisition.

To compute the adjustment made on January 1, 20X9, the carrying amount of Parker's investment in Smith on that date must first be calculated. Because Parker previously owned 30% of Smith, the investment would have been accounted for using the equity method:

| | |
|---|---|
| Investment in Smith, 1/1/X8 | $400,000 |
| + 30% share of Smith's 20X8 earnings | 30,000 |
| - 30% share of Smith's 20X8 dividends | (9,000) |
| Investment in Smith, 12/31/X8 | $421,000 |

| | Original Interest 30% | Acquired Interest 45% | Noncontrolling Interest 25% | Total Fair Value |
|---|---|---|---|---|
| Beg. Carrying Amount | $421,000 | $1,012,000 | | |
| Adjustment | 254,000 | | 562,500 | |
| New Carrying Amount | $675,000 | $1,012,000 | $562,000 | $2,250,000 |


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The $254,000 adjustment necessary to adjust the original investment to its July 1, 20X9 fair value is recorded by Parker as a gain in 20X9.

Choice "a" is incorrect. A gain must be recorded to adjust the investment to fair value on 1/1/X9.

Choice "c" is incorrect. This calculation assumes that the 30% interest is reported at $400,000 on 1/1/X9. Parker would use the equity method to account for its investment in Smith during 20X8 and the ending value of the investment would be $421,000 on 12/31/X8 (see the calculation above).

Choice "d" is incorrect. This is the total fair value of the original 30% interest on July 1, 20X9.

**Consolidated Financial Statements**

**CPA-00372 Type1 M/C A-D Corr Ans: A PM#1 F 3-05**

39. CPA-00372 FARE C03 #1 Page 48

Assume Kiwi, Inc.'s planned combination with Mori Co. on December 31, 2000, can be structured either as an acquisition or a pooling of interests. Both Kiwi and Mori were incorporated and began business on January 1, 1999. Both Kiwi and Mori reported net income for 1999 and 2000. Consolidated retained earnings for Kiwi, Inc. and Subsidiary as of December 31, 2000 will include the net income of Mori Co., from what date?

| | *Purchase* | *Pooling* |
|---|---|---|
| a. | It will not include the net income of Mori Co. | January 1, 1999 |
| b. | It will not include the net Income of Mori Co. | January 1, 2000 |
| c. | January 1, 1999 | January 1, 1999 |
| d. | January 1, 2000 | January 1, 1999 |

**CPA-00372 Explanation**
Choice "a" is correct. A pooling is considered a retroactive combining together of stockholder interests. In a pooling, consolidated retained earnings includes the retained earnings of all pooled subsidiaries. Consolidated retained earnings would include Mori's net income from its inception. In acquisition accounting, the earnings of a subsidiary are only included in consolidated retained earnings from the date of acquisition.

**CPA-00373 Type1 M/C A-D Corr Ans: C PM#2 F 3-05**

40. CPA-00373 FARE Nov 95 #52 Page 48

In a business combination, how should long-term debt of the acquired company generally be reported under each of the following methods?

| | *Pooling of interest* | *Acquisition* |
|---|---|---|
| a. | Fair value | Carrying amount |
| b. | Fair value | Fair value |
| c. | Carrying amount | Fair value |
| d. | Carrying amount | Carrying amount |

**CPA-00373 Explanation**
Choice "c" is correct. In the pooling of interest method, all assets and liabilities are reported at their carrying value, since no acquisition is recognized. In the acquisition method, all assets and liabilities are reported at their fair values (as if the net assets had been purchased separately).

**CPA-00381 Type1 M/C A-D Corr Ans: A PM#3 F 3-05**

41. CPA-00381 FARE May 95 #54 Page 48

Poe, Inc. acquired 100% of Shaw Co. in a business combination on September 30, 1994. During 1994, Poe declared quarterly dividends of $25,000 and Shaw declared quarterly dividends of $10,000. Under


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each of the following methods of accounting for the business combination, what amount should be reported as dividends declared in the December 31, 1994, consolidated statement of retained earnings?

| | *Acquisition* | *Pooling of interests* |
|---|---|---|
| a. | $100,000 | $130,000 |
| b. | $100,000 | $140,000 |
| c. | $130,000 | $130,000 |
| d. | $130,000 | $140,000 |

**CPA-00381 Explanation**

Choice "a" is correct, $100,000 – $130,000.

**Rule:** In an "acquisition," net income and dividends declared of a newly acquired sub will only be included in the consolidated statements from the date of acquisition. In a "pooling" net income and dividends declared of a newly acquired sub are included in the consolidated statements for the entire period regardless of the date of pooling. In both cases, any intercompany profits or dividends are eliminated.

| | | | *Acquisition* | *Pooling* |
|---|---|---|---|---|
| Dividends declared | | | | |
| By parent (Poe) | 1 | Q | $ 25,000 | $ 25,000 |
| | 2 | Q | $ 25,000 | $ 25,000 |
| | 3 | Q | $ 25,000 | $ 25,000 |
| | 4 | Q | $ 25,000 | $ 25,000 |
| Dividends declared | | | | |
| By subsidiary | | | | |
| (Shaw) | 1 | Q | $ 0 | $ 10,000 |
| | 2 | Q | $ 0 | $ 10,000 |
| | 3 | Q | $ 0 | $ 10,000 |
| Acquired 9/30/94 | 4 | Q | $ 10,000 | $ 10,000 |
| Sub-total | | | $110,000 | $140,000 |
| Less intercompany | | | (10,000) | (10,000) |
| | | | $100,000 | $130,000 |

**CPA-00382 Type1 M/C A-D Corr Ans: D PM#4 F 3-05**

42. CPA-00382 FARE May 94 #52 Page 48

A business combination occurs in the middle of the year. Results of operations for the year of combination would include the combined results of operations of the separate companies for the entire year if the business combination is a:

| | *Acquisition* | *Pooling of interests* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | No |
| d. | No | Yes |

**CPA-00382 Explanation**

Choice "d" is correct. Acquisition accounting includes results of operations from the acquisition date forward. Pooling of interests combines the results of operations from the beginning of the fiscal year, and if comparative financial statements are presented, retroactively restates the results of operations as if the companies were always one entity.

**CPA-00386 Type1 M/C A-D Corr Ans: D PM#5 F 3-05**

43. CPA-00386 PI May 93 #8 Page 22


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On June 30, 1992, Pane Corp. exchanged 150,000 shares of its $20 par value common stock for all of Sky Corp.'s common stock. At that date, the fair value of Pane's common stock issued was equal to the book value of Sky's net assets. Both corporations continued to operate as separate businesses, maintaining accounting records with years ending December 31. Information from separate company operations follows:

| | *Pane* | *Sky* |
|---|---|---|
| Retained earnings-12/31/91 | $3,200,000 | $925,000 |
| Net income-six months ended 6/30/92 | 800,000 | 275,000 |
| Dividends paid-3/25/92 | 750,000 | - |

If the business combination is accounted for as an acquisition, what amount of retained earnings would Pane report, in its June 30, 1992, consolidated balance sheet?

a. $5,200,000
b. $3,525,000
c. $4,450,000
d. $3,250,000

**CPA-00386 Explanation**
Choice "d" is correct, $3,250,000 consolidated retained earnings in 6/30/92 balance sheet (acquisition method).

| | *Pane* | *Sky* | *Total* |
|---|---|---|---|
| Retained earnings (12/31/91) | $3,200,000 | N/A | $3,200,000 |
| Net income (12/1/91-6/30/92) | 800,000 | N/A | 800,000 |
| Less div paid (3/25/92) | (750,000) | N/A | (750,000) |
| | $3,250,000 | N/A | $3,250,000 |

**CPA-00388 Type1 M/C A-D Corr Ans: B PM#6 F 3-05**

44. CPA-00388 Nov 92 T #31 Page 21

Penn, Inc., a manufacturing company, owns 75% of the common stock of Sell, Inc., an investment company. Sell owns 60% of the common stock of Vane, Inc., an insurance company. In Penn's consolidated financial statements, should consolidation accounting or equity method accounting be used for Sell and Vane?

a. Consolidation used for Sell and equity method used for Vane.
b. Consolidation used for both Sell and Vane.
c. Equity method used for Sell and consolidation used for Vane.
d. Equity method used for both Sell and Vane.

**CPA-00388 Explanation**
Choice "b" is correct, in Penn's consolidated financial statements, consolidation accounting should be used for both Sell and Vane.

**Rule:** In a vertical chain, where parent co. owns more than 50% of subsidiary co., and subsidiary owns more than 50% of a third company, consolidate:

1. Third co. into subsidiary co.
2. Subsidiary co. (now consolidated with third co.) into parent co.

**Acquisition Method (external reporting)**

**CPA-00416 Type1 M/C A-D Corr Ans: D PM#3 F 3-06**

45. CPA-00416 FARE R96 #3 (Adapted) Page 22

Mega, Inc. was organized to consolidate the resources of Lone Co. and Small Co. in a business combination accounted for by the acquisition method. Mega issued 31,000 shares of its $10 par voting


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stock with a fair value of $15 per share, in exchange for all the outstanding capital stock of Lone and Small. The equity accounts of Lone and Small on the date of the exchange were:

| | *Lone* | *Small* | *Total* |
|---|---|---|---|
| Common stock, at par | $100,000 | $200,000 | $300,000 |
| Additional paid-in capital | 12,500 | 17,500 | 30,000 |
| Retained earnings | 60,000 | 105,000 | 165,000 |
| | $172,500 | $322,500 | $495,000 |

What is the balance in Mega's additional paid-in capital account immediately after the business combination?

a. $12,500
b. $17,500
c. $30,000
d. $155,000

**CPA-00416 Explanation**
Choice "d" is correct. The transaction is recorded at the fair market value of the stock issued. The journal entry would be:

| | | | |
|---|---|---|---|
| **DR:** | Investment in sub | $465,000 | |
| **CR:** | Common stock (par) | | $310,000 |
| **CR:** | APIC | | $155,000 |

Choice "a" is incorrect. Lone's APIC is not the correct amount.

Choice "b" is incorrect. Small's APIC is not the correct amount.

Choice "c" is incorrect. The combined APIC of Lone and Small is not the correct amount.

**CPA-00418 Type1 M/C A-D Corr Ans: C PM#4 F 3-06**

46. CPA-00418 FARE Nov 95 #53 (Adapted) Page 22

In a business combination accounted for as a purchase, the appraised values of the identifiable assets acquired exceeded the acquisition price. How should the excess appraised value be reported?

a. As negative goodwill.
b. As an extraordinary gain.
c. As a reduction of the values assigned to noncurrent assets and an extraordinary gain for any unallocated portion.
d. As positive goodwill.

**CPA-00418 Explanation**
Choice "c" is correct. When the appraised values of the identifiable net assets exceed the acquisition price (i.e., a "bargain" purchase), the noncurrent assets must be written down on a relative value basis with any unallocated portion of the excess value being recorded as an extraordinary gain. FASB 141 para. 62

Choice "a" is incorrect. Negative goodwill is not recorded. Instead, the noncurrent assets must be written down on a relative value basis with any unallocated portion of the excess value being recorded as an extraordinary gain.

Choice "b" is incorrect. An extraordinary gain is recognized only after the noncurrent assets have been written down.

Choice "d" is incorrect. Positive goodwill results, and is recorded, only if the acquisition price exceeds the fair values of the identifiable net assets.

**CPA-00420 Type1 M/C A-D Corr Ans: C PM#5 F 3-06**


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47. CPA-00420 FARE May 95 #53 Page 26

A business combination is accounted for properly as an acquisition. Direct costs of combination, other than registration and issuance costs of equity securities, should be:

a. Capitalized as a deferred charge and amortized.
b. Deducted directly from the retained earnings of the combined corporation.
c. Deducted in determining the net income of the combined corporation for the period in which the costs were incurred.
d. Included in the acquisition cost to be allocated to identifiable assets according to their fair values.

**CPA-00420 Explanation**
Choice "c" is correct. Direct costs are expensed in the period incurred.

**CPA-00421 Type1 M/C A-D Corr Ans: B PM#6 F 3-06**

48. CPA-00421 Th May 93 #6 Page 28

On September 1, 1990, Phillips, Inc. issued common stock in exchange for 20% of Sago, Inc.'s outstanding common stock. On July 1, 1992, Phillips issued common stock for an additional 75% of Sago's outstanding common stock. Sago continues in existence as Phillips' subsidiary. How much of Sago's 1992 net income should be reported as accruing to Phillips?

a. 20% of Sago's net income to June 30 and all of Sago's net income from July 1 to December 31.
b. 20% of Sago's net income to June 30 and 95% of Sago's net income from July 1 to December 31.
c. 95% of Sago's net income.
d. All of Sago's net income.

**CPA-00421 Explanation**
Choice "b" is correct, 20% of Sago's net income to June 30 and 95% of Sago's net income from July 1 to December 31.

**Rule:** In an acquisition, the net income of a newly acquired subsidiary will only be included in consolidated net income from the date of acquisition. Therefore, only 20% of Sago net income is included in consolidated earnings until June 30 and 95% thereafter.

**CPA-00422 Type1 M/C A-D Corr Ans: D PM#7 F 3-06**

49. CPA-00422 Th May 93 #7 Page 28

PDX Corp. acquired 100% of the outstanding common stock of Sea Corp. in an acquisition transaction. The cost of the acquisition exceeded the fair value of the identifiable assets and assumed liabilities. The general guidelines for assigning amounts to the inventories acquired provide for:

a. Raw materials to be valued at original cost.
b. Work in process to be valued at the estimated selling prices of finished goods, less both costs to complete and costs of disposal.
c. Finished goods to be valued at replacement cost.
d. Finished goods to be valued at estimated selling prices, less both costs of disposal and a reasonable profit allowance.

**CPA-00422 Explanation**
Choice "d" is correct. With acquisition accounting the net assets acquired are based on fair market value. The fair value of finished goods and merchandise inventory are based upon selling price less disposal costs and a reasonable profit allowance.

Choice "a" is incorrect. The fair value of raw materials should be based upon replacement costs.

Choice "b" is incorrect. The fair value of work in process should be based upon the estimated selling price of finished goods less the costs to complete and dispose and a reasonable profit allowance.


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Choice "c" is incorrect. Replacement costs are an appropriate measure of fair market value for raw materials inventory, but not finished goods.

**CPA-00426 Type1 M/C A-D Corr Ans: C PM#9 F 3-06**

50. CPA-00426 May 92 I #6 (Adapted) Page 28

On January 1, 1991, Dallas, Inc. acquired 80% of Style, Inc.'s outstanding common stock for $120,000. On that date, the carrying amounts of Style's assets and liabilities approximated their fair values. During 1991, Style paid $5,000 cash dividends to its stockholders. Summarized balance sheet information for the two companies follows:

| | *Dallas* | *Style* | |
|---|---|---|---|
| | 12/31/91 | 12/31/91 | 1/1/91 |
| Investment in Style (equity method) | $132,000 | | |
| Other assets | 138,000 | $115,000 | $100,000 |
| | $270,000 | $115,000 | $100,000 |
| Common stock | $ 50,000 | $ 20,000 | $ 20,000 |
| Additional paid-in capital | 80,250 | 44,000 | 44,000 |
| Retained earnings | 139,750 | 51,000 | 36,000 |
| | $270,000 | $115,000 | $100,000 |

What amount should Dallas report as earnings from subsidiary, in its 1991 income statement?

a. $12,000
b. $15,000
c. $16,000
d. $20,000

**CPA-00426 Explanation**
Choice "c" is correct, $16,000 earnings from subsidiary.

| *Subsidiary's retained earnings statement* | | |
|---|---|---|
| 1/1/91 balance | | $36,000 |
| Income | squeeze | 20,000 |
| | | 56,000 |
| Dividend paid | | (5,000) |
| 12/31/91 balance | | 51,000 |

| *Earnings from subsidiary* | |
|---|---|
| 1991 income | 20,000 |
| Percent owned | x 80% |
| Dallas' share | $16,000 |

**CPA-00427 Type1 M/C A-D Corr Ans: A PM#10 F 3-06**

51. CPA-00427 May 92 I #7 Page 28

On January 1, 1991, Dallas, Inc. acquired 80% of Style, Inc.'s outstanding common stock for $120,000. On that date, the carrying amounts of Style's assets and liabilities approximated their fair values. During 1991, Style paid $5,000 cash dividends to its stockholders. Summarized balance sheet information for the two companies follows:

| | *Dallas* | *Style* | |
|---|---|---|---|
| | 12/31/91 | 12/31/91 | 1/1/91 |
| Investment in Style (equity method) | $132,000 | | |
| Other assets | 138,000 | $115,000 | $100,000 |
| | $270,000 | $115,000 | $100,000 |
| Common stock | $ 50,000 | $ 20,000 | $ 20,000 |
| Additional paid-in capital | 80,250 | 44,000 | 44,000 |


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| | | | |
|---|---|---|---|
| Retained earnings | 139,750 | 51,000 | 36,000 |
| | $270,000 | $115,000 | $100,000 |

What amount of total stockholders' equity should be reported in Dallas' December 31, 1991, consolidated balance sheet?

a. $270,000
b. $286,000
c. $362,000
d. $385,000

**CPA-00427 Explanation**
Choice "a" is correct, $270,000 total consolidated stockholders' equity.

Dallas' consolidated stockholders' equity will be the same as the parent company stockholders' equity:

| | |
|---|---|
| Common stock | $50,000 |
| Additional paid in | 80,250 |
| Retained earnings | 139,750 |
| | $270,000 |

**CPA-00429 Type1 M/C A-D Corr Ans: D PM#11 F 3-06**

52. CPA-00429 Nov 91 II #10 Page 28

Beni Corp. purchased 100% of Carr Corp.'s outstanding capital stock for $430,000 cash. Immediately before the acquisition, the balance sheets of both corporations reported the following:

| | *Beni* | *Carr* |
|---|---|---|
| Assets | $2,000,000 | $750,000 |
| Liabilities | $ 750,000 | $400,000 |
| Common stock | 1,000,000 | 310,000 |
| Retained earnings | 250,000 | 40,000 |
| Liabilities and stockholders' equity | $2,000,000 | $750,000 |

At the date of purchase, the fair value of Carr's assets was $50,000 more than the aggregate carrying amounts. In the consolidated balance sheet prepared immediately after the acquisition, the consolidated stockholders' equity should amount to:

a. $1,680,000
b. $1,650,000
c. $1,600,000
d. $1,250,000

**CPA-00429 Explanation**
Choice "d" is correct, $1,250,000 consolidated stockholders' equity (the same as the parent company).

**Rule:** At date of acquisition, the consolidated equity will be the same as the parent company's equity. The subsidiary company's equity accounts are eliminated.

**CPA-00486 Type1 M/C A-D Corr Ans: A PM#13 F 3-06**

53. CPA-00486 May 91 I #13 (Adapted) Page 29

The separate condensed balance sheets and income statements of Purl Corp. and its wholly-owned subsidiary, Scott Corp., are as follows:

**BALANCE SHEETS**
**December 31, 1990**

| | *Purl* | *Scott* |
|---|---|---|
| *Assets* | | |


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| | | |
|---|---|---|
| Current assets | | |
| Cash | $ 80,000 | $ 60,000 |
| Accounts receivable (net) | 140,000 | 25,000 |
| Inventories | 90,000 | 50,000 |
| Total current assets | 310,000 | 135,000 |
| Property, plant, and equipment (net) | 625,000 | 280,000 |
| Investment in Scott (equity method) | 400,000 | - |
| Total assets | $1,335,000 | $415,000 |
| | *Liabilities and Stockholders' Equity* | |
| Current liabilities | | |
| Accounts payable | $ 160,000 | $ 95,000 |
| Accrued liabilities | 110,000 | 30,000 |
| Total current liabilities | 270,000 | 125,000 |
| Stockholders' equity | | |
| Common stock ($10 par) | 300,000 | 50,000 |
| Additional paid-in capital | - | 10,000 |
| Retained earnings | 765,000 | 230,000 |
| Total stockholders' equity | 1,065,000 | 290,000 |
| Total liabilities and stockholders' equity | $1,335,000 | $415,000 |

**INCOME STATEMENTS**
For the Year Ended December 31, 1990

| | *Purl* | *Scott* |
|---|---|---|
| Sales | $2,000,000 | $750,000 |
| Cost of goods sold | 1,540,000 | 500,000 |
| Gross margin | 460,000 | 250,000 |
| Operating expenses | 260,000 | 150,000 |
| Operating income | 200,000 | 100,000 |
| Equity in earnings of Scott | 70,000 | - |
| Income before income taxes | 270,000 | 100,000 |
| Provision for income taxes | 60,000 | 30,000 |
| Net income | $ 210,000 | $ 70,000 |

Additional information:

- On January 1, 1990, Purl purchased for $360,000 all of Scott's $10 par, voting common stock. On January 1, 1990, the fair value of Scott's assets and liabilities equaled their carrying amount of $395,000 and $145,000, respectively, except that the fair values of certain items identifiable in Scott's inventory were $10,000 more than their carrying amounts. These items were still on hand at December 31, 1990.
- During 1990, Purl and Scott paid cash dividends of $100,000 and $30,000, respectively. For tax purposes, Purl receives the 100% exclusion for dividends received from Scott.
- There were no intercompany transactions, except for Purl's receipt of dividends from Scott and Purl's recording of its share of Scott's earnings.
- Both Purl and Scott paid income taxes at the rate of 30%.
- During Year X, there was no impairment of goodwill.

In the December 31, 1990, consolidated financial statements of Purl and its subsidiary:

Total current assets should be:

a. $455,000
b. $445,000


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c. $310,000
d. $135,000

**CPA-00486 Explanation**
Choice "a" is correct, $455,000 total current assets.

| | |
|---|---|
| Purl | $310,000 |
| Scott | 135,000 |
| Inventory adjust to FMV | 10,000 |
| | $455,000 |

**CPA-00492 Type1 M/C A-D Corr Ans: D PM#14 F 3-06**

54. CPA-00492 May 91 I #15 (Adapted) Page 22

The separate condensed balance sheets and income statements of Purl Corp. and its wholly-owned subsidiary, Scott Corp., are as follows:

**BALANCE SHEETS**
**December 31, 1990**

| | *Purl* | *Scott* |
|---|---|---|
| *Assets* | | |
| Current assets | | |
| Cash | $ 80,000 | $ 60,000 |
| Accounts receivable (net) | 140,000 | 25,000 |
| Inventories | 90,000 | 50,000 |
| Total current assets | 310,000 | 135,000 |
| Property, plant, and equipment (net) | 625,000 | 280,000 |
| Investment in Scott (equity method) | 400,000 | - |
| Total assets | $1,335,000 | $415,000 |
| | *Liabilities and Stockholders' Equity* | |
| Current liabilities | | |
| Accounts payable | $ 160,000 | $ 95,000 |
| Accrued liabilities | 110,000 | 30,000 |
| Total current liabilities | 270,000 | 125,000 |
| Stockholders' equity | | |
| Common stock ($10 par) | 300,000 | 50,000 |
| Additional paid-in capital | - | 10,000 |
| Retained earnings | 765,000 | 230,000 |
| Total stockholders' equity | 1,065,000 | 290,000 |
| Total liabilities and stockholders' equity | $1,335,000 | $415,000 |

**INCOME STATEMENTS**
For the Year Ended December 31, 1990

| | *Purl* | *Scott* |
|---|---|---|
| Sales | $2,000,000 | $750,000 |
| Cost of goods sold | 1,540,000 | 500,000 |
| Gross margin | 460,000 | 250,000 |
| Operating expenses | 260,000 | 150,000 |
| Operating income | 200,000 | 100,000 |
| Equity in earnings of Scott | 70,000 | - |
| Income before income taxes | 270,000 | 100,000 |
| Provision for income taxes | 60,000 | 30,000 |
| Net income | $ 210,000 | $ 70,000 |


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Additional information:

- On January 1, 1990, Purl purchased for $360,000 all of Scott's $10 par, voting common stock. On January 1, 1990, the fair value of Scott's assets and liabilities equaled their carrying amount of $395,000 and $145,000, respectively, except that the fair values of certain items identifiable in Scott's inventory were $10,000 more than their carrying amounts. These items were still on hand at December 31, 1990.
- During 1990, Purl and Scott paid cash dividends of $100,000 and $30,000, respectively. For tax purposes, Purl receives the 100% exclusion for dividends received from Scott.
- There were no intercompany transactions, except for Purl's receipt of dividends from Scott and Purl's recording of its share of Scott's earnings.
- Both Purl and Scott paid income taxes at the rate of 30%.
- During Year X, there was no impairment of goodwill.

In the December 31, 1990, consolidated financial statements of Purl and its subsidiary:

Total retained earnings should be:

a. $985,000
b. $825,000
c. $795,000
d. $765,000

**CPA-00492 Explanation**
Choice "d" is correct, $765,000 total retained earnings. Consolidated retained earnings are the same as the parent company retained earnings, when financial statements are consolidated under the acquisition method.

**CPA-00494 Type1 M/C A-D Corr Ans: B PM#15 F 3-06**

55. CPA-00494 May 91 I #16 (Adapted) Page 22

The separate condensed balance sheets and income statements of Purl Corp. and its wholly-owned subsidiary, Scott Corp., are as follows:

**BALANCE SHEETS**
**December 31, 1990**

| | *Purl* | *Scott* |
|---|---|---|
| *Assets* | | |
| Current assets | | |
| Cash | $ 80,000 | $ 60,000 |
| Accounts receivable (net) | 140,000 | 25,000 |
| Inventories | 90,000 | 50,000 |
| Total current assets | 310,000 | 135,000 |
| Property, plant, and equipment (net) | 625,000 | 280,000 |
| Investment in Scott (equity method) | 400,000 | - |
| Total assets | $1,335,000 | $415,000 |
| | *Liabilities and Stockholders' Equity* | |
| Current liabilities | | |
| Accounts payable | $ 160,000 | $ 95,000 |
| Accrued liabilities | 110,000 | 30,000 |
| Total current liabilities | 270,000 | 125,000 |
| Stockholders' equity | | |
| Common stock ($10 par) | 300,000 | 50,000 |
| Additional paid-in capital | - | 10,000 |


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| | | |
|---|---|---|
| Retained earnings | 765,000 | 230,000 |
| Total stockholders' equity | 1,065,000 | 290,000 |
| Total liabilities and stockholders' equity | $1,335,000 | $415,000 |

**INCOME STATEMENTS**
For the Year Ended December 31, 1990

| | *Purl* | *Scott* |
|---|---|---|
| Sales | $2,000,000 | $750,000 |
| Cost of goods sold | 1,540,000 | 500,000 |
| Gross margin | 460,000 | 250,000 |
| Operating expenses | 260,000 | 150,000 |
| Operating income | 200,000 | 100,000 |
| Equity in earnings of Scott | 70,000 | - |
| Income before income taxes | 270,000 | 100,000 |
| Provision for income taxes | 60,000 | 30,000 |
| Net income | $ 210,000 | $ 70,000 |

Additional information:

- On January 1, 1990, Purl purchased for $360,000 all of Scott's $10 par, voting common stock. On January 1, 1990, the fair value of Scott's assets and liabilities equaled their carrying amount of $395,000 and $145,000, respectively, except that the fair values of certain items identifiable in Scott's inventory were $10,000 more than their carrying amounts. These items were still on hand at December 31, 1990.
- During 1990, Purl and Scott paid cash dividends of $100,000 and $30,000, respectively. For tax purposes, Purl receives the 100% exclusion for dividends received from Scott.
- There were no intercompany transactions, except for Purl's receipt of dividends from Scott and Purl's recording of its share of Scott's earnings.
- Both Purl and Scott paid income taxes at the rate of 30%.
- During Year X, there was no impairment of goodwill.

In the December 31, 1990, consolidated financial statements of Purl and its subsidiary:

Net income should be:

a. $270,000
b. $210,000
c. $190,000
d. $170,000

**CPA-00494 Explanation**
Choice "b" is correct, $210,000 net income. Consolidated net income is the same as parent company net income, when the equity method is used.

**CPA-00590 Type1 M/C A-D Corr Ans: C PM#16 F 3-06**

56. CPA-00590 PI May 93 #25 Page 16

On November 30, 1992, Parlor, Inc. purchased for cash at $15 per share all 250,000 shares of the outstanding common stock of Shaw Co. At November 30, 1992, Shaw's balance sheet showed a carrying amount of net assets of $3,000,000. At that date, the fair value of Shaw's property, plant and equipment exceeded its carrying amount by $400,000. In its November 30, 1992, consolidated balance sheet, what amount should Parlor report as goodwill?

a. $750,000
b. $400,000


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c. $350,000
d. $0

**CPA-00590 Explanation**
Choice "c" is correct. Goodwill is the difference between the fair value of the subsidiary of $3,750,000 ($15 x $250,000) and fair market value of the net assets acquired, $3,400,000. $3,750,000 - $3,400,000 = $350,000. APB 16 para. 87

Choice "a" is incorrect. Goodwill is the difference between the fair value of the subsidiary and the fair market value of the net assets acquired, not the carrying amount.

Choice "b" is incorrect. Goodwill is the difference between the fair value of the subsidiary and fair market value of the net assets acquired, not the difference between carrying value and the fair market value of the assets acquired.

Choice "d" is incorrect. Goodwill is recorded in the acquisition. It is the fair value of the subsidiary less the fair market value of the net assets acquired.

**CPA-05617 Type1 M/C A-D Corr Ans: D PM#17 F 3-06**

57. CPA-05617 Page 27

On January 1, 20X5, Placid Company acquired 80% of Serene Company's 100,000 shares of common stock for $1,600,000. Placid accounts for the investment internally using the cost method. On January 1, 20X9, Placid sold 50,000 shares of Serene for $25 per share. What is the total gain to be reported on Placid's 20X9 income statement?

a. $0
b. $150,000
c. $250,000
d. $400,000

**CPA-05617 Explanation**
Choice "d" is correct. When an investor sells shares and goes from control to non-control, the investor must recognize a gain or loss from the sale of the stock and then remeasure the remaining non-consolidating interest to fair value. The fair value adjustment is recognized as an additional gain or loss on the income statement.

In 20X5, Placid purchased 80,000 shares (80% x 100,000) for $1,600,000 or $20 per share ($1,600,000 / 80,000 shares = $20/share). When Placid sells 50,000 shares on 1/1/X9, the company will recognize a gain on the sale, which will be recorded as follows:

| | | | | |
|---|---|---|---|---|
| Dr. | Cash | $1,250,000 | | (50,000 shares x $25/share sale price) |
| Cr. | Investment in Serene | | $1,000,000 | (50,000 shares x $20/share cost) |
| Cr. | Gain | | 250,000 | |

The remaining 30,000 shares must be remeasured to fair value on 1/1/X9 by recording a gain due to the increase in the price per share from $20 cost on 1/1/X5 to the $25 fair value on 1/1/X9:

| | | | | |
|---|---|---|---|---|
| Dr. | Investment in Serene | $150,000 | | (30,000 shares x ($25 - $20)) |
| Cr. | Gain | | $150,000 | |

The total gain related to the sale and remeasurement is $400,000 ($250,000 gain on sale + $150,000 gain on remeasurement).

Choice "a" is incorrect. A gain must be reported from the partial sale of the investment and the remeasurement of the remaining shares.

Choice "b" is incorrect. This is the gain from the remeasurement of the remaining shares only, not the total gain.

Choice "c" is incorrect. This is the gain from the sale of the 50,000 shares only, not the total gain.


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**CPA-05618 Type1 M/C A-D Corr Ans: D PM#18 F 3-06**

58. CPA-05618 Page 34

On January 1, 20X9, Paul Corporation acquired 80% of Saul Corporation's 200,000 shares of the outstanding common stock of for $5,000,000. Paul did not pay a control premium in the acquisition. On the date of acquisition, the $6,000,000 book value of Saul's net assets equaled fair value. During 20X9, Saul reported net income of $550,000 and paid dividends of $165,000. What is the noncontrolling interest that will be reported on Paul Corporation's December 31, 20X9 consolidated balance sheet?

a. $1,200,000
b. $1,250,000
c. $1,277,000
d. $1,327,000

**CPA-05618 Explanation**

Choice "d" is correct. The noncontrolling interest to be reported on the December 31, 20X9 balance sheet is equal to the noncontrolling interest on January 1, 20X9, adjusted for the noncontrolling shareholders' share of Saul's 20X9 income and dividends.

Noncontrolling interest on January 1, 20X9 is the fair value of the portion of Saul Corporation that was not acquired by Paul Corporation. Because no control premium was paid by Paul, the fair value of Saul can be calculated using the acquisition price:

Fair Value of Saul x 80% = Acquisition Price
Fair Value of Saul x 80% = $5,000,000
Fair Value of Saul = $5,000,000 / 80% = $6,250,000

Using the total fair value of Saul, the noncontrolling interest in Saul on the acquisition date can be calculated:

$6,250,000 x 20% = $1,250,000

The noncontrolling interest in Saul on December 31, 20X9 is:

| | |
|---|---|
| Beginning Noncontrolling Interest | $1,250,000 |
| + 20% of Saul's Net Income | 110,000 |
| - 20% of Saul's Dividends | (33,000) |
| Ending Noncontrolling Interest | $1,327,000 |

Choice "a" is incorrect. This is the book value of the noncontrolling interest on January 1, 20X9. The noncontrolling interest is recognized at fair value.

Choice "b" is incorrect. This is the fair value of the noncontrolling interest on January 1, 20X9. The question asks for the year end value.

Choice "c" is incorrect. This is the book value of the noncontrolling interest on January 1, 20X9, adjusted for the noncontrolling shareholders' share of Saul's 20X9 income and dividends. Noncontrolling interest is recognized at fair value, not at book value.

**CPA-05619 Type1 M/C A-D Corr Ans: B PM#19 F 3-06**

59. CPA-05619 Page 35

During 20X8, Poppy Inc. acquired 100% of Seed Inc. by issuing 250,000 shares of its common stock. The acquisition was announced on March 31, 20X8, when Poppy's common stock was selling for $45 per share, and finalized on October 15, 20X8, when the market price of Poppy's common stock was $50 per share. On October 15, 20X8, Seed's net assets had a book value of $10,750,000. Book value equaled fair value for all recognized assets and liabilities, expect land, which had a fair value $500,000 higher than book value. Seed also had unpatented technology with a fair value of $225,000 and in-process research and development with a fair value of $365,000. What is the goodwill to be reported on Poppy Inc.'s December 31, 20X8 balance sheet?


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a. $500,000
b. $660,000
c. $1,250,000
d. $1,750,000

**CPA-05619 Explanation**
Choice "b" is correct. The acquisition price paid by Poppy is calculated on the date the acquisition is finalized:

Acquisition Price on 10/15/X8 = 250,000 shares x $50/share = $12,500,000

The difference between the $12,500,000 acquisition price (the fair value of Seed Inc.) and the $10,750,000 book value of the net assets acquired must be allocated first to adjusting 100% of the existing balance sheet from book value to fair value, second recognizing 100% of the fair value of all identifiable intangible assets and finally recognizing any excess as goodwill:

| | |
|---|---|
| FV of Seed Inc. | $12,500,000 |
| - Balance Sheet of Seed at BV | (10,750,000) |
| - Adjust Balance Sheet to FV | (500,000) |
| - Recognize Identifiable Intangibles at FV | (590,000) |
| Excess is Goodwill | $ 660,000 |

The acquisition date eliminating journal entry would be:

| | | | |
|---|---|---|---|
| Dr. | Equity - Seed (CAR) | $10,750,000 | |
| Cr. | Investment in Seed | | $12,500,000 |
| Cr. | Noncontrolling Interest | | $ 0 |
| Dr. | Balance Sheet Adjusted to FV | $ 500,000 | |
| Dr. | Identifiable Intangible Assets at FV | $ 590,000 | |
| Dr. | Goodwill | $ 660,000 | |

Choice "a" is incorrect. The $500,000 balance sheet fair value adjustment for land is not recognized as goodwill.

Choice "c" is incorrect. The fair value of the identifiable intangible assets must be recognized before calculating goodwill.

Choice "d" is incorrect. Goodwill is not the difference between the acquisition price and the book value of the net assets acquired.

**CPA-05620 Type1 M/C A-D Corr Ans: A PM#20 F 3-06**

60. CPA-05620 Page 24

On January 1, 20X9, Pacific Corporation acquired 75% of Sand Corporation's 200,000 outstanding common shares for $2,850,000. The remaining shares traded at $18.50 per share on the acquisition date. On January 1, the book value of Sand's net assets was $3,000,000. Book value equaled fair value for all of Sand's assets and liabilities except land, which had a fair value $200,000 greater than book value, and equipment, which had a fair value $150,000 greater than book value. On January 1, 20X9, Sand had a noncompete agreement with a fair value of $300,000. What is the goodwill to be reported on Pacific Corporation's December 31, 20X9 balance sheet?

a. $125,000
b. $287,500
c. $337,500
d. $425,000

**CPA-05620 Explanation**
Choice "a" is correct. On the acquisition date, the fair value of the subsidiary is the total of the acquisition price paid by the parent and the fair value of the noncontrolling interest:

| | |
|---|---|
| Acquisition Price | $2,850,000 |


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| | | |
|---|---|---|
| + FV of Noncontrolling Interest | 925,000 | [(200,000 shares x 25%) x $18.50 per share] |
| FV of Sand Corporation | $3,775,000 | |

The difference between the $3,775,000 fair value of the subsidiary and the $3,000,000 book value of Sand's net assets acquired must be allocated first to adjusting 100% of the existing balance sheet from book value to fair value, second recognizing 100% of the fair value of all identifiable intangible assets and finally recognizing any excess as goodwill:

| | |
|---|---|
| FV of Sand Corporation | $3,775,000 |
| - Balance Sheet of Sand at BV | (3,000,000) |
| - Adjust Balance Sheet to FV | (350,000) |
| - Recognize Identifiable Intangibles at FV | (300,000) |
| Excess is Goodwill | $ 125,000 |

The acquisition date eliminating journal entry would be:

| | | | |
|---|---|---|---|
| Dr. | Equity - Sand (CAR) | $3,000,000 | |
| Cr. | Investment in Sand | | $2,850,000 |
| Cr. | Noncontrolling Interest | | $ 925,000 |
| Dr. | Balance Sheet Adjusted to FV | $ 350,000 | |
| Dr. | Identifiable Intangible Assets at FV | $ 300,000 | |
| Dr. | Goodwill | $ 125,000 | |

Choice "b" is incorrect. This answer is calculated by incorrectly recognizing 75% of the balance sheet fair value adjustment and 75% of the fair value of the identifiable intangible assets. The acquisition method required that 100% of the fair value of the balance sheet, including identifiable intangible assets, be reported in the consolidated financial statements.

Choice "c" is incorrect. This answer is calculated by incorrectly recognizing the noncontrolling interest at book value, recognizing only 75% of the balance sheet fair value adjustment and recognizing no identifiable intangible assets. This methodology is not correct under the acquisition method.

Choice "d" is incorrect. This answer is calculated by failing to recognize the fair value of the identifiable intangible assets.

**CPA-05621 Type1 M/C A-D Corr Ans: D PM#21 F 3-06**

61. CPA-05621 Page 38

On October 1, 20X8, Pepper Inc. acquired 100% of Salt Inc. for $275,000. On that date, the carrying values of Salt Inc.'s assets and liabilities were $450,000 and $200,000, respectively. The fair values of Salt's assets and liabilities were $550,000 and $200,000, respectively. Additionally, Salt had identifiable intangible assets at the time of acquisition with a fair value of $60,000. What is the gain to be reported on Pepper's December 31, 20X8 consolidated income statement?

a. $0
b. $25,000
c. $75,000
d. $135,000

**CPA-05621 Explanation**

Choice "d" is correct. When acquiring a corporation with an acquisition cost that is less than the fair value of 100% of the underlying net assets acquired, the balance sheet, including any identifiable intangible assets, must be adjusted to fair value. This creates a negative balance in the acquisition cost account, which is recorded as a gain.

| | |
|---|---|
| Investment in subsidiary | $275,000 |
| Liabilities assumed | 200,000 |
| Acquisition cost | $475,000 |
| Adjust balance sheet to FV | (550,000) |
| Record identifiable intangibles at FV | (60,000) |


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| | |
|---|---|
| Gain | $(135,000) |

The eliminating journal entry on the date of acquisition would be:

| | | | |
|---|---|---|---|
| Dr. | Equity - subsidiary (CAR) | $250,000 | |
| Cr. | Investment in subsidiary | | $275,000 |
| Cr. | Noncontrolling interest | | $ 0 |
| Dr. | Balance sheet adjustment | $100,000 | |
| Dr. | Intangible assets | $ 60,000 | |
| Cr. | Gain | | $135,000 |

Choice "a" is incorrect. A gain must be recorded because the fair value of the underlying net assets acquired is greater than the acquisition price.

Choice "b" is incorrect. The gain is not the difference between the purchase price and the book value of the net assets acquired.

Choice "c" is incorrect. The fair value of the identifiable intangible assets must be recognized at the time of acquisition.

**Intercompany Transactions**

**CPA-00432 Type1 M/C A-D Corr Ans: B PM#1 F 3-07**

62. CPA-00432 FARE Nov 95 #49 Page 34

On January 2, 1994, Pare Co. acquired 75% of Kidd Co.'s outstanding common stock. Selected balance sheet data at December 31, 1994, is as follows:

| | *Pare* | *Kidd* |
|---|---|---|
| Total assets | $420,000 | $180,000 |
| Liabilities | 120,000 | 60,000 |
| Common stock | 100,000 | 50,000 |
| Retained earnings | 200,000 | 70,000 |
| | $420,000 | $180,000 |

During 1994, Pare and Kidd paid cash dividends of $25,000 and $5,000, respectively, to their shareholders. There were no other intercompany transactions.

In its December 31, 1994, consolidated statement of retained earnings, what amount should Pare report as dividends paid?

a. $5,000
b. $25,000
c. $26,250
d. $30,000

**CPA-00432 Explanation**
Choice "b" is correct, $25,000 consolidated dividends paid (same as parent dividends paid) since dividends paid by sub (Kidd) are 100% eliminated in consolidation.

Interco. dividends paid by Kidd to Pare (5,000 x .75 = 3,750) should be eliminated.

The dividends paid to the noncontrolling shareholders (5,000 x .25 = 1,250) would decrease their noncontrolling interest.

| Eliminating Entry: | *Dr* | *Cr* |
|---|---|---|
| Investment in Kidd | 3,750 | |
| Noncontrolling interest | 1,250 | |
| Dividends paid/retained earnings | | 5,000 |

**CPA-00433 Type1 M/C A-D Corr Ans: B PM#2 F 3-07**


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63. CPA-00433 FARE Nov 95 #50 Page 27

On January 2, 1994, Pare Co. acquired 75% of Kidd Co.'s outstanding common stock. On the acquisition date, the book value of Kidd's assets and liabilities equaled their fair values. Selected balance sheet data at December 31, 1994, is as follows:

| | *Pare* | *Kidd* |
|---|---|---|
| Total assets | $420,000 | $180,000 |
| Liabilities | 120,000 | 60,000 |
| Common stock | 100,000 | 50,000 |
| Retained earnings | 200,000 | 70,000 |
| | $420,000 | $180,000 |

During 1994, Pare and Kidd paid cash dividends of $25,000 and $5,000, respectively, to their shareholders. There were no other intercompany transactions.

In Pare's December 31, 1994, consolidated balance sheet, what amount should be reported as noncontrolling interest in net assets?

a. $0
b. $30,000
c. $45,000
d. $105,000

**CPA-00433 Explanation**
Choice "b" is correct, $30,000 noncontrolling interest in net assets at 12/31/94.

| | |
|---|---|
| Total assets @ fair value - Kidd | $180,000 |
| Total liabilities @ fair value - Kidd | (60,000) |
| Fair value of net assets - Kidd (com stk 50,000 + re 70,000) | 120,000 |
| Noncontrolling interest percentage (100% - 75%) | 25% |
| Amount to report as noncontrolling interest | $ 30,000 |

**CPA-00435 Type1 M/C A-D Corr Ans: B PM#3 F 3-07**

64. CPA-00435 FARE Nov 95 #51 Page 23

On January 2, 1994, Pare Co. purchased 75% of Kidd Co.'s outstanding common stock. Selected balance sheet data at December 31, 1994, is as follows:

| | *Pare* | *Kidd* |
|---|---|---|
| Total assets | $420,000 | $180,000 |
| Liabilities | 120,000 | 60,000 |
| Common stock | 100,000 | 50,000 |
| Retained earnings | 200,000 | 70,000 |
| | $420,000 | $180,000 |

During 1994, Pare and Kidd paid cash dividends of $25,000 and $5,000, respectively, to their shareholders. There were no other intercompany transactions.

In its December 31, 1994, consolidated balance sheet, what amount should Pare report as common stock?

a. $50,000
b. $100,000
c. $137,500
d. $150,000

**CPA-00435 Explanation**
Choice "b" is correct, $100,000 consolidated common stock at 12/31/94 (same as parent).

**Rule:** 100% of a purchased subsidiary's shareholders' equity (including common stock) as of the date of acquisition is eliminated in consolidation.


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**CPA-00436 Type1 M/C A-D Corr Ans: D PM#4 F 3-07**

65. CPA-00436 FARE May 95 #50 Page 34

Selected information from the separate and consolidated balance sheets and income statements of Pare, Inc. and its subsidiary, Shel Co., as of December 31, 1994, and for the year then ended is as follows:

| | *Pare* | *Shel* | *Consolidated* |
|---|---|---|---|
| Balance sheet accounts | | | |
| Accounts receivable | $ 52,000 | $ 38,000 | $ 78,000 |
| Inventory | 60,000 | 50,000 | 104,000 |
| Income statement accounts | | | |
| Revenues | $400,000 | $280,000 | $616,000 |
| Cost of goods sold | 300,000 | 220,000 | 462,000 |
| Gross profit | $100,000 | $ 60,000 | $154,000 |

Additional information:

During 1994, Pare sold goods to Shel at the same markup on cost that Pare uses for all sales.

What was the amount of intercompany sales from Pare to Shel during 1994?

a. $ 6,000
b. $12,000
c. $58,000
d. $64,000

**CPA-00436 Explanation**
Choice "d" is correct, $64,000 interco sales.

| | |
|---|---|
| Revenues - Pare | $ 400,000 |
| Revenues - Shel | 280,000 |
| | 680,000 |
| Revenues - consolidated | (616,000) |
| Interco sales | $ 64,000 |

**CPA-00437 Type1 M/C A-D Corr Ans: B PM#5 F 3-07**

66. CPA-00437 FARE May 95 #51 Page 34

Selected information from the separate and consolidated balance sheets and income statements of Pare, Inc. and its subsidiary, Shel Co., as of December 31, 1994, and for the year then ended is as follows:

| | *Pare* | *Shel* | *Consolidated* |
|---|---|---|---|
| Balance sheet accounts | | | |
| Accounts receivable | $ 52,000 | $ 38,000 | $ 78,000 |
| Inventory | 60,000 | 50,000 | 104,000 |
| Income statement accounts | | | |
| Revenues | $400,000 | $280,000 | $616,000 |
| Cost of goods sold | 300,000 | 220,000 | 462,000 |
| Gross profit | $100,000 | $ 60,000 | $154,000 |

Additional information:

During 1994, Pare sold goods to Shel at the same markup on cost that Pare uses for all sales.

At December 31, 1994, what was the amount of Shel's payable to Pare for intercompany sales?

a. $6,000
b. $12,000
c. $58,000


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d. $64,000

**CPA-00437 Explanation**
Choice "b" is correct, $12,000 interco payable.

The interco receivable/payable due from Shel to Pare should equal the interco receivable from Pare to Shel

| | |
|---|---|
| Accounts receivable – Pare | $52,000 |
| Accounts receivable – Shel | 38,000 |
| | 90,000 |
| Receivables – consolidated | 78,000 |
| Interco payable | $12,000 |

**CPA-00440 Type1 M/C A-D Corr Ans: A PM#6 F 3-07**

67. CPA-00440 FARE May 95 #52 Page 34

Selected information from the separate and consolidated balance sheets and income statements of Pare, Inc. and its subsidiary, Shel Co., as of December 31, 1994, and for the year then ended is as follows:

| | *Pare* | *Shel* | *Consolidated* |
|---|---|---|---|
| Balance sheet accounts | | | |
| Accounts receivable | $ 52,000 | $ 38,000 | $ 78,000 |
| Inventory | 60,000 | 50,000 | 104,000 |
| Income statement accounts | | | |
| Revenues | $400,000 | $280,000 | $616,000 |
| Cost of goods sold | 300,000 | 220,000 | 462,000 |
| Gross profit | $100,000 | $ 60,000 | $154,000 |

Additional information:

During 1994, Pare sold goods to Shel at the same markup on cost that Pare uses for all sales.

In Pare's consolidating worksheet, what amount of unrealized intercompany profit was eliminated?

a. $6,000
b. $12,000
c. $58,000
d. $64,000

**CPA-00440 Explanation**
Choice "a" is correct, $6,000 unrealized interco profit eliminated.

| | |
|---|---|
| Inventory - Pare | $ 60,000 |
| Inventory - Shel | 50,000 |
| | 110,000 |
| Inventory - consolidated | 104,000 |
| Unrealized interco profit eliminated | $ 6,000 |

**CPA-00442 Type1 M/C A-D Corr Ans: A PM#7 F 3-07**

68. CPA-00442 Nov 94 #56 Page 34

Sun, Inc. is a wholly owned subsidiary of Patton, Inc. On June 1, 1993, Patton declared and paid a $1 per share cash dividend to stockholders of record on May 15, 1993. On May 1, 1993, Sun bought 10,000 shares of Patton's common stock for $700,000 on the open market, when the book value per share was $30. What amount of gain should Patton report from this transaction in its consolidated income statement for the year ended December 31,1993?

a. $0


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b. $390,000
c. $400,000
d. $410,000

**CPA-00442 Explanation**
Choice "a" is correct, $0 gain from the purchase of Patton's (parent) stock by Sun (subsidiary). The purchase by the member of a consolidated group of stock of another member of the consolidated group is treated as a treasury stock transaction. This follows the theory of consolidated financial statements presenting one economic entity. (You cannot make money selling stock to yourself.)

**CPA-00443 Type1 M/C A-D Corr Ans: A PM#8 F 3-07**

69. CPA-00443 FARE May 94 #16 Page 35

In its financial statements, Pare, Inc. uses the fair value method of accounting for its 15% ownership of Sabe Co. At December 31, 1993, Pare has a receivable from Sabe. How should the receivable be reported in Pare's December 31, 1993, balance sheet?

a. The total receivable should be reported separately.
b. The total receivable should be included as part of the investment in Sabe, without separate disclosure.
c. Eighty-five percent of the receivable should be reported separately, with the balance offset against Sabe's payable to Pare.
d. The total receivable should be offset against Sabe's payable to Pare, without separate disclosure.

**CPA-00443 Explanation**
Choice "a" is correct; the total receivable should be reported separately.

**Rule:** When a company owns less than 50% of the common stock of an investee corporation, the investment account can be reported under the cost or equity method, depending on whether significant influence is exercised. Receivables and payables to the investee are reported separately on the balance sheet.

Choice "b" is incorrect. The receivable is not part of the investment.

Choice "c" is incorrect. 100% must be disclosed and there can be no elimination.

Choice "d" is incorrect. Receivables and payables must be presented separately with separate disclosure made in the footnotes.

**CPA-00446 Type1 M/C A-D Corr Ans: A PM#9 F 3-07**

70. CPA-00446 FARE May 94 #56 (Adapted) Page 23

On January 1, 1993, Owen Corp. acquired all of Sharp Corp.'s common stock for $1,200,000. On that date, the fair values of Sharp's assets and liabilities equaled their carrying amounts of $1,320,000 and $320,000, respectively. During 1993, Sharp paid cash dividends of $20,000.

Selected information from the separate balance sheets and income statements of Owen and Sharp as of December 31, 1993, and for the year then ended follows:

| | *Owen* | *Sharp* |
|---|---|---|
| Balance sheet accounts | | |
| Investment in subsidiary | $1,300,000 | - |
| Retained earnings | 1,240,000 | 540,000 |
| Total stockholders' equity | 2,620,000 | 1,100,000 |
| | | |
| Income statement accounts | | |
| Operating income | 420,000 | 200,000 |
| Equity in earnings of Sharp | 120,000 | - |
| Net income | 400,000 | 120,000 |


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In Owen's December 31, 1993, consolidated balance sheet, what amount should be reported as total retained earnings?

a. $1,240,000
b. $1,360,000
c. $1,380,000
d. $1,800,000

**CPA-00446 Explanation**
Choice "a" is correct, $1,240,000 consolidated retained earnings. The parent company equity account at 12/31/93 (per the facts of the question) becomes the consolidated equity account when the acquisition method is used.

**Note:** When using the acquisition method, 100% of the subsidiary equity accounts are eliminated in consolidation.

**CPA-00450 Type1 M/C A-D Corr Ans: B PM#11 F 3-07**

71. CPA-00450 May 93 T #4 Page 39

Port, Inc. owns 100% of Salem Inc. On January 1, 1992, Port sold Salem delivery equipment at a gain. Port had owned the equipment for two years and used a five-year straight-line depreciation rate with no residual value. Salem is using a three-year straight-line depreciation rate with no residual value for the equipment. In the consolidated income statement, Salem's recorded depreciation expense on the equipment for 1992 will be decreased by:

a. 20% of the gain on sale.
b. 33 1/3% of the gain on sale.
c. 50% of the gain on sale.
d. 100% of the gain on sale.

**CPA-00450 Explanation**
Choice "b" is correct; depreciation expense will be decreased by 33 1/3% of the gain on sale, the amount that depreciation expense has been overstated.

Example:

| | |
|---|---|
| Original purchase price by Port | $100 |
| Two years' depreciation ($100 ÷ 5 = $20 per year × 2) | (40) |
| Net book value at date of sale | 60 |
| Sale price to Salem | 75 |
| Gain on sale | $ 15 |
| | |
| Depreciation expense recorded by Salem ($75 ÷ 3 year life) | $ 25 |
| Consolidated depreciation expense ($100 ÷ 5 year life) | 20 |
| Elimination of excess depreciation ($15 gain x 1/3) | 5 |

**CPA-00452 Type1 M/C A-D Corr Ans: C PM#12 F 3-07**

72. CPA-00452 May 93 I #9 Page 36

Clark Co. had the following transactions with affiliated parties during 1992:

- Sales of $60,000 to Dean, Inc., with $20,000 gross profit. Dean had $15,000 of inventory on hand at year-end. Clark owns a 15% interest in Dean and does not exert significant influence.
- Purchases of raw materials totaling $240,000 from Kent Corp., a wholly-owned subsidiary. Kent's gross profit on the sale was $48,000. Clark had $60,000 of this inventory remaining on December 31,1992.

Before eliminating entries, Clark had consolidated current assets of $320,000. What amount should Clark report in its December 31,1992, consolidated balance sheet for current assets?


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a. $320,000
b. $317,000
c. $308,000
d. $303,000

**CPA-00452 Explanation**
Choice "c" is correct, $308,000 current assets in the 12/31/92 consolidated balance sheet ($320,000 less 12,000 unrealized profit in inventory).

| | |
|---|---|
| Inventory on hand at year end | $ 60,000 |
| Gross profit percentage (48,000 ÷ 240,000) | 20% |
| Amount to eliminate from ending inventory | $ 12,000 |

**Note:** No elimination is made related to the transaction with Dean, Inc. because Dean (owned less than 50%) is not consolidated.

**CPA-00459 Type1 M/C A-D Corr Ans: D PM#14 F 3-07**

73. CPA-00459 Nov 92 I #14 (Adapted) Page 36

Selected information from the separate and consolidated balance sheets and income statements of Pard, Inc. and its subsidiary, Spin Co., as of December 31, 1991, and for the year then ended is as follows:

| | *Pard* | *Spin* | *Consolidated* |
|---|---|---|---|
| Balance sheet accounts | | | |
| Accounts receivable | $ 26,000 | $ 19,000 | $ 39,000 |
| Inventory | 30,000 | 25,000 | 52,000 |
| Investment in Spin | 67,000 | - | - |
| Goodwill | - | - | 30,000 |
| Noncontrolling interest | - | - | 10,000 |
| Stockholders, equity | 154,000 | 50,000 | 154,000 |

| | *Pard* | *Spin* | *Consolidated* |
|---|---|---|---|
| Income statement accounts | | | |
| Revenues | $200,000 | $140,000 | $308,000 |
| Cost of goods sold | 150,000 | 110,000 | 231,000 |
| Gross profit | 50,000 | 30,000 | 77,000 |
| Equity in earnings of Spin | 11,000 | - | - |
| Net income | 36,000 | 20,000 | 40,000 |

Additional information:

- During 1991, Pard sold goods to Spin at the same markup on cost that Pard uses for all sales. At December 31, 1991, Spin had not paid for all of these goods and still held 37.5% of them in inventory.
- Pard acquired its interest in Spin on January 2, 1988.

What was the amount of intercompany sales from Pard to Spin during 1991?

a. $3,000
b. $6,000
c. $29,000
d. $32,000

**CPA-00459 Explanation**
Choice "d" is correct, $32,000 of intercompany sales from Pard to Spin during 1991.

| | |
|---|---|
| Revenue - Pard | $200,000 |
| Revenue - Spin | 140,000 |
| Total before elim. | 340,000 |
| Consolidated revenue | (308,000) |
| Interco sales elim. | $ 32,000 |


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**CPA-00462 Type1 M/C A-D Corr Ans: B PM#15 F 3-07**

74. CPA-00462 Nov 92 I #15 (Adapted) Page 34

Selected information from the separate and consolidated balance sheets and income statements of Pard, Inc. and its subsidiary, Spin Co., as of December 31, 1991, and for the year then ended is as follows:

| | *Pard* | *Spin* | *Consolidated* |
|---|---|---|---|
| Balance sheet accounts | | | |
| Accounts receivable | $ 26,000 | $ 19,000 | $ 39,000 |
| Inventory | 30,000 | 25,000 | 52,000 |
| Investment in Spin | 67,000 | - | - |
| Goodwill | - | - | 30,000 |
| Noncontrolling interest | - | - | 10,000 |
| Stockholders, equity | 154,000 | 50,000 | 154,000 |

| | *Pard* | *Spin* | *Consolidated* |
|---|---|---|---|
| Income statement accounts | | | |
| Revenues | $200,000 | $140,000 | $308,000 |
| Cost of goods sold | 150,000 | 110,000 | 231,000 |
| Gross profit | 50,000 | 30,000 | 77,000 |
| Equity in earnings of Spin | 11,000 | - | - |
| Net income | 36,000 | 20,000 | 40,000 |

Additional information:

- During 1991, Pard sold goods to Spin at the same markup on cost that Pard uses for all sales. At December 31, 1991, Spin had not paid for all of these goods and still held 37.5% of them in inventory.
- Pard acquired its interest in Spin on January 2, 1988.

At December 31, 1991, what was the amount of Spin's payable to Pard for intercompany sales?

a. $3,000
b. $6,000
c. $29,000
d. $32,000

**CPA-00462 Explanation**
Choice "b" is correct, $6,000 payable.

| | |
|---|---|
| Accts rec - Pard | $26,000 |
| Accts rec - Spin | 19,000 |
| | 45,000 |
| Accts rec consol | (39,000) |
| Interco rec/pay eliminated | $ 6,000 |

**CPA-00464 Type1 M/C A-D Corr Ans: C PM#16 F 3-07**

75. CPA-00464 Nov 92 I #16 (Adapted) Page 36

Selected information from the separate and consolidated balance sheets and income statements of Pard, Inc. and its subsidiary, Spin Co., as of December 31, 1991, and for the year then ended is as follows:

| | *Pard* | *Spin* | *Consolidated* |
|---|---|---|---|
| Balance sheet accounts | | | |
| Accounts receivable | $ 26,000 | $ 19,000 | $ 39,000 |
| Inventory | 30,000 | 25,000 | 52,000 |
| Investment in Spin | 67,000 | - | - |
| Goodwill | - | - | 30,000 |
| Noncontrolling interest | - | - | 10,000 |


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| | | | |
|---|---|---|---|
| Stockholders, equity | 154,000 | 50,000 | 154,000 |

| | *Pard* | *Spin* | *Consolidated* |
|---|---|---|---|
| Income statement accounts | | | |
| Revenues | $200,000 | $140,000 | $308,000 |
| Cost of goods sold | 150,000 | 110,000 | 231,000 |
| Gross profit | 50,000 | 30,000 | 77,000 |
| Equity in earnings of Spin | 11,000 | - | - |
| Net income | 36,000 | 20,000 | 40,000 |

Additional information:

- During 1991, Pard sold goods to Spin at the same markup on cost that Pard uses for all sales. At December 31, 1991, Spin had not paid for all of these goods and still held 37.5% of them in inventory.
- Pard acquired its interest in Spin on January 2, 1988.

In Pard's consolidated balance sheet, what was the carrying amount of the inventory that Spin purchased from Pard?

a. $3,000
b. $6,000
c. $9,000
d. $12,000

**CPA-00464 Explanation**
Choice "c" is correct, $9,000.

| | |
|---|---|
| Inventory - Pard | $30,000 |
| Inventory - Spin | 25,000 |
| Total before interco eliminations | 55,000 |
| Inventory - consolidated | (52,000) |
| Interco profit in end inv - eliminated | $ 3,000 |
| Gross profit margin (50,000 ÷ 200,000) | ÷ 25% |
| Interco inv in end balance sheet | 12,000 |
| Less profit in end inv | (3,000) |
| Carrying amount of interco inventory | $ 9,000 |

**CPA-00466 Type1 M/C A-D Corr Ans: B PM#17 F 3-07**

76. CPA-00466 Nov 92 I #17 (Adapted) Page 27

Selected information from the separate and consolidated balance sheets and income statements of Pard, Inc. and its subsidiary, Spin Co., as of December 31, 1991, and for the year then ended is as follows:

| | *Pard* | *Spin* | *Consolidated* |
|---|---|---|---|
| Balance sheet accounts | | | |
| Accounts receivable | $ 26,000 | $ 19,000 | $ 39,000 |
| Inventory | 30,000 | 25,000 | 52,000 |
| Investment in Spin | 67,000 | - | - |
| Goodwill | - | - | 30,000 |
| Noncontrolling interest | - | - | 10,000 |
| Stockholders, equity | 154,000 | 50,000 | 154,000 |

| | *Pard* | *Spin* | *Consolidated* |
|---|---|---|---|
| Income statement accounts | | | |
| Revenues | $200,000 | $140,000 | $308,000 |
| Cost of goods sold | 150,000 | 110,000 | 231,000 |
| Gross profit | 50,000 | 30,000 | 77,000 |


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| | | | |
|---|---|---|---|
| Equity in earnings of Spin | 11,000 | - | - |
| Net income | 36,000 | 20,000 | 40,000 |

Additional information:

- During 1991, Pard sold goods to Spin at the same markup on cost that Pard uses for all sales. At December 31, 1991, Spin had not paid for all of these goods and still held 37.5% of them in inventory.
- Pard acquired its interest in Spin on January 2, 1988.

What is the percent of noncontrolling interest ownership in Spin?

a. 10%
b. 20%
c. 25%
d. 45%

**CPA-00466 Explanation**
Choice "b" is correct, 20% noncontrolling interest.

| | |
|---|---|
| Minority interest | 10,000 |
| Spin's Equity | 50,000 |

**CPA-00467 Type1 M/C A-D Corr Ans: B PM#18 F 3-07**

77. CPA-00467 Nov 92 T #34 Page 27

A 70%-owned subsidiary company declares and pays a cash dividend. What effect does the dividend have on the retained earnings and noncontrolling interest balances in the parent company's consolidated balance sheet?

a. No effect on either retained earnings or noncontrolling interest.
b. No effect on retained earnings and a decrease in noncontrolling interest.
c. Decreases in both retained earnings and noncontrolling interest.
d. A decrease in retained earnings and no effect on noncontrolling interest.

**CPA-00467 Explanation**
Choice "b" is correct, no effect on retained earnings and a decrease in noncontrolling interest. The parent's balance sheet would reflect 70% of the sub's earnings. Receipt of 70% of the dividends would simply transfer cash from one company to another. The dividend would be eliminated in consolidation. However, 30% of the dividend would be paid to the noncontrolling shareholders and would reduce noncontrolling interest on the consolidated balance sheet.

Choice "a" is incorrect. The dividend affects noncontrolling interest but not retained earnings.

Choice "c" is incorrect. The dividend does not affect retained earnings.

Choice "d" is incorrect. The dividend reduces noncontrolling interest.

**CPA-00468 Type1 M/C A-D Corr Ans: A PM#19 F 3-07**

78. CPA-00468 Nov 92 II #60 Page 34

The following information pertains to shipments of merchandise from Home Office to Branch during 1991:

| | |
|---|---|
| Home Office's cost of merchandise | $160,000 |
| Intracompany billing | 200,000 |
| Sales by Branch | 250,000 |
| Unsold merchandise at Branch on December 31, 1991 | 20,000 |

In the combined income statement of Home Office and Branch for the year ended December 31, 1991, what amount of the above transactions should be included in sales?

a. $250,000
b. $230,000


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c. $200,000
d. $180,000

**CPA-00468 Explanation**
**Rule:** All intercompany billings are eliminated in consolidation.

Choice "a" is correct, $250,000. Sales by the branch are to outside parties and are not eliminated.

Choices "b", "c", and "d" are incorrect, per the above explanation.

**CPA-00478 Type1 M/C A-D Corr Ans: A PM#20 F 3-07**

79. CPA-00478 May 92 I #4 Page 37

Wagner, a holder of a $1,000,000 Palmer, Inc. bond, collected the interest due on March 31, 1992, and then sold the bond to Seal, Inc. for $975,000. On that date, Palmer, a 75% owner of Seal, had a $1,075,000 carrying amount for this bond. What was the effect of Seal's purchase of Palmer's bond on the retained earnings and noncontrolling interest amounts reported in Palmer's March 31, 1992, consolidated balance sheet?

| | *Retained earnings* | *Noncontrolling interest* |
|---|---|---|
| a. | $100,000 increase | $0 |
| b. | $75,000 increase | $25,000 increase |
| c. | $0 | $25,000 increase |
| d. | $0 | $100,000 increase |

**CPA-00478 Explanation**
Choice "a" is correct, $100,000 increase in consolidated earnings. $0 effect on noncontrolling interest. The purchase of the parent company bond by the subsidiary is treated as if the bond were retired when the financial statements are consolidated. Because the bond had a book value of $1,075,000, but was "retired" for $975,000, a gain is recorded upon consolidation.

*Journal entry on consolidated ws*

| Bond Premium | Dr | Cr |
|---|---|---|
| Bond premium (Palmer's books) | 75,000 | |
| Bond payable (Palmer's books) | 1,000,000 | |
| Bond investment (Seal's books) | | 975,000 |
| Retained earnings - consolidated | | 100,000 |
| Noncontrolling interest | | 0 |

**CPA-00479 Type1 M/C A-D Corr Ans: C PM#21 F 3-07**

80. CPA-00479 May 92 I #11 Page 36

Parker Corp. owns 80% of Smith Inc.'s common stock. During 1991, Parker sold Smith $250,000 of inventory on the same terms as sales made to third parties. Smith sold all of the inventory purchased from Parker in 1991. The following information pertains to Smith and Parker's sales for 1991:

| | *Parker* | *Smith* |
|---|---|---|
| Sales | $1,000,000 | $700,000 |
| Cost of sales | 400,000 | 350,000 |
| | $ 600,000 | $350,000 |

What amount should Parker report as cost of sales in its 1991 consolidated income statement?

a. $750,000
b. $680,000
c. $500,000
d. $430,000


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**CPA-00479 Explanation**
Choice "c" is correct, $500,000 cost of sales in consolidated income statement.

| | |
|---|---|
| Unadjusted cost of sales: | |
| Parker | $ 400,000 |
| Smith | 350,000 |
| | 750,000 |
| Adjustment for interco sales | (250,000) |
| Adjusted cost of sales | $ 500,000 |

**CPA-00481 Type1 M/C A-D Corr Ans: B PM#22 F 3-07**

81. CPA-00481 May 92 II #20 Page 36

Ahm Corp. owns 90% of Bee Corp.'s common stock and 80% of Cee Corp.'s common stock. The remaining common shares of Bee and Cee are owned by their respective employees. Bee sells exclusively to Cee, Cee buys exclusively from Bee, and Cee sells exclusively to unrelated companies. Selected 1991 information for Bee and Cee follows:

| | *Bee Corp.* | *Cee Corp.* |
|---|---|---|
| Sales | $130,000 | $91,000 |
| Cost of sales | 100,000 | 65,000 |
| Beginning inventory | None | None |
| Ending inventory | None | 65,000 |

What amount should be reported as gross profit in Bee and Cee's combined income statement for the year ended December 31, 1991?

a. $26,000
b. $41,000
c. $47,800
d. $56,000

**CPA-00481 Explanation**
Choice "b" is correct, $41,000 gross profit in combined income statement.

**Rule:** "Combined financial statements" do not eliminate "equity" accounts (they are all added across); however, all other intercompany "transactions" and "balances" are eliminated in combined financial statements just as they are in consolidated financial statements.

| *Income Statement* | *Bee* | *Cee* | Dr(Cr) *Elims* | *Combined* |
|---|---|---|---|---|
| Sales | 130 | 91 | 130* | 91 |
| Cost of sales | 100 | 65 | (100)*<br>(15)† | 50 |
| Gross profit | 30 | 26 | (15) | 41 |
| *Balance Sheet* | | | | |
| Inventory | 0 | 65 | (15)† | 50 |

* Eliminate interco sales and interco cost of sales.
† Eliminate interco profit in Cee's Cost of Sales and Ending Inventory.

$$\text{Interco gross profit \%} = \frac{\text{Gross Profit}}{\text{Sales}} = \frac{30}{130} = .23077$$

$$.23077 \times \text{Cee's Cost of Sales } \$65{,}000 = \$15{,}000$$

$$.23077 \times \text{Cee's Ending Inventory } \$65{,}000 = \$15{,}000$$


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**CPA-00483 Type1 M/C A-D Corr Ans: C PM#23 F 3-07**

82. CPA-00483 May 92 T #41 Page 34

In its financial statements, Pulham Corp. uses the equity method of accounting for its 30% ownership of Angles Corp. At December 31, l991, Pulham has a receivable from Angles. How should the receivable be reported in Pulham's 1991 financial statements?

a. The receivable should be eliminated.
b. Seventy percent of the receivable should be separately reported, with the balance eliminated.
c. The total receivable should be disclosed separately.
d. The total receivable should be included as part of the investment in Angles, without separate disclosure.

**CPA-00483 Explanation**
Choice "c" is correct. The total receivable should be disclosed separately.

Choice "a" is incorrect. There can be no elimination as there is no consolidation.

Choice "b" is incorrect. 100% must be disclosed and there can be no elimination.

Choice "d" is incorrect. The receivable is not part of the investment.

**CPA-00495 Type1 M/C A-D Corr Ans: C PM#25 F 3-07**

83. CPA-00495 May 91 II #19 Page 36

Nolan owns 100% of the capital stock of both Twill Corp. and Webb Corp. Twill purchases merchandise inventory from Webb at 140% of Webb's cost. During 1990, merchandise that cost Webb $40,000 was sold to Twill. Twill sold all of this merchandise to unrelated customers for $81,200 during 1990. In preparing combined financial statements for 1990, Nolan's bookkeeper disregarded the common ownership of Twill and Webb.

By what amount was unadjusted revenue overstated in the combined income statement for 1990?

a. $16,000
b. $40,000
c. $56,000
d. $81,200

**CPA-00495 Explanation**
Choice "c" is correct, $56,000. Merchandise that cost Twill $40,000 was sold to Webb at 140% of Twill's cost ($56,000) and must be eliminated.

**CPA-00496 Type1 M/C A-D Corr Ans: A PM#26 F 3-07**

84. CPA-00496 May 91 II #20 Page 36

Nolan owns 100% of the capital stock of both Twill Corp. and Webb Corp. Twill purchases merchandise inventory from Webb at 140% of Webb's cost. During 1990, merchandise that cost Webb $40,000 was sold to Twill. Twill sold all of this merchandise to unrelated customers for $81,200 during 1990. In preparing combined financial statements for 1990, Nolan's bookkeeper disregarded the common ownership of Twill and Webb.

What amount should be eliminated from cost of goods sold in the combined income statement for 1990?

a. $56,000
b. $40,000
c. $24,000
d. $16,000


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**CPA-00496 Explanation**
Choice "a" is correct, $56,000 elimination from cost of goods sold.

| | |
|---|---|
| Webb's cost of sales to Twill | $40,000 |
| Markup percentage | x 140% |
| Revenue from intercompany sales (including profit) | $56,000 |

**Rule:** The sales and cost of sales elimination is always the same amount if no inventory related to intercompany sales is on hand at the end of the year. Interco profit elimination is based on the amount of inventory remaining on the ending balance sheet.

**Note:** In this question, there is no interco profit to eliminate from ending inventory because everything had been sold to outside parties.

**CPA-00497 Type1 M/C A-D Corr Ans: C PM#27 F 3-07**

85. CPA-00497 Nov 90 T #2 Page 39

Water Co. owns 80% of the outstanding common stock of Fire Co. On December 31, 1989, Fire sold equipment to Water at a price in excess of Fire's carrying amount, but less than its original cost. On a consolidated balance sheet at December 31, 1989, the carrying amount of the (cost less accumulated depreciation) equipment should be reported at:

a. Water's original cost.
b. Fire's original cost.
c. Water's original cost less Fire's recorded gain.
d. Water's original cost less 80% of Fire's recorded gain.

**CPA-00497 Explanation**
Choice "c" is correct, on the consolidated balance sheet at 12/31/89, equipment should be reported at Water's original cost less Fire's recorded gain (which equals Fire's carrying value prior to sale).

Illustrative example:

| | |
|---|---|
| Fire's original cost | 100 |
| Accum depr prior to sale | (40) |
| Net carrying value to Fire | 60 |
| Sale price to Water | 75 |
| Gain to Fire | 15 |
| Water's "original" cost | 75 |
| Less Fire's gain | 15 |
| Carrying value on consolidated financial statements | 60 |

**Rule:** Fixed asset cost is based on original cost from the outside world and remains the same on the consolidated financial statements.

**CPA-00498 Type1 M/C A-D Corr Ans: A PM#28 F 3-07**

86. CPA-00498 May 90 T #2 Page 35

P Co. purchased term bonds at a premium on the open market. These bonds represented 20 percent of the outstanding class of bonds issued at a discount by S Co., P's wholly owned subsidiary. P intends to hold the bonds until maturity. In a consolidated balance sheet, the difference between the bond carrying amounts in the two companies would be:

a. Included as a decrease to retained earnings.
b. Included as an increase to retained earnings.
c. Reported as a deferred debit to be amortized over the remaining life of the bonds.
d. Reported as a deferred credit to be amortized over the remaining life of the bonds.

**CPA-00498 Explanation**


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Choice "a" is correct, in a consolidated balance sheet, the difference between the bond carrying amounts would be included as a decrease to retained earnings.

**Rule:** When members of a consolidated group have intercompany bond holdings, the bonds are eliminated in consolidation and the difference (gain or loss) between the discounted issue price and the premium on reacquisition would be included in retained earnings.

**CPA-00499 Type1 M/C A-D Corr Ans: D PM#29 F 3-07**

87. CPA-00499 May 90 I #11 Page 34

At December 31, 1989, Grey, Inc. owned 90% of Winn Corp., a consolidated subsidiary, and 20% of Carr Corp., an investee in which Grey cannot exercise significant influence. On the same date, Grey had receivables of $300,000 from Winn and $200,000 from Carr. In its December 31, 1989 consolidated balance sheet, Grey should report accounts receivable from affiliates of:

a. $500,000
b. $340,000
c. $230,000
d. $200,000

**CPA-00499 Explanation**
Choice "d" is correct, $200,000.

The receivable from Winn will be eliminated in the consolidation. The receivable from Carr will not be eliminated (Carr is not a subsidiary), thus, it remains. Grey reports accounts receivable from affiliates (Carr) of $200,000 in its consolidated balance sheet.

**CPA-00500 Type1 M/C A-D Corr Ans: C PM#30 F 3-07**

88. CPA-00500 Nov 89 I #55 Page 36

Selected data for two subsidiaries of Dunn Corp. taken from December 31, 1988 pre-closing trial balances are as follows:

| | *Banks Co.* *Debit* | *Lamm Co.* *Credit* |
|---|---|---|
| Shipments to Banks | $ - | $ 150,000 |
| Shipments from Lamm | 200,000 | - |
| Intercompany inventory profit on total shipments | - | 50,000 |

Additional data relating to the December 31, 1988 inventory are as follows:

| | | |
|---|---|---|
| Inventory acquired from outside parties | $175,000 | $ 250,000 |
| Inventory acquired from Lamm | 60,000 | - |

At December 31, 1988, the inventory reported on the combined balance sheet of the two subsidiaries should be:

a. $425,000
b. $435,000
c. $470,000
d. $485,000

**CPA-00500 Explanation**
Choice "c" is correct, $470,000.

| | *Banks* | *Lamm* | *Combined* |
|---|---|---|---|
| Inventory acquired from outside parties | 175,000 | 250,000 | 425,000 |
| Inventory acquired from Lamm (intercompany) | 60,000 | | 60,000 |
| Less unrealized gross margin (25% of 60,000)* | (15,000) | | (15,000) |
| Inventory on combined balance sheet | 220,000 | 250,000 | 470,000 |


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*Gross Margin % calculated as ($200,000 –150,000)/200,000

**CPA-05451 Type1 M/C A-D Corr Ans: B PM#31 F 3-07**

89. CPA-05451 Released 2007 Page 39

Zest Co. owns 100% of Cinn, Inc. On January 2, 1999, Zest sold equipment with an original cost of $80,000 and a carrying amount of $48,000 to Cinn for $72,000. Zest had been depreciating the equipment over a five-year period using straight-line depreciation with no residual value. Cinn is using straight-line depreciation over three years with no residual value. In Zest's December 31, 1999, consolidating worksheet, by what amount should depreciation expense be decreased?

a. $0
b. $8,000
c. $16,000
d. $24,000

**CPA-05451 Explanation**
Choice "b" is correct. Depreciation expense should be decreased by the difference between the depreciation expense calculated by Cinn and the depreciation that would have been calculated by Zest had Zest not sold the asset in an intercompany transaction:

| | |
|---|---|
| Depreciation expense after intercompany sale | $24,000 = $72,000/3 |
| Depreciation expense if no intercompany sale | 16,000 = $80,000/5 |
| Difference | $ 8,000 |

Note that this $8,000 depreciation expense adjustment can also be calculated by dividing the difference between the pre-intercompany-sale asset book value and post-intercompany-sale asset book value by the useful life to be used by the new owner:

($72,000 - $48,000) / 3 = $8,000

Choice "a" is incorrect. In all intercompany sales of depreciable assets, depreciation expense must be adjusted back to what the expense would have been if the sale had not taken place. This adjustment is made at the time of consolidation.

Choice "c" is incorrect. This is the annual depreciation recorded by Zest before selling the asset to Cinn.

Choice "d" is incorrect. This is the annual depreciation recorded by Cinn after acquiring the asset from Zest.

**Combined Financial Statements / Push Down Accounting**

**CPA-00506 Type1 M/C A-D Corr Ans: D PM#1 F 3-08**

90. CPA-00506 May 93 T #8 Page 41

Combined statements may be used to present the results of operations of:

| | *Companies under common management* | *Commonly controlled companies* |
|---|---|---|
| a. | No | Yes |
| b. | Yes | No |
| c. | No | No |
| d. | Yes | Yes |

**CPA-00506 Explanation**
Choice "d" is correct, Yes - Yes. Combined statements may be used for companies under common management or commonly controlled companies (e.g., individual owns many companies).


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Procedure:

1. All intercompany transactions and balances among the related companies are eliminated.
2. Minority interests are treated as in consolidated financial statements.
3. Equity accounts are added across, not eliminated.
4. Income statement accounts are added across.

**CPA-00507 Type1 M/C A-D Corr Ans: D PM#2 F 3-08**

91. CPA-00507 Nov 91 T #8 Page 41

For which of the following reporting units is the preparation of combined financial statements most appropriate?

a. A corporation and a majority-owned subsidiary with nonhomogeneous operations.
b. A corporation and a foreign subsidiary with nonintegrated homogeneous operations.
c. Several corporations with related operations with some common individual owners.
d. Several corporations with related operations owned by one individual.

**CPA-00507 Explanation**
Choice "d" is correct, combined financial statements would be most appropriate for several corporations owned by one individual.

Choices "a" and "b" are incorrect. As consolidated statements are appropriate for a parent and subsidiary.

Choice "c" is incorrect. There are only "some common owners."

**CPA-00508 Type1 M/C A-D Corr Ans: A PM#3 F 3-08**

92. CPA-00508 Nov 90 T #3 Page 41

Combined statements may be used to present the results of operations of:

| | *Unconsolidated subsidiaries* | *Companies under common management* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |

**CPA-00508 Explanation**
Choice "a" is correct, Yes - Yes.

**Rule:** Combined financial statements may be prepared for:

1. Many companies owned by one individual.
2. Many companies under common management.
3. Unconsolidated subsidiaries (rare since SFAS 94).

**CPA-00509 Type1 M/C A-D Corr Ans: C PM#4 F 3-08**

93. CPA-00509 Nov 90 I #60 Page 41

Mr. Cord owns four corporations. Combined financial statements are being prepared for these corporations, which have intercompany loans of $200,000 and intercompany profits of $500,000. What amount of these intercompany loans and profits should be included in the combined financial statements?

| | *Intercompany* | |
|---|---|---|
| | *Loans* | *Profits* |
| a. | $200,000 | $0 |
| b. | $200,000 | $500,000 |


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| | | |
|---|---|---|
| c. | $0 | $0 |
| d. | $0 | $500,000 |

**CPA-00509 Explanation**
Choice "c" is correct, loans, $0; profits, $0. (All of the $200,000 interco loans and $500,000 interco profits should be eliminated.)

**Rule:** "Combined financial statements" do not eliminate "equity" accounts (they are all added across). However, all other intercompany "transactions" and "balances" are eliminated in combined financial statements just as they are in consolidated financial statements.

**Note:** The question is tricky because it asks what should be "included" rather than "eliminated."

**CPA-00510 Type1 M/C A-D Corr Ans: C PM#5 F 3-08**

94. CPA-00510 Nov 89 T #40 Page 41

Which of the following items should be treated in the same manner in both combined financial statements and consolidated statements?

| | *Different fiscal periods* | *Foreign operations* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | Yes |
| d. | Yes | No |

**CPA-00510 Explanation**
Choice "c" is correct, Yes - Yes. Different fiscal periods and foreign operations are treated in the same manner in both combined financial statements and consolidated statements.

Combined financial statements are prepared in the same manner as consolidated financial statements except there is no parent company. Therefore, there is no investment in sub account to eliminate against sub equity accounts.

**Supplemental Questions**

**CPA-00502 Type1 M/C A-D Corr Ans: B PM#1 F 3-99**

95. CPA-00502 Th Nov 93 #12 Page 48

In a business combination accounted for as a pooling:

a. Income is combined only from date of combination, not for prior periods presented.
b. Income is combined for all periods presented.
c. After the combination, balance sheet amounts are carried at fair market value.
d. Direct acquisition costs are recorded as part of the cost of the investment.

**CPA-00502 Explanation**
Choice "b" is correct. In a business combination accounted for as a pooling, all accounts are combined as if the combination had occurred at the beginning of the year. All prior periods presented are also retroactively adjusted as if the companies had always been one entity.

Choice "a" is incorrect. In a business combination accounted for as a pooling, all accounts are combined as if the combination had occurred at the beginning of the year and all prior periods presented are restated.

Choice "c" is incorrect. Under a pooling of interests, all account balances are reflected at the original book value of the combined entities.

Choice "d" is incorrect. Under a pooling, direct acquisition costs are expenses of the combined corporation.


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**CPA-00504 Type1 M/C A-D Corr Ans: B PM#2 F 3-99**

96. CPA-00504 Th Nov 93 #13 Page 48

Which of the following statements is supportive of the pooling-of-interests method in accounting for a business combination?

a. Bargaining between the parties is based on current values for assets and liabilities.
b. Stockholder groups remain intact but combine.
c. Goodwill is generally a part of any acquisition.
d. A portion of the total cost is assigned to individual assets acquired on the basis of their fair value.

**CPA-00504 Explanation**
Choice "b" is correct, the "pooling-of-interests" method of accounting for a business combination assumes that stockholder groups remain intact but combine.

Choice "a" is incorrect. The purchase method uses bargaining between the parties based on current values for assets and liabilities.

Choice "c" is incorrect. The purchase method generally results in goodwill not the pooling method.

Choice "d" is incorrect. In a pooling "net book values" of the newly "pooled companies" remain the same while in a purchase, net book values of a newly acquired company are adjusted (generally upward due to inflation) to acquisition date "fair value."

**CPA-00511 Type1 M/C A-D Corr Ans: D PM#3 F 3-99**

97. CPA-00511 Nov 89 II #3 Page 4

Lee Corp. reported the following available-for-sale marketable equity security on its December 31, 1994, balance sheet:

| | |
|---|---|
| Neu Corp. common stock, at cost | $100,000 |
| Less: Allowance for decline in market value | (20,000) |
| Balance | $ 80,000 |

At December 31, 1995, the market value of Lee's investment in the Neu Corp. stock was $85,000. As a result of the 1995 increase in this stock's market value, Lee's 1995 income statement should report:

a. An unrealized gain of $5,000.
b. A realized gain of $5,000.
c. An unrealized loss of $15,000.
d. No gain or loss.

**CPA-00511 Explanation**
Choice "d" is correct. No gain or loss should be reported in the income statement.

**Rule:** Available-for-sale marketable securities are carried at market value.

Any unrealized loss is charged to other comprehensive income. The valuation account ("allowance for unrealized losses") and accumulated OCI are adjusted each year-end to reflect the current cumulative difference between aggregate cost and aggregate market.

In this example, the valuation account and accumulated OCI account (both balance sheet accounts) would be reduced by $5,000 (from $20,000 to $15,000).

Choices "a", "b", and "c" are incorrect. The income statement is only affected by gains or losses from trading securities, or on available-for-sale securities if the unrealized loss is considered permanent.

**CPA-00514 Type1 M/C A-D Corr Ans: D PM#4 F 3-99**

98. CPA-00514 Nov 89 #2 Page 4


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Robin Co. has a marketable equity securities portfolio classified as available-for-sale. None of the holdings enables Robin to exercise significant influence over an investee. The aggregate cost exceeds its aggregate market value. The decline is considered temporary and should be reported as a (an):

a. Unrealized loss in the income statement.
b. Realized loss in the income statement.
c. Valuation allowance in the noncurrent liability section of the balance sheet.
d. Valuation allowance in the asset section of the balance sheet.

**CPA-00514 Explanation**
Choice "d" is correct. The temporary decline of an available-for-sale marketable equity securities portfolio below aggregate cost should be reported as a valuation allowance in the asset section of the balance sheet.

**Rule:** Temporary losses on available-for-sale securities (where aggregate cost exceeds aggregate market) should be credited to an asset valuation account and debited direct to other comprehensive income.

Choices "a" and "b" are incorrect. There is no income statement effect for an available-for-sale portfolio unless the loss is permanent.

Choice "c" is incorrect. The valuation account is a "contra-asset" (valuation account) and not a liability.

**CPA-00518 Type1 M/C A-D Corr Ans: D PM#5 F 3-99**

99. CPA-00518 May 90 I #2 Page 4

During 1994, Scott Corp. purchased marketable equity securities as available-for-sale investments. Pertinent data follow:

| | | *Market Value* |
|---|---|---|
| *Security* | *Cost* | *at 12/31/94* |
| D | $ 36,000 | $ 40,000 |
| E | 80,000 | 60,000 |
| F | 180,000 | 186,000 |
| | $296,000 | $286,000 |

Scott appropriately carries these securities at market value. The amount of unrealized loss on these securities in Scott's 1994 income statement should be:

a. $20,000
b. $14,000
c. $10,000
d. $0

**CPA-00518 Explanation**
Choice "d" is correct. $0 unrealized loss should be in the income statement.

**Rule:** If unrealized loss on available-for-sale marketable equity securities:

If Temporary -
1. Do not record loss in the income statement.
2. Record (debit) difference in other comprehensive income.
3. Record (credit) difference in a valuation (contra) account (a component of the noncurrent asset section of the balance sheet).
4. Subsequent recoveries in market value are debited to the valuation account and credited to other comprehensive income.

If Permanent -
1. Record realized loss (debit) in the income statement.
2. Credit the cost of the individual security account.

**CPA-00521 Type1 M/C A-D Corr Ans: A PM#6 F 3-99**

100. CPA-00521 May 90 I #57 Page 6


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During 1994, Wall Co. purchased 2,000 shares of Hemp Corp. common stock for $31,500 as a trading investment. The market value of this investment was $29,500 at December 31, 1994. Wall sold all of the Hemp common stock for $14 per share on December 15, 1995, incurring $1,400 in brokerage commissions and taxes. On the sale, Wall should report a realized loss in its income statement of:

a. $2,900
b. $3,500
c. $4,900
d. $1,500

**CPA-00521 Explanation**
Choice "a" is correct. $2,900 realized loss in 1995 income statement on sale of stock.

**Rule:** Trading securities are reported at fair value with unrealized gains and losses included in earnings. Fair value becomes the new basis (revalued cost) for computing realized gains or losses upon sale.

| | | Trading Investment |
|---|---|---|
| Original cost in 1994 | | $ 31,500 |
| Unrealized loss charged to income in 1994, as if realized | | (2,000) |
| Fair value at 12-31-94 (revalued cost) | | 29,500 |
| Sales proceeds ($14 × 2,000 SH) | $28,000 | |
| Less brokerage commissions & taxes | (1,400) | 26,600 |
| realized loss in 1995 income statement | | $ 2,900 |

**CPA-00523 Type1 M/C A-D Corr Ans: B PM#7 F 3-99**

101. CPA-00523 May 91 I #18 Page 4

Data regarding Ball Corp.'s available-for-sale marketable equity securities follow:

| | *Cost* | *Market Value* |
|---|---|---|
| December 31, 1994 | $150,000 | $130,000 |
| December 31, 1995 | 150,000 | 160,000 |

Differences between cost and market values are considered temporary. The decline in market value was considered temporary and was properly accounted for at December 31, 1994. Ball's 1995 statement of changes in stockholders' equity would report an increase of:

a. $20,000
b. $30,000
c. $10,000
d. $0

**CPA-00523 Explanation**
Choice "b" is correct. $30,000 increase in Accumulated Other Comprehensive Income.

**Rule:** Temporary declines in aggregate market values of available-for-sale securities are charged to (decrease) Stockholders' Equity.

Subsequent recoveries and/or advances in aggregate market values are credited to (increase) other comprehensive income to reflect fair value.

| | |
|---|---|
| Original cost | $150,000 |
| Market value 12/31/94 | (130,000) |
| 1994 decrease in accumulated OCI | $ 20,000 |
| | |
| Market value 12/31/95 | $160,000 |
| Prior fair value | (130,000) |
| 1995 increase in accumulated OCI | $ 30,000 |


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**CPA-00525 Type1 M/C A-D Corr Ans: C PM#8 F 3-99**

102. CPA-00525 May 92 I #13 Page 4

Reed, Inc. began operations on January 1, 1994. The following information pertains to Reed's December 31, 1994, portfolio of marketable equity securities:

| | *Trading* | *Available-for-Sale* |
|---|---|---|
| Aggregate cost | $360,000 | $550,000 |
| Market value | 320,000 | 450,000 |

If the market declines are judged to be temporary, what amounts should Reed report as valuation allowances for its trading and available-for-sale marketable equity securities in its December 31, 1994 balance sheet?

| | *Trading* | *Available-for-Sale* |
|---|---|---|
| a. | $40,000 | $0 |
| b. | $0 | $100,000 |
| c. | $40,000 | $100,000 |
| d. | $56,000 | $130,000 |

**CPA-00525 Explanation**
Choice "c" is correct. $40,000 and $100,000.

**Rule:** Unrealized gains or losses on trading and available-for-sale marketable equity securities (e.g., stocks) are based on fair values.

| | | Trading | Available-for-Sale |
|---|---|---|---|
| Aggregate cost | | $360,000 | $ 550,000 |
| Market value | | (320,000) | (450,000) |
| Valuation allowance | - Cr | $ 40,000 | $ 100,000 |
| | - Dr | Income Statement | Other Comprehensive Income |

**CPA-00527 Type1 M/C A-D Corr Ans: D PM#9 F 3-99**

103. CPA-00527 May 92 I #14 Page 3

The following information pertains to Smoke, Inc.'s investment in marketable equity securities:

- On December 31, 1995, Smoke reclassified a security with a $70,000 cost and a $50,000 fair value from trading to available-for-sale.
- An available-for-sale marketable equity security costing $75,000, written down to $30,000 in 1994, had a $60,000 fair value on December 31, 1995. Smoke believes the recovery is permanent.

What is the net effect of the above items on Smoke's valuation allowance for available-for-sale marketable equity securities as of December 31, 1995?

a. $10,000 decrease.
b. No effect.
c. $20,000 increase.
d. $30,000 decrease.

**CPA-00527 Explanation**
**Rule:** The transfer of a security between categories of investments shall be accounted for at fair value. At the date of the transfer, the security's unrealized holding gain or loss shall be accounted for as follows:

a. For a security transferred from the trading category, the unrealized holding gain or loss at the date of the transfer will have already been recognized in earnings and shall not be reversed.


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b. For a security transferred into the trading category, the unrealized holding gain or loss at the date of the transfer shall be recognized in earnings immediately.

Choice "d" is correct. The reclassified security is transferred in at fair market value and thus, has no effect on the valuation allowance. The adjustment for the existing available for sale security would be as follows:

| | Dec. 31, 1994 | Dec. 31, 1995 | Net Change |
|---|---|---|---|
| Cost | 75,000 | 75,000 | 0 |
| FMV | (30,000) | (60,000) | (30,000) |
| Val. Allowance | 45,000 | 15,000 | (30,000) |

**CPA-00529 Type1 M/C A-D Corr Ans: D PM#10 F 3-99**

104. CPA-00529 Nov 89 #33 Page 48

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. A portion of the total cost is assigned to individual assets acquired on the basis of their fair value.
d. It was developed within the boundaries of the historical-cost system and is compatible with it.

**CPA-00529 Explanation**
Choice "d" is correct. The pooling of interests method of accounting for a business combination was developed within the boundaries of the historical-cost system and is compatible with it.

Choice "a" is incorrect. The purchase method of accounting is generally used for a business combination where one company is clearly the dominant and continuing entity.

Choice "b" is incorrect. Goodwill is not reported under the pooling method since pooling creates no goodwill - only the purchase method could produce goodwill.

Choice "c" is incorrect. In a pooling "net book values" of the newly "pooled companies" remain the same while in a purchase, net book values of a newly acquired company are adjusted (generally upwards due to inflation) to acquisition date "fair value."

**CPA-00530 Type1 M/C A-D Corr Ans: C PM#11 F 3-99**

105. CPA-00530 May 90 #32 Page 48

In order to report a business combination as a pooling of interests, the minimum amount of an investee's common stock that must be acquired during the combination period in exchange for the investor's common stock is:

a. 51 percent.
b. 80 percent.
c. 90 percent.
d. 100 percent.

**CPA-00530 Explanation**
Choice "c" is correct. 90 percent of an investee's common stock must be acquired during the combination period in exchange for the investor's common stock in order to report a business combination as a pooling of interests.

**CPA-00531 Type1 M/C A-D Corr Ans: B PM#12 F 3-99**

106. CPA-00531 Nov 90 #5 Page 49


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A business combination is accounted for as a pooling of interests. In the consolidated balance sheet, the following component(s) of stockholders' equity may be less than the sum of those same components of the merging companies:

| | *Retained earnings* | *Contributed capital* |
|---|---|---|
| a. | No | No |
| b. | Yes | No |
| c. | No | Yes |
| d. | Yes | Yes |

**CPA-00531 Explanation**

Choice "b" is correct. In the consolidated BS following a pooling:

Yes - Retained earnings may be less than the sum of the merging companies due to pooling expenses.

No - Contributed capital (capital stock at par or stated value, plus additional paid-in capital, less treasury stock) would be the same as (not less than) the sum of the merging companies.

**Rules:** In a pooling almost all of the acquired retained earnings of the subsidiary will be added to the consolidated retained earnings.

Net income of the subsidiary for the entire year is added to consolidated net income regardless of the date of "pooling." Thus, a pooling consummated on the last day of the year will result in additional consolidated net income from the newly pooled company for the entire year.

Expenses related to combination (e.g., costs of registering and issuing equity securities, including finders, consultants, legal and accounting fees) are expenses in determining net income of the resulting combined corporation for the period incurred.

When new stock is issued for a newly acquired "pooled" corporation, the "shareholders equity" is increased by the total net book value of the newly pooled corporation. "Net book values" of the newly "pooled companies" remain the same. Thus, it remains within the boundaries of the "historical cost" system.

**CPA-00533 Type1 M/C A-D Corr Ans: D PM#13 F 3-99**

107. CPA-00533 Nov 92 I #44 Page 13

Information pertaining to dividends from Wray Corp.'s common stock investments for the year ended December 31, 1991, follows:

- On September 8, 1991, Wray received a $50,000 cash dividend from Seco, Inc., in which Wray owns a 30% interest. A majority of Wray's directors are also directors of Seco.
- On October 15, 1991, Wray received a $6,000 liquidating dividend from King Co. Wray owns a 5% interest in King Co.
- Wray owns a 2% interest in Bow Corp., which declared a $200,000 cash dividend on November 27, 1991, to stockholders of record on December 15, 1991, payable on January 5, 1992.

What amount should Wray report as dividend income in its income statement for the year ended December 31, 1991?

a. $60,000
b. $56,000
c. $10,000
d. $4,000

**CPA-00533 Explanation**

| | Dividend income in income statement | Reduction of investments in balance sheet |
|---|---|---|
| Seco dividend (equity method) | | $ 50,000 |
| King Co. liquidating dividend | | 6,000 |


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| | | |
|---|---|---|
| Bow Corp. Dividend receivable ($200,000 × .02) | $4,000 | |
| | $4,000 | $ 56,000 |
| | **D** | Not **B** |

Choice "d" is correct. $4,000 dividend income should be reported in income statement.

**CPA-04347 Type1 M/C H,T,A Corr Ans: T PM#14 F 3-99**

108. CPA-04347 FARE Nov 95 PR 2 1 Page 3

Camp Co. purchased various securities during 1994 to be classified as held-to-maturity securities, trading securities, or available-for-sale securities.

This question describes a security purchased by Camp. Select from the following list the appropriate category for the security.

- Debt securities bought and held for the purpose of selling in the near term.

*Categories*

[A] Available-for-sale.
[H] Held-to-maturity.
[T] Trading.

**CPA-04347 Explanation**
**Choice "T" is correct.** Trading securities are those marketable securities [debt and equity], which will be sold in the near term.

**CPA-04348 Type1 M/C H,T,A Corr Ans: H PM#15 F 3-99**

109. CPA-04348 FARE Nov 95 PR 2 2 Page 3

Camp Co. purchased various securities during 1994 to be classified as held-to-maturity securities, trading securities, or available-for-sale securities.

This question describes a security purchased by Camp. Select from the following list the appropriate category for the security.

- U.S. Treasury bonds that Camp has both the positive intent and the ability to hold to maturity.

*Categories*

[A] Available-for-sale.
[H] Held-to-maturity.
[T] Trading.

**CPA-04348 Explanation**
**Choice "H" is correct.** Held-to-maturity securities are investments in bonds that will be held until the maturity date. Camp has both the intent and the ability to do so.

**CPA-04350 Type1 M/C H,T,A Corr Ans: A PM#16 F 3-99**

110. CPA-04350 FARE Nov 95 PR 2 3 Page 3

Camp Co. purchased various securities during 1994 to be classified as held-to-maturity securities, trading securities, or available-for-sale securities.

This question describes a security purchased by Camp. Select from the following list the appropriate category for the security.

- $3 million debt security bought and held for the purpose of selling in three years to finance payment of Camp's $2 million long-term note payable when it matures.


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*Categories*

[A] Available-for-sale.
[H] Held-to-maturity.
[T] Trading.

**CPA-04350 Explanation**
**Choice "A" is correct.** Available-for-sale securities are those marketable securities [debt and equity], which will be held longer than a year or operating cycle before disposal. These debt securities will not be held until maturity.

**CPA-04353 Type1 M/C H,T,A Corr Ans: A PM#17 F 3-99**

111. CPA-04353 FARE Nov 95 PR 2 4 Page 3

Camp Co. purchased various securities during 1994 to be classified as held-to-maturity securities, trading securities, or available-for-sale securities.

This question describes a security purchased by Camp. Select from the following list the appropriate category for the security.

- Convertible preferred stock that Camp does not intend to sell in the near term.

*Categories*

[A] Available-for-sale.
[H] Held-to-maturity.
[T] Trading.

**CPA-04353 Explanation**
**Choice "A" is correct.** Available-for-sale securities are those marketable securities (debt and equity), which are not classified as trading securities or held-to-maturity securities.

**CPA-04355 Type1 M/C A-K Corr Ans: G PM#18 F 3-99**

112. CPA-04355 FARE Nov 95 PR 2 5 Page 3

The following information pertains to Dayle, Inc.'s portfolio of marketable investments for the year ended December 31, 1994:

| | Cost | Fair value 12/31/93 | 1994 activity Purchases | Sales | Fair value 12/31/94 |
|---|---|---|---|---|---|
| Held-to-maturity securities | | | | | |
| Security ABC | | | $100,000 | | $95,000 |
| Trading securities | | | | | |
| Security DEF | $150,000 | $160,000 | | | 155,000 |
| Available-for-sale securities | | | | | |
| Security GHI | 190,000 | 165,000 | | $175,000 | |
| Security JKL | 170,000 | 175,000 | | | 160,000 |

Security ABC was purchased at par. All declines in fair value are considered to be temporary.

This question describes an amount to be reported in Dayle's 1994 financial statements. Select from the following list the correct numerical response. Ignore income tax considerations.

- Carrying amount of security ABC at December 31, 1994.

*Answer List*

[A] $0
[B] $5,000


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[C] $10,000
[D] $15,000
[E] $25,000
[F] $95,000
[G] $100,000
[H] $150,000
[I] $155,000
[J] $160,000
[K] $170,000

**CPA-04355 Explanation**
**Choice "G" is correct.** At year end, held-to-maturity investments are reported at their carrying value (amortized cost), not fair value. Carrying value of security ABC is the purchase price of $100,000.

**CPA-04357 Type1 M/C A-K Corr Ans: I PM#19 F 3-99**

113. CPA-04357 FARE Nov 95 PR 2 6 Page 3

The following information pertains to Dayle, Inc.'s portfolio of marketable investments for the year ended December 31, 1994:

| | Cost | Fair value 12/31/93 | 1994 activity Purchases | Sales | Fair value 12/31/94 |
|---|---|---|---|---|---|
| Held-to-maturity securities | | | | | |
| Security ABC | | | $100,000 | | $95,000 |
| Trading securities | | | | | |
| Security DEF | $150,000 | $160,000 | | | 155,000 |
| Available-for-sale securities | | | | | |
| Security GHI | 190,000 | 165,000 | | $175,000 | |
| Security JKL | 170,000 | 175,000 | | | 160,000 |

Security ABC was purchased at par. All declines in fair value are considered to be temporary.

This question describes an amount to be reported in Dayle's 1994 financial statements. Select from the following list the correct numerical response. Ignore income tax considerations.

- Carrying amount of security DEF at December 31, 1994.

*Answer List*

[A] $0
[B] $5,000
[C] $10,000
[D] $15,000
[E] $25,000
[F] $95,000
[G] $100,000
[H] $150,000
[I] $155,000
[J] $160,000
[K] $170,000

**CPA-04357 Explanation**
**Choice "I" is correct.** The year-end carrying amount of trading investments is the fair value at year-end. Fair value of security DEF is $155,000.

**CPA-04358 Type1 M/C A-K Corr Ans: J PM#20 F 3-99**


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114. CPA-04358 FARE Nov 95 PR 2 7 Page 3

The following information pertains to Dayle, Inc.'s portfolio of marketable investments for the year ended December 31, 1994:

| | Cost | Fair value 12/31/93 | 1994 activity Purchases | Sales | Fair value 12/31/94 |
|---|---|---|---|---|---|
| Held-to-maturity securities | | | | | |
| Security ABC | | | $100,000 | | $95,000 |
| Trading securities | | | | | |
| Security DEF | $150,000 | $160,000 | | | 155,000 |
| Available-for-sale securities | | | | | |
| Security GHI | 190,000 | 165,000 | | $175,000 | |
| Security JKL | 170,000 | 175,000 | | | 160,000 |

Security ABC was purchased at par. All declines in fair value are considered to be temporary.

This question describes an amount to be reported in Dayle's 1994 financial statements. Select from the following list the correct numerical response. Ignore income tax considerations.

- Carrying amount of security JKL at December 31, 1994.

*Answer List*

[A] $0
[B] $5,000
[C] $10,000
[D] $15,000
[E] $25,000
[F] $95,000
[G] $100,000
[H] $150,000
[I] $155,000
[J] $160,000
[K] $170,000

**CPA-04358 Explanation**
**Choice "J" is correct.** The year-end carrying amount of available for sale investments is the fair value at year end. Fair value of security JKL is $160,000.

**CPA-04359 Type1 M/C A-K Corr Ans: D PM#21 F 3-99**

115. CPA-04359 FARE Nov 95 PR 2 8 Page 3

The following information pertains to Dayle, Inc.'s portfolio of marketable investments for the year ended December 31, 1994:

| | Cost | Fair value 12/31/93 | 1994 activity Purchases | Sales | Fair value 12/31/94 |
|---|---|---|---|---|---|
| Held-to-maturity securities | | | | | |
| Security ABC | | | $100,000 | | $95,000 |
| Trading securities | | | | | |
| Security DEF | $150,000 | $160,000 | | | 155,000 |
| Available-for-sale securities | | | | | |
| Security GHI | 190,000 | 165,000 | | $175,000 | |
| Security JKL | 170,000 | 175,000 | | | 160,000 |


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Security ABC was purchased at par. All declines in fair value are considered to be temporary.

This question describes an amount to be reported in Dayle's 1994 financial statements. Select from the following list the correct numerical response. Ignore income tax considerations.

- Recognized gain or loss on sale of security GHI.

*Answer List*
[A] $0
[B] $5,000
[C] $10,000
[D] $15,000
[E] $25,000
[F] $95,000
[G] $100,000
[H] $150,000
[I] $155,000
[J] $160,000
[K] $170,000

**CPA-04359 Explanation**
**Choice "D" is correct.** The $175,000 sales proceeds less the $190,000 cost yields a realized loss of $15,000.

**CPA-04360 Type1 M/C A-K Corr Ans: B PM#22 F 3-99**

116. CPA-04360 FARE Nov 95 PR 2 9 Page 3

The following information pertains to Dayle, Inc.'s portfolio of marketable investments for the year ended December 31, 1994:

| | Cost | Fair value 12/31/93 | 1994 activity Purchases | Sales | Fair value 12/31/94 |
|---|---|---|---|---|---|
| Held-to-maturity securities | | | | | |
| Security ABC | | | $100,000 | | $95,000 |
| Trading securities | | | | | |
| Security DEF | $150,000 | $160,000 | | | 155,000 |
| Available-for-sale securities | | | | | |
| Security GHI | 190,000 | 165,000 | | $175,000 | |
| Security JKL | 170,000 | 175,000 | | | 160,000 |

Security ABC was purchased at par. All declines in fair value are considered to be temporary.

This question describes an amount to be reported in Dayle's 1994 financial statements. Select from the following list the correct numerical response. Ignore income tax considerations.

- Unrealized gain or loss to be reported in 1994 income statement.

*Answer List*
[A] $0
[B] $5,000
[C] $10,000
[D] $15,000
[E] $25,000
[F] $95,000
[G] $100,000
[H] $150,000


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[I] $155,000
[J] $160,000
[K] $170,000

**CPA-04360 Explanation**
**Choice "B" is correct.** Only adjustments to trading securities valuations are reported on the income statement. The $160,000 carrying value of the trading securities must be reduced to the $155,000 fair value and an income statement unrealized loss of $5,000 is recognized.

**CPA-04361 Type1 M/C A-K Corr Ans: C PM#23 F 3-99**

117. CPA-04361 FARE Nov 95 PR 2 10 Page 3

The following information pertains to Dayle, Inc.'s portfolio of marketable investments for the year ended December 31, 1994:

| | Cost | Fair value 12/31/93 | 1994 activity Purchases | Sales | Fair value 12/31/94 |
|---|---|---|---|---|---|
| Held-to-maturity securities | | | | | |
| Security ABC | | | $100,000 | | $95,000 |
| Trading securities | | | | | |
| Security DEF | $150,000 | $160,000 | | | 155,000 |
| Available-for-sale securities | | | | | |
| Security GHI | 190,000 | 165,000 | | $175,000 | |
| Security JKL | 170,000 | 175,000 | | | 160,000 |

Security ABC was purchased at par. All declines in fair value are considered to be temporary.

This question describes an amount to be reported in Dayle's 1994 financial statements. Select from the following list the correct numerical response. Ignore income tax considerations.

- Unrealized gain or loss to be reported at December 31, 1994, as other comprehensive income.

*Answer List*
[A] $0
[B] $5,000
[C] $10,000
[D] $15,000
[E] $25,000
[F] $95,000
[G] $100,000
[H] $150,000
[I] $155,000
[J] $160,000
[K] $170,000

**CPA-04361 Explanation**
**Choice "C" is correct.** Adjustments to available-for-sale securities are reported as other comprehensive income. The $175,000 fair value/carrying value of the available-for-sale JKL securities must be reduced to the $160,000 fair value for an unrealized loss of $15,000, and that unrealized loss is reported in other comprehensive income. The accumulated other comprehensive income amount on the balance sheet for that security, which was a debit balance of $5,000 due to 12/31/93's increase to $175,000, is thus adjusted to a credit balance of $10,000 ($15,000 - $5,000) and now reflects the $10,000 difference between the original cost and the 12/31/94 fair value. Using a valuation account, the security would be presented as follows:

| | |
|---|---|
| Cost | $170,000 |
| Allowance to adjust available-for-sale securities to market | (10,000) |


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$160,000

However, in addition to security JKL, security GHI also had an impact on other comprehensive income. That security was sold during 1994 when it had a valuation allowance and an amount in accumulated comprehensive income of $25,000 ($190,000 - $165,000). When the security is sold, the security and the valuation allowance both had to be removed from the accounts. That entry would have produced an adjustment of $25,000 to accumulated other comprehensive income. This adjustment of $25,000 (an increase to OCI, or a "gain") from security GHI combined with the unrealized loss adjustment of $15,000 (a decrease to OCI, or a "loss") from security JKL would mean a total effect for the year on other comprehensive income of an increase to OCI in the amount of $10,000 (a "gain").


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# CPA PassMaster Questions–Financial 4
# Export Date: 10/30/08


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**Working Capital and its Components**

**CPA-00026 Type1 M/C A-D Corr Ans: C PM#1 F 4-01**

1. CPA-00026 FARE R01 #1 Page 5

Inch Co. had the following balances at December 31, 1999:

| | |
|---|---|
| Cash in checking account | $35,000 |
| Cash in money market account | 75,000 |
| U.S. Treasury bill, purchased 12/1/99, maturing 2/28/00 | 200,000 |
| U.S. Treasury bill, purchased 12/1/98, maturing 5/31/00 | 150,000 |

Inch's policy is to treat as cash equivalents all highly-liquid investments with a maturity of three months or less when purchased. What amount should Inch report as cash and cash equivalents in its December 31, 1999, balance sheet?

a. $110,000
b. $235,000
c. $310,000
d. $460,000

**CPA-00026 Explanation**
Choice "c" is correct. The company's policy is to treat all highly-liquid investments with a maturity of three months or less when purchased as cash equivalents. The following items are therefore treated as cash and cash equivalents at December 31:

| | |
|---|---|
| Cash in checking account | $ 35,000 |
| Cash in money market account | $ 75,000 |
| U.S. Treasury bill, purchased 12-1-99 maturing 2-28-00 | $200,000 |
| Total | $310,000 |

The $150,000 Treasury bill matures in five months after its purchase and does not qualify.

**CPA-00030 Type1 M/C A-D Corr Ans: C PM#2 F 4-01**

2. CPA-00030 FARE R01 #2 Page 9

In its December 31, 1999, balance sheet, Fleet Co. reported accounts receivable of $100,000 before allowance for uncollectible accounts of $10,000. Credit sales during 2000 were $611,000, and collections from customers, excluding recoveries, totaled $591,000. During 2000, accounts receivable of $45,000 were written off and $17,000 were recovered. Fleet estimated that $15,000 of the accounts receivable at December 31, 2000, were uncollectible. In its December 31, 2000, balance sheet, what amount should Fleet report as accounts receivable before allowance for uncollectible accounts?

a. $58,000
b. $67,000
c. $75,000
d. $82,000

**CPA-00030 Explanation**
Choice "c" is correct. The question requires the determination of accounts receivable **before** the allowance for uncollectible accounts. The calculation of the accounts receivable balance is:

| | | | |
|---|---|---|---|
| **B** | Beginning: | A/R 1/1/00 | $100,000 |
| **A** | Additions: | Credit sales | 611,000 |
| | | Recoveries | 17,000 |
| **S** | Subtracts: | Collections | (591,000) |
| | | Collections (Recovery) | (17,000) |


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| | | | |
|---|---|---|---|
| | | Written-off A/R | (45,000) |
| **E** | Ending: | A/R 12/31/00 | $ 75,000 |

**CPA-00039 Type1 M/C A-D Corr Ans: B PM#6 F 4-01**

3. CPA-00039 FARE May 95 #35 Page 12

Which method of recording uncollectible accounts expense is consistent with accrual accounting?

| | *Allowance* | *Direct write-off* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |

**CPA-00039 Explanation**

Choice "b" is correct. The allowance method is used to match expenses with revenues and to record the proper carrying amount for accounts receivable. The direct write-off method does not achieve these objectives.

**CPA-00040 Type1 M/C A-D Corr Ans: C PM#7 F 4-01**

4. CPA-00040 FARE Nov 94 #11 Page 21

Mare Co.'s December 31, 1993, balance sheet reported the following current assets:

| | |
|---|---|
| Cash | $ 70,000 |
| Accounts receivable | 120,000 |
| Inventories | 60,000 |
| Total | $250,000 |

An analysis of the accounts disclosed that accounts receivable consisted of the following:

| | |
|---|---|
| Trade accounts | $ 96,000 |
| Allowance for uncollectible accounts | (2,000) |
| Selling price of Mare's unsold goods out on consignment, at 130% of cost, **not** included in Mare's ending inventory | 26,000 |
| Total | $120,000 |

At December 31, 1993, the total of Mare's current assets is:

a. $224,000
b. $230,000
c. $244,000
d. $270,000

**CPA-00040 Explanation**

| | | | | |
|---|---|---|---|---|
| Selling price of consigned goods | 26,000 | ÷ | 130% | = |
| Cost of consigned goods | 20,000 | | 100 | |
| Unrealized profit | 6,000 | | 30% | |

| Current assets | *Prelim* | *AJE* | *Final* |
|---|---|---|---|
| cash | 70,000 | | 70,000 |
| accts rec'able (net) | 120,000 | (26,000) | 94,000 |
| inventories | 60,000 | 20,000 | 80,000 |
| Total | 250,000 | (6,000) | 244,000 |

Choice "c" is correct, $244,000 total current assets.


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**CPA-00044 Type1 M/C A-D Corr Ans: A PM#8 F 4-01**

5. CPA-00044 FARE Nov 94 #12 Page 14

When the allowance method of recognizing uncollectible accounts is used, the entry to record the write-off of a specific account:

a. Decreases both accounts receivable and the allowance for uncollectible accounts.
b. Decreases accounts receivable and increases the allowance for uncollectible accounts.
c. Increases the allowance for uncollectible accounts and decreases net income.
d. Decreases both accounts receivable and net income.

**CPA-00044 Explanation**
Choice "a" is correct, when the allowance method of recognizing uncollectible accounts is used, the entry to record the write-off of a specific account decreases both accounts receivable and the allowance for uncollectible accounts.

| Journal entry | *Dr* | *Cr* |
|---|---|---|
| Allowance for uncollectible accounts | XX | |
| Accounts receivable | | XX |

Choice "b" is incorrect. The allowance for uncollectable accounts decreases.

Choice "c" is incorrect. The allowance for uncollectible accounts decreases, but net income is not affected.

Choice "d" is incorrect. Net income is not affected.

**CPA-00053 Type1 M/C A-D Corr Ans: B PM#10 F 4-01**

6. CPA-00053 FARE May 94 #12 Page 6

The following information pertains to Grey Co. at December 31, 1993:

| | |
|---|---|
| Checkbook balance | $12,000 |
| Bank statement balance | 16,000 |
| Check drawn on Grey's account, payable to a vendor, dated and recorded 12/31/93 but not mailed until 1/10/94 | 1,800 |

On Grey's December 31, 1993, balance sheet, what amount should be reported as cash?

a. $12,000
b. $13,800
c. $14,200
d. $16,000

**CPA-00053 Explanation**
Choice "b" is correct. Since the check is not disbursed as of December 31, 1993, it should be added back to the checkbook balance in determining the 12/31/93 cash balance. Thus, the correct cash balance = $12,000 + $1,800 = $13,800.

**CPA-00056 Type1 M/C A-D Corr Ans: C PM#11 F 4-01**

7. CPA-00056 FARE May 94 #13 Page 5

At December 31, 1993, Kale Co. had the following balances in the accounts it maintains at First State Bank:

| | |
|---|---|
| Checking account #101 | $175,000 |
| Checking account #201 | (10,000) |


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| | |
|---|---|
| Money market account | 25,000 |
| 90-day certificate of deposit, due 2/28/94 | 50,000 |
| 180-day certificate of deposit, due 3/15/94 | 80,000 |

Kale classifies investments with original maturities of three months or less as cash equivalents. In its December 31, 1993, balance sheet, what amount should Kale report as cash and cash equivalents?

a. $190,000
b. $200,000
c. $240,000
d. $320,000

**CPA-00056 Explanation**
Choice "c" is correct, $240,000 cash and cash equivalents in 12/31/93 balance sheet.

| **First State Bank accounts** | *Cash and cash equivalents* |
|---|---|
| Checking account #101 | $175,000 |
| Checking account #201 | (10,000) |
| Money market account | 25,000 |
| 90-day CD, due 2/28/94 | 50,000 |
| 180-day CD, due 3/15/94 | – |
| Total | $240,000 |

Choices "a" and "b" are incorrect, per the explanation above.

Choice "d" is incorrect. The company policy is to classify investments with original maturities of 3 months or less as cash equivalents. Therefore, the 180-day certificate of deposit would not be included in cash and cash equivalents.

Note: a legal right of offset requires a company with different bank accounts to offset overdrawn accounts with positive balances in other accounts of the same bank to arrive at cash.

**CPA-00058 Type1 M/C A-D Corr Ans: A PM#12 F 4-01**

8. CPA-00058 FARE May 94 #15 Page 10

Delta, Inc. sells to wholesalers on terms of 2/15, net 30. Delta has no cash sales but 50% of Delta's customers take advantage of the discount. Delta uses the gross method of recording sales and trade receivables. An analysis of Delta's trade receivables balances at December 31, 1993, revealed the following:

| *Age* | *Amount* | *Collectible* |
|---|---|---|
| 0-15 days | $100,000 | 100% |
| 16-30 days | 60,000 | 95% |
| 31-60 days | 5,000 | 90% |
| Over 60 days | 2,500 | $500 |
| | $167,500 | |

In its December 31, 1993, balance sheet, what amount should Delta report for allowance for discounts?

a. $1,000
b. $1,620
c. $1,675
d. $2,000

**CPA-00058 Explanation**
Choice "a" is correct, $1,000 allowance for discounts at 12/31/93.

| | |
|---|---|
| Accounts receivable - 0-15 days | $100,000 |
| 50% of customers take 2% discount | × 1% |
| Allowance for discounts at 12/31/93 | $ 1,000 |


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**CPA-00060 Type1 M/C A-D Corr Ans: A PM#14 F 4-01**

9. CPA-00060 PI Nov 93 #18 Page 13

On March 31, 1993, Vale Co. had an unadjusted credit balance of $1,000 in its allowance for uncollectible accounts. An analysis of Vale's trade accounts receivable at that date revealed the following:

| *Age* | *Amount* | *Estimated uncollectible* |
|---|---|---|
| 0-30 days | $60,000 | 5% |
| 31-60 days | 4,000 | 10% |
| Over 60 days | 2,000 | $1,400 |

What amount should Vale report as allowance for uncollectible accounts in its March 31, 1993, balance sheet?

a. $4,800
b. $4,000
c. $3,800
d. $3,000

**CPA-00060 Explanation**
Choice "a" is correct. If bad debts are based on accounts receivable, the result of the aging will be the balance in the allowance account.

| | |
|---|---|
| $60,000 × 5% | $3,000 |
| $4,000 × 10% | 400 |
| Over 60 days | 1,400 |
| | $4,800 |

Note: The bad debt expense for the year would be $3,800 ($4,800 – $1,000).

Choice "b" is incorrect. If bad debts are based on accounts receivable, the results of the aging will be the balance in the allowance for uncollectibles account.

Choice "c" is incorrect. $3,800 is the bad debt expense for the year. If accounts receivable is the basis for bad debts, the aging results is the balance in the allowance for uncollectibles account.

Choice "d" is incorrect. If bad debts are based on accounts receivable, the results of the aging will be the balance in the allowance for uncollectible account.

**CPA-00062 Type1 M/C A-D Corr Ans: C PM#16 F 4-01**

10. CPA-00062 PI May 93 #12 Page 9

The following information relates to Jay Co.'s accounts receivable for 1992:

| | |
|---|---|
| Accounts receivable, 1/1/92 | $ 650,000 |
| Credit sales for 1992 | 2,700,000 |
| Sales returns for 1992 | 75,000 |
| Accounts written off during 1992 | 40,000 |
| Collections from customers during 1992 | 2,150,000 |
| Estimated future sales returns at 12/31/92 | 50,000 |
| Estimated uncollectible accounts at 12/31/92 | 110,000 |

What amount should Jay report for accounts receivable, before allowances for sales returns and uncollectible accounts, at December 31, 1992?

a. $1,200,000
b. $1,125,000
c. $1,085,000


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d. $925,000

**CPA-00062 Explanation**
Choice "c" is correct, $1,085,000 (gross) accounts receivable, before allowances for (future) estimated sales returns and uncollectible accounts.

| | *Gross A/R* |
|---|---|
| Begin balance, 1/1/92 | $ 650 |
| Add: credit sales | 2,700 |
| Subtotal | 3,350 |
| Less: collections | (2,150) |
| 1992 writeoffs | (40) |
| 1992 sales returns | (75) |
| Ending balance, 12/31/92 | $ 1,085 |

**CPA-00064 Type1 M/C A-D Corr Ans: A PM#17 F 4-01**

11. CPA-00064 PI May 93 #17 Page 13

The following information pertains to Tara Co.'s accounts receivable at December 31, 1992:

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

During 1992, Tara wrote off $7,000 in receivables and recovered $4,000 that had been written off in prior years. Tara's December 31, 1991, allowance for uncollectible accounts was $22,000. Under the aging method, what amount of allowance for uncollectible accounts should Tara report at December 31, 1992?

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

**CPA-00064 Explanation**
Choice "a" is correct. Under the aging method of calculating uncollectible accounts, the balance in the allowance account is determined by multiplying receivables by the uncollectible percentage. The existing balance in the allowance account is used to determine the expense for the year.

| | |
|---|---|
| $120,000 × 1% | $ 1,200 |
| $90,000 × 2% | 1,800 |
| $100,000 × 6% | 6,000 |
| Allowance, 12/31/92 | $ 9,000 |

**CPA-04676 Type1 M/C A-D Corr Ans: B PM#19 F 4-01**

12. CPA-04676 Released 2005 Page 12

Foster Co. adjusted its allowance for uncollectible accounts at year-end. The general ledger balances for the accounts receivable and the related allowance account were $1,000,000 and $40,000, respectively. Foster uses the percentage-of-receivables method to estimate its allowance for uncollectible accounts. Accounts receivable were estimated to be 5% uncollectible. What amount should Foster record as an adjustment to its allowance for uncollectible accounts at year-end?

a. $10,000 decrease.
b. $10,000 increase.


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c. $50,000 decrease.
d. $50,000 increase.

**CPA-04676 Explanation**
Choice "b" is correct. Under the percentage-of-receivables method the ending balance in the allowance account is equal to the total estimated uncollectible amount. Foster Co. would have a balance of $50,000 ($1,000,000 x 5%) in its allowance for uncollectible accounts at year end. Using the BASE format the adjustment would equal;

Allowance for uncollectible accounts:

| | |
|---|---|
| Beginning balance (given) | $40,000 |
| ***Add expense (squeezed)*** | ***10,000*** |
| Subtotal (added up) | 50,000 |
| Subtract write offs (none given) | 0 |
| Ending balance (calculated) | $50,000 |

JE for above

| | | |
|---|---|---|
| Bad debt expense | $10,000 | |
| Allowance for uncollectible accounts | | $10,000 |

**CPA-04679 Type1 M/C A-D Corr Ans: B PM#20 F 4-01**

13. CPA-04679 Released 2005 Page 12

Marr Co. had the following sales and accounts receivable balances, prior to any adjustments, at year-end:

| | |
|---|---|
| Credit sales | $10,000,000 |
| Accounts receivable | 3,000,000 |
| Allowance for uncollectible accounts | 50,000 |

Marr uses 3% of accounts receivable to determine its allowance for uncollectible accounts at year-end. By what amount should Marr adjust allowance for uncollectible accounts at year-end?

a. $0
b. $40,000
c. $90,000
d. $140,000

**CPA-04679 Explanation**
Choice "b" is correct. Under the percentage-of-receivables method the ending balance in the allowance account is equal to the total estimated uncollectible amount. Marr Co. would have a balance of $90,000 ($3,000,000 x 3%) in its allowance for uncollectible accounts at year end. Using the BASE format the adjustment would equal;

Allowance for uncollectible accounts:

| | |
|---|---|
| Beginning balance (given) | $50,000 |
| ***Add expense (squeezed)*** | ***40,000*** |
| Subtotal (added up) | 90,000 |
| Subtract write offs (none given) | 0 |
| Ending balance (calculated) | $90,000 |

**CPA-00008 Type1 M/C A-D Corr Ans: C PM#31 F 4-01**

14. CPA-00008 FARE May 95 #25 Page 9

Ward, a consultant, keeps her accounting records on a cash basis. During 1994, Ward collected $200,000 in fees from clients. At December 31, 1993, Ward had accounts receivable of $40,000. At December 31, 1994, Ward had accounts receivable of $60,000, and unearned fees of $5,000. On an accrual basis, what was Ward's service revenue for 1994?


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a. $175,000
b. $180,000
c. $215,000
d. $225,000

**CPA-00008 Explanation**
Choice "c" is correct, $215,000 service revenue for 1994.

| | Accounts receivable | |
|---|---|---|
| 12/31/93 | $40,000 | |
| Revenue - squeeze | ? | 215,000 |
| Subtotal | 255,000 | |
| Collections | (195,000) | |
| Balance at 12/31/94 | $60,000 | |

Note: Collections are $200,000 less $5,000 of unearned fees collected.

**CPA-00009 Type1 M/C A-D Corr Ans: B PM#31 F 4-01**

15. CPA-00009 FARE May 95 #35 Page 11

Which method of recording uncollectible accounts expense is consistent with accrual accounting?

| | *Allowance* | *Direct write-off* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |

**CPA-00009 Explanation**
Choice "b" is correct, Yes - No. Allowance method is consistent with accrual accounting; direct write-off is not consistent with accrual accounting.

**CPA-00021 Type1 M/C A-D Corr Ans: A PM#31 F 4-01**

16. CPA-00021 PI May 93 #37 Page 11

Fenn Stores, Inc. had sales of $1,000,000 during December 1992. Experience has shown that merchandise equaling 7% of sales will be returned within 30 days and an additional 3% will be returned within 90 days. Returned merchandise is readily resalable. In addition, merchandise equaling 15% of sales will be exchanged for merchandise of equal or greater value. What amount should Fenn report for net sales in its income statement for the month of December 1992?

a. $900,000
b. $850,000
c. $780,000
d. $750,000

**CPA-00021 Explanation**
Choice "a" is correct. When sales returns can be estimated, a decrease in revenue with a credit to allowance for sales returns is made. 10% returns are expected. $1,000,000 less 10% is $900,000. Expected exchanges do not affect net sales or inventory or cost of sales. The earnings process is complete for the exchanges. SFAS 48 para. 3,4.

Choice "b" is incorrect. Net sales should reflect estimated sales returns but not exchanges.

Choice "c" is incorrect. Net sales should be reduced by 10% as the allowance for returns, but should not be reduced for exchanges.


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Choice "d" is incorrect. Net sales should reflect estimated sales returns but not exchanges.

**CPA-04668 Type1 M/C A-D Corr Ans: B PM#31 F 4-01**

17. CPA-04668 Released 2005 Page 45

The following financial ratios and calculations were based on information from Kohl Co.'s financial statements for the current year:

*Accounts receivable turnover*
Ten times during the year

*Total assets turnover*
Two times during the year

*Average receivables during the year*
$200,000

What was Kohl's average total assets for the year?

a. $2,000,000
b. $1,000,000
c. $400,000
d. $200,000

**CPA-04668 Explanation**
Choice "b" is correct. By formula:

$$\textbf{Total asset turnover} = \frac{\text{Net sales}}{\text{Average total assets}}$$

$$\textbf{Average total assets} = \frac{\text{Net sales}}{\text{Total asset turnover}}$$

$$\textbf{1,000,000} = \frac{200{,}000 \times 10}{2}$$

**CPA-05226 Type1 M/C A-D Corr Ans: B PM#31 F 4-01**

18. CPA-05226 Released 2006 Page 6

At June 30, Almond Co.'s cash balance was $10,012 before adjustments, while its ending bank statement balance was $10,772. Check number 101 was issued June 2 in the amount of $95, but was erroneously recorded in Almond's general ledger balance as $59. The check was correctly listed in the bank statement at $95. The bank statement also included a credit memo for interest earned in the amount of $35, and a debit memo for monthly service charges in the amount of $50. What was Almond's adjusted cash balance at June 30?

a. $9,598
b. $9,961
c. $10,048
d. $10,462

**CPA-05226 Explanation**
Choice "b" is correct. Almond's adjusted cash balance is computed as follows:

Adjusted cash balance = Unadjusted cash balance +/- bank errors + credit memos - service charges

Adjusted cash balance = $10,012 - ($95 - $59) + $35 - $50 = $9,961


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Choice "a" is incorrect, per the above calculation.

Choice "c" is incorrect, per the above calculation. The difference between this answer and the correct answer is $87, and it was likely calculated as $10,012 + ($95 - $59).

Choice "d" is incorrect, per the above calculation.

**CPA-04684 Type1 M/C A-D Corr Ans: B PM#36 F 4-01**

19. CPA-04684 Released 2005 Page 4

Verona Co. had $500,000 in short-term liabilities at the end of the current year. Verona issued $400,000 of common stock subsequent to the end of the year, but before the financial statements were issued. The proceeds from the stock issue were intended to be used to pay the short-term debt. What amount should Verona report as a short-term liability on its balance sheet at the end of the current year?

a. $0
b. $100,000
c. $400,000
d. $500,000

**CPA-04684 Explanation**
Choice "b" is correct. Verona Co.'s financial statements have not been issued and the actual amount of the transaction is known. The $400,000 transaction should be included in Verona Co's financial statements and disclosed as a "subsequent event" resulting in a net short term liability amount of $100,000 for the current period. Disclosure is necessary for the financial statements not to be misleading.

The journal entry to record this transaction at the end of the current year would be:

| | | | |
|---|---|---|---|
| Dr. | Short-term liability | 400,000 | |
| Cr. | Long-term liability | | 400,000 |

The credit is to long-term liability rather than common stock because Footnote 2 of SFAS No 6, *Classification of Short-Term Obligations Expected to Be Refinanced,* states "if equity securities have been issued [after the balance sheet date but before the balance sheet is issued], the short-term obligation, although excluded from current liabilities, shall not be included in owners' equity."

Choices "a", "c", and "d" are incorrect, per the above.

**CPA-05418 Type1 M/C A-D Corr Ans: B PM#37 F 4-01**

20. CPA-05418 Released 2007 Page 4

On December 31, year 1, Taylor, Inc. signed a binding agreement with a bank for the refinancing of an existing note payable scheduled to mature in February, year 2. The terms of the refinancing included extending the maturity date of the note by three years. On January 15, year 2, the note was refinanced. How should Taylor report the note payable in its December 31, year 1, balance sheet?

a. A current liability.
b. A long-term liability.
c. A long-term note receivable.
d. A current note receivable.

**CPA-05418 Explanation**
Choice "b" is correct. A short-term obligation is excluded from current liabilities and included in noncurrent debt if the company intends to refinance it on a long-term basis and the intent is supported by either the existence of a noncancelable financing agreement or an actual refinancing prior to the issuance of the financial statements. As both of these conditions have been met, the note should be reported as a long-term liability on the December 31, year 1, balance sheet.


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Choice "a" is incorrect. This note should be classified as long-term, not current, on the December 31, year 1, balance sheet because the company signed a binding refinancing agreement with the bank on December 31.

Choices "c" and "d" are incorrect. As Taylor, Inc. has an obligation to repay funds to the bank, the note would not be classified as a receivable.

**CPA-05437 Type1 M/C A-D Corr Ans: B PM#38 F 4-01**

21. CPA-05437 Released 2007 Page 15

Red Co. had $3 million in accounts receivable recorded on its books. Red wanted to convert the $3 million in receivables to cash in a more timely manner than waiting the 45 days for payment as indicated on its invoices. Which of the following would alter the timing of Red's cash flows for the $3 million in receivables already recorded on its books?

a. Change the due date of the invoice.
b. Factor the receivables outstanding.
c. Discount the receivables outstanding.
d. Demand payment from customers before the due date.

**CPA-05437 Explanation**
Choice "b" is correct. Factoring receivables is the process by which a company converts its receivables to cash by assigning them to a factor, either with or without recourse.

Choice "a" is incorrect. The fact that the receivables have been recorded implies that the company has already sent invoices to its customers setting the payment due date. Generally, the due date cannot be changed after the invoice has been sent, nor is changing the due date likely to speed up the overall customer payment rate.

Choice "c" is incorrect. Discounting is the process of converting notes receivable, not accounts receivable, to cash.

Choice "d" is incorrect. Demanding payment from customers before the due date is likely to anger customers, but is not likely to speed up the overall customer payment rate. The invoice sets the payment terms of the receivable.

**CPA-05443 Type1 M/C A-D Corr Ans: B PM#39 F 4-01**

22. CPA-05443 Released 2007 Page 4

On December 31, 2002, Paxton Co. had a note payable due on August 1, 2003. On January 20, 2003, Paxton signed a financing agreement to borrow the balance of the note payable from a lending institution to refinance the note. The agreement does not expire within one year, and no violation of any provision in the financing agreement exists. On February 1, 2003, Paxton was informed by its financial advisor that the lender is not expected to be financially capable of honoring the agreement. Paxton's financial statements were issued on March 31, 2003. How should Paxton classify the note on its balance sheet at December 31, 2002?

a. As a current liability because the financing agreement was signed after the balance sheet date.
b. As a current liability because the lender is **not** expected to be financially capable of honoring the agreement.
c. As a long-term liability because the agreement does **not** expire within one year.
d. As a long-term liability because **no** violation of any provision in the financing agreement exists.

**CPA-05443 Explanation**
Choice "b" is correct. A short-term obligation may be excluded from current liabilities and included in non-current debt if the company has both the intent and the ability to refinance the debt on a long-term basis, as evidenced by an actual refinancing before the issuance of the financial statements, or by the existence of a noncancelable financing agreement from a lender with the financial resources to accomplish the


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refinancing. Because Paxton's lender does not have the financial resources to accomplish the refinancing, the note must be reported as a current liability on its December 31, 2002 balance sheet.

Choices "a", "c", and "d" are incorrect for the reason described above.

**CPA-05449 Type1 M/C A-D Corr Ans: B PM#40 F 4-01**

23. CPA-05449 Released 2007 Page 4

Bake Co.'s trial balance included the following at December 31, 2003:

| | |
|---|---|
| Accounts payable | $ 80,000 |
| Bonds payable, due 2004 | 300,000 |
| Discount on bonds payable | 15,000 |
| Deferred income tax liability | 25,000 |

The deferred income tax liability is not related to an asset for financial accounting purposes and is expected to reverse in 2004. What amount should be included in the current liability section of Bake's December 31, 2003, balance sheet?

a. $365,000
b. $390,000
c. $395,000
d. $420,000

**CPA-05449 Explanation**
Choice "b" is correct. All of the items listed will be included in the current liabilities section of Bake's December 31, 2003 balance sheet. Accounts payable are current liabilities. The bond payable, less the discount, is classified as a current liability because it will be paid in the next operating period. The deferred tax liability is classified as current because it is not related to an asset and will reverse during the next operating period. Total current liabilities are calculated as:

| | |
|---|---|
| Accounts payable | $ 80,000 |
| Bonds payable | 300,000 |
| Bond discount | (15,000) |
| Deferred tax liability | 25,000 |
| Total current liabilities | $390,000 |

Choice "a" is incorrect. The deferred tax liability should be included in total current liabilities because it is not related to an asset and is expected to reverse in the next operating period.

Choice "c" is incorrect. The deferred tax liability should be included in total current liabilities because it is not related to an asset and is expected to reverse in the next operating period. Additionally, the discount on the bond payable should be subtracted from, not added to, total current liabilities. Bond discounts always reduce the carrying amount of the associated bonds.

Choice "d" is incorrect. The discount on the bond payable should be subtracted from, not added to, total current liabilities. Bond discounts always reduce the carrying amount of the associated bonds.

**Inventories**

**CPA-00075 Type1 M/C A-D Corr Ans: A PM#1 F 4-02**

24. CPA-00075 FARE R03 #7 Page 25

During periods of inflation, a perpetual inventory system would result in the same dollar amount of ending inventory as a periodic inventory system under which of the following inventory valuation methods?

| | *FIFO* | *LIFO* |
|---|---|---|
| a. | Yes | No |
| b. | Yes | Yes |
| c. | No | Yes |


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d. No No

**CPA-00075 Explanation**
Choice "a" is correct. FIFO periodic and FIFO perpetual will always result in the same dollar valuation of ending inventory. LIFO or average, perpetual versus periodic will not.

Choices "b", "c", and "d" are incorrect. Each wrongly addresses either FIFO or LIFO.

**CPA-00080 Type1 M/C A-D Corr Ans: C PM#2 F 4-02**

25. CPA-00080 FARE R02 #1 Page 60

Bach Co. adopted the dollar-value LIFO inventory method as of January 1, 2000. A single inventory pool and an internally computed price index are used to compute Bach's LIFO inventory layers. Information about Bach's dollar value inventory follows:

| | *Inventory* | |
|---|---|---|
| | *At base* | *At current* |
| *Date* | *year cost* | *year cost* |
| 1/1/00 | $90,000 | $90,000 |
| 2000 layer | 20,000 | 30,000 |
| 2001 layer | 40,000 | 80,000 |

What was the price index used to compute Bach's 2001 dollar value LIFO inventory layer?

a. 1.09
b. 1.25
c. 1.33
d. 2.00

**CPA-00080 Explanation**
Choice "c" is correct. Calculated as follows:

| Date | Base Year Cost | Current Year Cost | LIFO Inventory Layer | |
|---|---|---|---|---|
| 1/1/200 | $90,000 | $90,000 | $90,000 | |
| 2000 Layer | 20,000 | 30,000 | 21,818 | **[Note 1]** |
| | 110,000 | 120,000 | 111,818 | EI at 12/31/00 |
| 2001 Layer | 40,000 | 80,000 | 53,333 | **[Note 2]** |
| | $150,000 | $200,000 | $165,151 | EI at 12/31/01 |

| | | | | |
|---|---|---|---|---|
| **[Note 1]** | Price Index | $120,000/$110,000 | = | 1.09 |
| | LIFO Layer | $20,000 x 1.09 | = | $21,818 |
| **[Note 2]** | Price Index | $200,000/$150,000 | = | **1.33 Answer "c"** |
| | LIFO Layer | $40,000 x 1.33 | = | $53,333 |

**CPA-00084 Type1 M/C A-D Corr Ans: B PM#3 F 4-02**

26. CPA-00084 FARE R02 #2 Page 29

Nest Co. recorded the following inventory information during the month of January:

| | *Units* | *Unit cost* | *Total cost* | *Units on hand* |
|---|---|---|---|---|
| Balance on 1/1 | 2,000 | $1 | $2,000 | 2,000 |
| Purchased on 1/8 | 1,200 | 3 | 3,600 | 3,200 |


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| | | | | |
|---|---|---|---|---|
| Sold on 1/23 | 1,800 | | | 1,400 |
| Purchased on 1/28 | 800 | 5 | 4,000 | 2,200 |

Nest uses the LIFO method to cost inventory. What amount should Nest report as inventory on January 31 under each of the following methods of recording inventory?

| | *Perpetual* | *Periodic* |
|---|---|---|
| a. | $2,600 | $5,400 |
| b. | $5,400 | $2,600 |
| c. | $2,600 | $2,600 |
| d. | $5,400 | $5,400 |

**CPA-00084 Explanation**
Choice "b" is correct.

LIFO Perpetual

| | *Units* | *Unit cost* | *Total cost* | *Inventory balance* |
|---|---|---|---|---|
| Balance on 1/1 | 2,000 | $1 | $2,000 | $2,000 |
| Purchased on 1/8 | 1,200 | $3 | 3,600 | 5,600 |
| Sold on 1/23 | (1,200) | $3 | (3,600) | |
| | (600) | $1 | (600) | |
| Subtotal | 1,400 | $1 | 1,400 | 1,400 |
| Purchased on 1/28 | 800 | $5 | 4,000 | $5,400 |
| | 2,200 | | | |

LIFO Periodic

Ending inventory in units = 2,200 (from above) x oldest cost = LIFO valuation

| | *Units* | *Unit cost* | *$* |
|---|---|---|---|
| 1/1 Beginning bal | 2,000 | $1 | $2,000 |
| 1/8 Purchase | 200 | 3 | 600 |
| | | | $2,600 |

**CPA-00087 Type1 M/C A-D Corr Ans: B PM#4 F 4-02**

27. CPA-00087 FARE R99 #11 Page 25

The following information pertained to Azur Co. for the year:

| | |
|---|---|
| Purchases | $102,800 |
| Purchase discounts | 10,280 |
| Freight-in | 15,420 |
| Freight-out | 5,140 |
| Beginning inventory | 30,840 |
| Ending inventory | 20,560 |

What amount should Azur report as cost of goods sold for the year?

a. $102,800
b. $118,220
c. $123,360
d. $128,500

**CPA-00087 Explanation**
Choice "b" is correct. Azur Co. should report $118,220 as cost of goods sold for the year.

| | |
|---|---|
| Beginning inventory | $ 30,840 |
| Purchases | 102,800 |


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| | |
|---|---|
| Purchase discounts | (10,280) |
| Freight-in | 15,420 |
| Freight-out | -- **[1]** |
| Ending inventory | (20,560) |
| Cost of goods sold | **$118,220** |

**[1]** Freight-out is a selling (i.e., a period) expense, not an item that is capitalizable as inventory.

Choice "a" is incorrect, as freight-in is capitalized as part of inventory (i.e., it is part of the cost of getting the inventory ready for its intended use).

Choice "c" is incorrect, as purchase discounts are a reduction to gross purchases and freight-in should be capitalized as part of inventory.

Choice "d" is incorrect, as purchase discounts are a reduction to gross purchases.

**CPA-00089 Type1 M/C A-D Corr Ans: D PM#5 F 4-02**

28. CPA-00089 FARE R97 #1 Page 24

The original cost of an inventory item is below the net realizable value and above the net realizable value less a normal profit margin. The inventory item's replacement cost is below the net realizable value less a normal profit margin. Under the lower of cost or market method, the inventory item should be valued at:

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

**CPA-00089 Explanation**
Choice "d" is correct, net realizable value less normal profit margin.

Approach: List costs in descending sequence from highest to lowest and assign arbitrary dollar values in descending sequence. Then use "rule of thumb."

Lower of cost or market (take lower of two)

Rule of thumb:

| | | |
|---|---|---|
| Market (take middle of three) | | |
| Net realizable value (ceiling) | $.90 | |
| Net realizable value less | | |
| Normal profit margin (floor) | .80 | .80 |
| Replacement cost | .70 | |
| Original cost | | .85 |
| Lower of cost or market (take lower of two) | | |
| Which is net realizable value less normal profit margin | | $.80 |

**CPA-00095 Type1 M/C A-D Corr Ans: B PM#7 F 4-02**

29. CPA-00095 FARE May 95 #11 Page 60

Walt Co. adopted the dollar-value LIFO inventory method as of January 1, 1994, when its inventory was valued at $500,000. Walt's entire inventory constitutes a single pool. Using a relevant price index of 1.10, Walt determined that its December 31, 1994, inventory was $577,500 at current year cost, and $525,000 at base year cost. What was Walt's dollar-value LIFO inventory at December 31, 1994?


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a. $525,000
b. $527,500
c. $552,500
d. $577,500

**CPA-00095 Explanation**
Choice "b" is correct. At base year costs, an additional layer of $25,000 ($525,000 base year cost at 12/31/94 less $500,000 base year cost at 1/1/94) was added. This layer was acquired for $27,500 [$25,000 × 1.10]. Dollar value LIFO inventory at year end equals $527,500 [$500,000 beginning inventory plus $27,500 additional layer].

Choice "a" is incorrect. An adjustment must be made for the price of the inventory layer acquired this year.

Choice "c" is incorrect. The relevant price index should be used to calculate the layer.

Choice "d" is incorrect. An adjustment should be made to the ending inventory.

**CPA-00111 Type1 M/C A-D Corr Ans: B PM#8 F 4-02**

30. CPA-00111 FARE May 95 #33 Page 21

During 1994, Kam Co. began offering its goods to selected retailers on a consignment basis. The following information was derived from Kam's 1994 accounting records:

| | |
|---|---|
| Beginning inventory | $122,000 |
| Purchases | 540,000 |
| Freight in | 10,000 |
| Transportation to consignees | 5,000 |
| Freight out | 35,000 |
| Ending inventory-held by Kam | 145,000 |
| Ending inventory-held by consignees | 20,000 |

In its 1994 income statement, what amount should Kam report as cost of goods sold?

a. $507,000
b. $512,000
c. $527,000
d. $547,000

**CPA-00111 Explanation**
**Rule:** Consignor must include consigned goods (in the hands of the consignee) in his own inventory, at his cost plus warehousing costs of consignor before goods are transferred to consignee plus shipping costs to consignee.

Choice "b" is correct, $512,000 cost of goods sold in 1994 income statement.

| | |
|---|---|
| Beginning inventory | $ 122,000 |
| Add: | |
| Purchases | 540,000 |
| Freight in | 10,000 |
| Transportation to consignees | 5,000 |
| Cost of goods available for sale | 677,000 |
| Less: ending inventory | |
| Held by Kam | (145,000) |
| Held by consignees | (20,000) |
| Cost of goods sold | $ 512,000 |

**CPA-00113 Type1 M/C A-D Corr Ans: B PM#10 F 4-02**


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31. CPA-00113 FARE Nov 94 #14 Page 24

Which of the following statements are correct when a company applying the lower of cost or market method reports its inventory at replacement cost?

I. The original cost is less than replacement cost.
II. The net realizable value is greater than replacement cost.

a. I only.
b. II only.
c. Both I and II.
d. Neither I nor II.

**CPA-00113 Explanation**
Choice "b" is correct. Statement I is false. If the replacement cost is the market value and inventory is reported at replacement cost, then the replacement cost is lower than the original cost. Statement II is true. The replacement cost is designated as market value if it is less than the net realizable value and greater than the net realizable value minus disposal costs. Since the inventory is reported at replacement cost, then replacement cost must be the market value (and lower than the original cost) and thus less than the net realizable value.

**CPA-00115 Type1 M/C A-D Corr Ans: B PM#12 F 4-02**

32. CPA-00115 Th Nov 93 #3 Page 60

Estimates of price-level changes for specific inventories are required for which of the following inventory methods?

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

**CPA-00115 Explanation**
Choice "b" is correct. The dollar-value LIFO method adjusts inventory retail prices and ending inventory cost for price-level changes.

Choice "a" is incorrect. The conventional retail method does not use price-level changes.

Choice "c" is incorrect. The weighted average cost method does not use price-level changes.

Choice "d" is incorrect. The average retail cost method does not use price-level changes.

**CPA-00116 Type1 M/C A-D Corr Ans: D PM#13 F 4-02**

33. CPA-00116 Th Nov 93 #4 Page 23

The lower of cost or market rule for inventories may be applied to total inventory, to groups of similar items, or to each item. Which application generally results in the lowest inventory amount?

a. All applications result in the same amount.
b. Total inventory.
c. Groups of similar items.
d. Separately to each item.

**CPA-00116 Explanation**
Choice "d" is correct. Applying the lower of cost or market rule (item by item) separately to "each item" results in the lowest inventory amount.

Choice "a" is incorrect. The three different applications generally result in different amounts.

Choice "b" is incorrect. Extending to total inventory generally results highest ending inventory.


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Choice "c" is incorrect. Extending to groups of similar items generally results in a value in between "b" and "d".

**CPA-00117 Type1 M/C A-D Corr Ans: D PM#14 F 4-02**

34. CPA-00117 PI Nov 93 #19 Page 29

Drew Co. uses the average cost inventory method for internal reporting purposes and LIFO for financial statement and income tax reporting. At December 31, 1992, the inventory was $375,000 using average cost and $320,000 using LIFO. The unadjusted credit balance in the LIFO Reserve account on December 31, 1992, was $35,000. What adjusting entry should Drew record to adjust from average cost to LIFO at December 31, 1992?

| | | *Debit* | *Credit* |
|---|---|---|---|
| a. | Cost of Goods Sold | $55,000 | |
| | Inventory | | $55,000 |
| b. | Cost of Goods Sold | $55,000 | |
| | LIFO Reserve | | $55,000 |
| c. | Cost of Goods Sold | $20,000 | |
| | Inventory | | $20,000 |
| d. | Cost of Goods Sold | $20,000 | |
| | LIFO Reserve | | $20,000 |

**CPA-00117 Explanation**

Choice "d" is correct.

LIFO reserve is the difference between inventory on the LIFO method versus any other cost method:

| | | |
|---|---|---|
| Inventory using avg. cost | | $375,000 |
| Inventory using LIFO | | 320,000 |
| LIFO reserve - required balance | | 55,000 |
| Less: unadjusted bal in LIFO reserve | | 35,000 |
| Adjustment required | | $ 20,000 |

| | | |
|---|---|---|
| Journal entry | | |
| Cost of goods sold | debit | 20,000 |
| LIFO reserve | credit | 20,000 |

**CPA-00118 Type1 M/C A-D Corr Ans: C PM#15 F 4-02**

35. CPA-00118 PI Nov 93 #20 Page 60

Brock Co. adopted the dollar-value LIFO inventory method as of January 1, 1991. A single inventory pool and an internally computed price index are used to compute Brock's LIFO inventory layers. Information about Brock's dollar value inventory follows:

| | *Inventory* | | |
|---|---|---|---|
| | *at base* | *at current* | *at dollar* |
| *Date* | *year cost* | *year cost* | *value LIFO* |
| 1/1/91 | $40,000 | $40,000 | $40,000 |
| 1991 layer | 5,000 | 14,000 | 6,000 |
| 12/31/91 | 45,000 | 54,000 | 46,000 |
| 1992 layer | 15,000 | 26,000 | ? |
| 12/31/92 | $60,000 | $80,000 | ? |

What was Brock's dollar value LIFO inventory at December 31, 1992?

a. $80,000
b. $74,000
c. $66,000
d. $60,000


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**CPA-00118 Explanation**
Choice "c" is correct. Dollar-value LIFO ending inventory is the dollar value base layer plus the current year base layer times the conversion factor.

| | |
|---|---|
| 12/31/91 at dollar value LIFO | $46,000 |
| Conversion factor (80 ÷ 60) × $15,000 | 20,000 |
| Dollar value LIFO inventory | $66,000 |

**CPA-00119 Type1 M/C A-D Corr Ans: C PM#16 F 4-02**

36. CPA-00119 PI Nov 93 #21 Page 24

Based on a physical inventory taken on December 31, 1992, Chewy Co. determined its chocolate inventory on a FIFO basis at $26,000 with a replacement cost of $20,000. Chewy estimated that, after further processing costs of $12,000, the chocolate could be sold as finished candy bars for $40,000. Chewy's normal profit margin is 10% of sales. Under the lower of cost or market rule, what amount should Chewy report as chocolate inventory in its December 31, 1992, balance sheet?

a. $28,000
b. $26,000
c. $24,000
d. $20,000

**CPA-00119 Explanation**
Choice "c" is correct. Under lower of cost or market the following need to be determined:

| | |
|---|---|
| Ceiling, net realizable value ($40,000 – 12,000) | $28,000 |
| Replacement cost | 20,000 |
| Floor, NRV less profit ($28,000 – 10% of $40,000) | 24,000 |
| Market (Floor) | 24,000 |
| Cost (FIFO) | 26,000 |
| Lower of cost or market | $24,000 |

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Choice "a" is incorrect. Cost is only $26,000, so $28,000 cannot be correct.

Choice "b" is incorrect. Market is less than cost. Market is replacement cost, but the ceiling and floor limit this amount.

Choice "d" is incorrect. Replacement cost cannot be less than the floor (NRV less profit).

**CPA-00120 Type1 M/C A-D Corr Ans: B PM#17 F 4-02**

37. CPA-00120 PI May 93 #18 Page 58

During January 1993, Metro Co., which maintains a perpetual inventory system, recorded the following information pertaining to its inventory:

| | *Units* | *Unit Cost* | *Total cost* | *Units on hand* |
|---|---|---|---|---|
| Balance on 1/1/93 | 1,000 | $1 | $1,000 | 1,000 |
| Purchased on 1/7/93 | 600 | 3 | 1,800 | 1,600 |
| Sold on 1/20/93 | 900 | | | 700 |
| Purchased on 1/25/93 | 400 | 5 | 2,000 | 1,100 |

Under the moving-average method, what amount should Metro report as inventory at January 31, 1993?

a. $2,640


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b. $3,225
c. $3,300
d. $3,900

**CPA-00120 Explanation**
Under the moving-average method, a new weighted average cost is computed after each purchase, and issues are priced at the latest weighted-average cost.

| | *Units* | *Unit Cost* | *Total Cost* |
|---|---|---|---|
| Balance 1/1/93 | 1,000 | $1.00 | $1,000 |
| Purchased 1/7/93 | 600 | 3.00 | 1,800 |
| Balance 1/7/93 | 1,600 | 1.75 | 2,800 |
| Sold 1/20/93 | (900) | 1.75 | (1,575) |
| Balance 1/20/93 | 700 | 1.75 | 1,225 |
| Purchased 1/25/93 | 400 | 5.00 | 2,000 |
| Balance 1/31/93 | 1,100 | 2.93 | 3,225 |

In this example, the next units sold would be priced at $2.93, the new weighted-average cost.

Choice "b" is correct, $3,225 inventory cost at January 31, 1993 under the moving-average method.

**CPA-00121 Type1 M/C A-D Corr Ans: B PM#18 F 4-02**

38. CPA-00121 PI May 93 #19 Page 29

During January 1993, Metro Co., which maintains a perpetual inventory system, recorded the following information pertaining to its inventory:

| | *Units* | *Unit Cost* | *Total cost* | *Units on hand* |
|---|---|---|---|---|
| Balance on 1/1/93 | 1,000 | $1 | $1,000 | 1,000 |
| Purchased on 1/7/93 | 600 | 3 | 1,800 | 1,600 |
| Sold on 1/20/93 | 900 | | | 700 |
| Purchased on 1/25/93 | 400 | 5 | 2,000 | 1,100 |

Under the LIFO method, what amount should Metro report as inventory at January 31, 1993?

a. $1,300
b. $2,700
c. $3,900
d. $4,100

**CPA-00121 Explanation**

| | *Units* | *Unit Cost* | *Total Cost* |
|---|---|---|---|
| Balance 1/1/93 | 1,000 | $1.00 | $1,000 |
| Purchased 1/7/93 | 600 | 3.00 | 1,800 |
| Sold 1/20/93 | (600) | 3.00 | (1,800) |
| Sold 1/31/93 | (300) | 1.00 | (300) |
| Purchased 1/25/93 | 400 | 5.00 | 2,000 |
| | 1,100 | | 2,700 |

Choice "b" is correct, $2,700 LIFO inventory cost at January 31, 1993.

**CPA-00130 Type1 M/C A-D Corr Ans: D PM#19 F 4-02**

39. CPA-00130 PI May 93 #20 Page 20


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The following items were included in Opal Co.'s inventory account at December 31, 1992:

| | |
|---|---|
| Merchandise out on consignment, at sales price, including 40% markup on selling price | $40,000 |
| Goods purchased, in transit, shipped F.O.B. shipping point | 36,000 |
| Goods held on consignment by Opal | 27,000 |

By what amount should Opal's inventory account at December 31, 1992, be reduced?

a. $103,000
b. $67,000
c. $51,000
d. $43,000

**CPA-00130 Explanation**
Choice "d" is correct. The 40% markup and the goods held on consignment (not belonging to Opal) must be eliminated to record inventory at cost. The $36,000 of goods shipped FOB shipping point should be included in inventory (title has passed to Opal). 40% × $40,000 = $16,000 plus $27,000 = $43,000.

Choice "a" is incorrect. Only the 40% markup on goods out on consignment must be eliminated to record inventory at cost. The $36,000 should be included in inventory (title has passed to Opal).

Choice "b" is incorrect. Only the 40% markup on goods out on consignment must be eliminated to record inventory at cost.

Choice "c" is incorrect. The 40% markup, not the 60% cost on goods out on consignment, must be eliminated.

**CPA-00131 Type1 M/C A-D Corr Ans: C PM#20 F 4-02**

40. CPA-00131PI May 93 #21 Page 24

Moss Co. has determined its December 31, 1992, inventory on a FIFO basis to be $400,000. Information pertaining to that inventory follows:

| | |
|---|---|
| Estimated selling price | $408,000 |
| Estimated cost of disposal | 20,000 |
| Normal profit margin | 60,000 |
| Current replacement cost | 360,000 |

Moss records losses that result from applying the lower of cost or market rule. At December 31, 1992, what should be the net carrying value of Moss' inventory?

a. $400,000
b. $388,000
c. $360,000
d. $328,000

**CPA-00131 Explanation**
Choice "c" is correct, $360,000 lower of cost or market inventory at Dec. 31, 1992.

Per rule of thumb: Compare "floor" with "ceiling" and "replacement cost" (use middle amount) compare that middle amount with "cost." Use lower of the two.

| | | |
|---|---|---|
| Cost (FIFO) | | $ 400,000 |
| Market: (take middle of three): | | |
| Ceiling: Est. Selling Price | $408,000 | |
| Less: Cost of Disposal | (20,000) | |
| Floor: Net Selling Price (ceiling) | 388,000 | |
| Less: Normal profit margin | (60,000) | |
| | 328,000 | |
| Replacement Cost | | 360,000 |


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| | |
|---|---|
| Loss-Market less than cost | $ 40,000 |

**CPA-00133 Type1 M/C A-D Corr Ans: C PM#22 F 4-02**

41. CPA-00133 PI May 93 #48 Page 23

The following information pertains to Deal Corp.'s 1992 cost of goods sold:

| | |
|---|---|
| Inventory, 12/31/91 | $ 90,000 |
| 1992 purchases | 124,000 |
| 1992 write-off of obsolete inventory | 34,000 |
| Inventory, 12/31/92 | 30,000 |

The inventory written off became obsolete due to an unexpected and unusual technological advance by a competitor. In its 1992 income statement, what amount should Deal report as cost of goods sold?

a. $218,000
b. $184,000
c. $150,000
d. $124,000

**CPA-00133 Explanation**
Choice "c" is correct. The cost of goods sold is calculated as follows:

| | |
|---|---|
| Inventory, 12/31/91 | $ 90,000 |
| 1992 purchases | 124,000 |
| Goods available | 214,000 |
| Obsolete inventory | (34,000) |
| Inventory, 12/31/92 | (30,000) |
| Cost of goods sold | $150,000 |

The write-off of obsolete inventory is treated as an operating loss and not as cost of goods sold.

Choice "a" is incorrect. The $34,000 write off of inventory is subtracted, not added to inventory.

Choice "b" is incorrect. Obsolete inventory is not included in cost of goods sold. It is deducted from inventory and included in unusual gains or losses on the income statement. Total reduction in inventory is $184,000, but $34,000 is not included in cost of goods sold.

Choice "d" is incorrect. Purchases reflect costs of goods sold on a cash basis, not on an accrual basis.

**CPA-04667 Type1 M/C A-D Corr Ans: B PM#23 F 4-02**

42. CPA-04667 Released 2005 Page 25

Which of the following statements regarding inventory accounting systems is true?

a. A disadvantage of the perpetual inventory system is that the inventory dollar amounts used for interim reporting purposes are estimated amounts.
b. A disadvantage of the periodic inventory system is that the cost of good sold amount used for financial reporting purposes includes both the cost of inventory sold and inventory shortages.
c. An advantage of the perpetual inventory system is that the record keeping required to maintain the system is relatively simple.
d. An advantage of the periodic inventory system is that it provides a continuous record of the inventory balance.

**CPA-04667 Explanation**
Choice "b" is correct. With a periodic inventory system, the quantity of inventory is determined only by physical count, usually at least annually. Therefore, units of inventory and the associated costs are counted and valued at the end of the accounting period and the cost of inventory sold and inventory shortages cannot be easily distinguished. With a perpetual inventory system, the inventory record for each item of inventory is updated for each purchase and each sale as they occur. The actual cost of


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goods sold is determined and recorded with each sale. At year end, inventory per the perpetual records can be compared to actual inventory per a physical count and inventory shortages can be identified.

Choices "a", "c", and "d" are incorrect, per above.

**CPA-04690 Type1 M/C A-D Corr Ans: B PM#24 F 4-02**

43. CPA-04690 Released 2005 Page 25

The following information was obtained from Smith Co.:

| | |
|---|---|
| Sales | $275,000 |
| Beginning inventory | 30,000 |
| Ending inventory | 18,000 |

Smith's gross margin is 20%. What amount represents Smith purchases?

a. $202,000
b. $208,000
c. $220,000
d. $232,000

**CPA-04690 Explanation**
Choice "b" is correct. Using the BASE account analysis format, purchases can be squeezed out as follows:

| | |
|---|---|
| Beginning Inventory (given) | 30,000 |
| ***Purchases (squeezed)*** | ***208,000*** |
| Goods available for sale (added up) ↑ | 238,000 |
| COGS (275,000 x 1-.20) | (220,000) |
| Ending Inventory (given) | 18,000 |

**CPA-04774 Type1 M/C A-D Corr Ans: B PM#25 F 4-02**

44. CPA-04774 Released 2005 Page 21

Garnett Co. shipped inventory on consignment to Hart Co. that originally cost $50,000. Hart paid $1,200 for advertising that was reimbursable from Garnett. At the end of the year, 40% of the inventory was sold for $32,000. The agreement stated that a commission of 10% will be provided to Hart for all sales. What amount should Garnett report as net income for the year?

a. $0
b. $7,600
c. $10,800
d. $12,000

**CPA-04774 Explanation**
Choice "b" is correct. In consignment sales, revenue is recognized when the goods are sold to a third party. Until the sale, the goods remain in the consignor's inventory. Hart sold $32,000 worth of the consigned inventory and all calculations will be based on that amount.

| | | |
|---|---|---|
| Sales | | $ 32,000 |
| Cost of Sales (40% of 50,000) | | (20,000) |
| Gross Profit | | 12,000 |
| Selling Expense | | |
| Advertising | 1,200 | |
| Commission | 3,200 | (4,400) |
| NET INCOME | | 7,600 |


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**CPA-05192 Type1 M/C A-D Corr Ans: A PM#26 F 4-02**

45. CPA-05192 Released 2006 Page 25

A flash flood swept through Hat, Inc.'s warehouse on May 1. After the flood, Hat's accounting records showed the following:

| | |
|---|---|
| Inventory, January 1 | $ 35,000 |
| Purchases, January 1 through May 1 | 200,000 |
| Sales, January 1 through May 1 | 250,000 |
| Inventory not damaged by flood | 30,000 |
| Gross profit percentage on sales | 40% |

What amount of inventory was lost in the flood?

a. $55,000
b. $85,000
c. $120,000
d. $150,000

**CPA-05192 Explanation**
Choice "a" is correct. The amount of inventory lost in the flood is calculated as follows:

Inventory = Beg inventory + Purchases - Sales reduced to a cost basis

Inventory = $35,000 + $200,000 - ($250,000 x (1-.40)) = $235,000 - $150,000 = $85,000

Inventory lost in the flood = $85,000 - $30,000 = $55,000

Choice "b" is incorrect. This answer is the total inventory, **not** the amount of inventory lost in the flood.

Choice "c" is incorrect. This answer is the sales reduced to a cost basis minus the inventory not lost in the flood, not the amount of inventory lost in the flood.

Choice "d" is incorrect. This answer is the sales reduced to a cost basis, **not** the amount of inventory lost in the flood.

**CPA-05208 Type1 M/C A-D Corr Ans: B PM#27 F 4-02**

46. CPA-05208 Released 2006 Page 21

Nomar Co.shipped inventory on consignment to Seabright Co. that cost $20,000. Seabright paid $500 for advertising that was reimbursable from Nomar. At the end of the year, 70% of the inventory was sold for $30,000. The agreement states that a commission of 20% will be provided to Seabright for all sales. What amount of net inventory on consignment remains on the balance sheet for the first year for Nomar?

a. $0
b. $6,000
c. $6,500
d. $20,000

**CPA-05208 Explanation**
Choice "b" is correct. The cost of consigned inventory includes the cost of the inventory and any costs needed to get the inventory in place for sale. In this question, that is $20,000. Because the $500 is paid for advertising, and not for something like freight, it is not included in the cost of the inventory. At the end of the year, 30% of the inventory will remain unsold. 30% of the original inventory (30% x $20,000 = $6,000) remains on the balance sheet.

Choice "a" is incorrect. Consigned inventory remains on the balance sheet of the consignor (Nomar).

Choice "c" is incorrect. This answer includes the $500 advertising in the cost of the inventory. The cost of advertising should not be included.

Choice "d" is incorrect. This answer includes the full original amount of the inventory. Some of it has been sold.


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**CPA-05227 Type1 M/C A-D Corr Ans: B PM#28 F 4-02**

47. CPA-05227 Released 2006 Page 28

Trans Co. uses a periodic inventory system. The following are inventory transactions for the month of January:

| | | |
|---|---|---|
| 1/1 | Beginning inventory | 10,000 units at $3 |
| 1/5 | Purchase | 5,000 units at $4 |
| 1/15 | Purchase | 5,000 units at $5 |
| 1/20 | Sales at $10 per unit | 10,000 units |

Trans uses the average pricing method to determine the value of its inventory. What amount should Trans report as cost of goods sold on its income statement for the month of January?

a. $30,000
b. $37,500
c. $40,000
d. $100,000

**CPA-05227 Explanation**
Choice "b" is correct. Regardless of the type of inventory costing method, the first step would be to calculate the number of units in the ending inventory and/or cost of goods sold. In this question, there are 20,000 units available for sale and thus 10,000 units (20,000 total purchases - 10,000 ending inventory) in cost of goods sold. The (weighted) average purchase price of the units available for sale is ((10,000 x $3) + (5,000 x $4) + (5,000 x $5) / (10,000 + 5,000 + 5,000) = $3.75). Thus the cost of goods sold is 10,000 x $3.75 = $37,500.

Choice "a" is incorrect. In a (weighted) average pricing inventory costing system, the cost of goods sold would not be at the price of the beginning inventory, or $3 in this question, even though there were 10,000 units sold and 10,000 units in the beginning inventory.

Choice "c" is incorrect. In a (weighted) average pricing inventory costing system, the cost of goods sold would not be costed at the price of the first purchase, or $4 in this question.

Choice "d" is incorrect. In a (weighted) average pricing inventory costing system, the cost of goods sold would not be costed at the selling price of the goods, or $10 in this question.

Note that this question does not use good terminology. The question asks about the "value" of the inventory. It should ask about the "cost" of the inventory. The value of the inventory is whatever the inventory could be sold for in the market.

**CPA-05291 Type1 M/C A-D Corr Ans: D PM#29 F 4-02**

48. CPA-05291 Released 2006 Page 28

Which of the following is correct concerning the LIFO method (as compared to the FIFO method) in a period when prices are rising?

a. Deferred tax and cost of goods sold are lower.
b. Current tax liability and ending inventory are higher.
c. Current tax liability is lower and ending inventory is higher.
d. Current tax liability is lower and cost of goods sold is higher.

**CPA-05291 Explanation**
Choice "d" is correct. Under LIFO, the last costs inventoried are the first costs transferred to cost of goods sold. Ending inventory, thus, includes the oldest costs. The ending balance of inventory will typically not approximate replacement cost, as it will under FIFO. Further, LIFO generally does not reflect the actual flow of goods in a company because most companies sell their oldest goods first to prevent holding old or obsolete items. This question asks about current and deferred income tax expenses and about current tax liability. Therefore, it is focusing on the effects of LIFO vs. FIFO on the income


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statement for tax expense. It further asks about the impact on the balance sheet. As discussed above, LIFO tends to match current revenues with current costs because (in a period of rising prices, as in this case) the cost of goods sold under LIFO tends to be higher than the cost of goods sold under FIFO. The ending inventory under LIFO, however, tends to be lower than the ending inventory under FIFO, as the oldest goods are the ones still in inventory under LIFO.

So, cost of goods sold is higher under LIFO than under FIFO in a period of rising prices. If the expense is higher on the tax return, then, the related income tax expense is lower. Therefore, the current tax liability would be lower.

Choice "a" is incorrect. As discussed above, LIFO tends to match current revenues with current costs because (in a period of rising prices, as in this case) the cost of goods sold under LIFO tends to be higher than the cost of goods sold under FIFO, not lower. Also, the effect on deferred tax really depends on if ending inventory is higher or lower than beginning inventory, so we don't have enough information to evaluate deferred tax liability, asset, or expense.

Choice "b" is incorrect. Cost of goods sold is higher under LIFO than under FIFO in a period of rising prices. If the expense is higher on the tax return, then, the related income tax expense is lower. Therefore, the current tax liability would be lower, not higher. Further, as discussed above, under LIFO (in a period of rising prices), ending inventory tends to be lower than under FIFO, not higher.

Choice "c" is incorrect. Cost of goods sold is higher under LIFO than under FIFO in a period of rising prices. If the expense is higher on the tax return, then, the related income tax expense is lower. Therefore, the current tax liability would be lower, as the option indicates. However, as discussed above, under LIFO (in a period of rising prices), ending inventory tends to be lower than under FIFO, not higher.

**CPA-05415 Type1 M/C A-D Corr Ans: B PM#30 F 4-02**

49. CPA-05415 Released 2007 Page 25

A material overstatement in ending inventory was discovered after the year-end financial statements of a company were issued to the public. What effect did this error have on the year-end financial statements?

| | *Current assets* | *Gross profit* |
|---|---|---|
| a. | Understated | Overstated |
| b. | Overstated | Overstated |
| c. | Understated | Understated |
| d. | Overstated | Understated |

**CPA-05415 Explanation**
Choice "b" is correct. Because inventory is a component of current assets, an overstatement of ending inventory will cause current assets to be overstated

The income statement effects of an inventory overstatement or understatement can best be seen by analyzing the cost of goods sold formula:

Beginning inventory
+ Purchases
Cost of goods available for sale
- Ending inventory
Cost of goods sold

Based on this formula, an overstatement of ending inventory will cause an understatement of cost of goods sold, which will result in an overstatement of gross profit (Sales - Cost of goods sold = Gross profit).

Choices "a", "c", and "d" are incorrect, per the above explanation.

**CPA-05441 Type1 M/C A-D Corr Ans: B PM#31 F 4-02**

50. CPA-05441 Released 2007 Page 23


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Loft Co. reviewed its inventory values for proper pricing at year end. The following summarizes two inventory items examined for the lower of cost or market:

| | *Inventory item #1* | *Inventory item #2* |
|---|---|---|
| Original cost | $210,000 | $400,000 |
| Replacement cost | 150,000 | 370,000 |
| Net realizable value | 240,000 | 410,000 |
| Less profit margin | 208,000 | 405,000 |

What amount should Loft include in inventory at year end, if it uses the total of the inventory to apply the lower of cost or market?

a. $520,000
b. $610,000
c. $613,000
d. $650,000

**CPA-05441 Explanation**
Choice "b" is correct. If total inventory is used to apply the lower of cost or market rule, then total cost and market are calculated as follows:

| | |
|---|---|
| Original cost | $610,000 |
| Replacement cost | 520,000 |
| Net realizable value | 650,000 |
| Less profit margin | 613,000 |

Market is the middle value of the replacement cost, net realizable value (ceiling) and net realizable value less profit margin (floor). In this problem, the market value is the market floor of $613,000. Because market is greater than the total cost of $610,000, the inventory will be reported at cost.

Choice "a" is incorrect. This is the replacement cost, which is not used as the market value of the inventory because it is not the middle value of the replacement cost, net realizable value (ceiling) and net realizable value less profit margin (floor).

Choice "c" is incorrect. Because the $613,000 market value is greater than the inventory cost of $610,000, the inventory will not be reported at market.

Choice "d" is incorrect. This is the market ceiling, which is not used as the market value of this inventory because it is not the middle value of the replacement cost, net realizable value (ceiling) and net realizable value less profit margin (floor). Additionally, this amount is greater than cost and inventory must be recorded at the lower of cost or market.

**Fixed Assets**

**CPA-00135 Type1 M/C A-D Corr Ans: A PM#2 F 4-03**

51. CPA-00135 FARE May 95 #12 Page 34

Theoretically, which of the following costs incurred in connection with a machine purchased for use in a company's manufacturing operations would be capitalized?

| | *Insurance on machine while in transit* | *Testing and preparation of machine for use* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |

**CPA-00135 Explanation**
Choice "a" is correct. Any cost incurred to acquire and make ready a plant asset is capitalized.


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**CPA-00136 Type1 M/C A-D Corr Ans: B PM#3 F 4-03**

52. CPA-00136 FARE May 94 #17 Page 37

Cole Co. began constructing a building for its own use in January 1993. During 1993, Cole incurred interest of $50,000 on specific construction debt, and $20,000 on other borrowings. Interest computed on the weighted-average amount of accumulated expenditures for the building during 1993 was $40,000. What amount of interest cost should Cole capitalize?

a. $20,000
b. $40,000
c. $50,000
d. $70,000

**CPA-00136 Explanation**
Choice "b" is correct. Total interest incurred equals the interest on the specific construction debt ($50,000) plus interest on other borrowing ($20,000) for a total of $70,000. Avoidable interest equals the interest on the weighted-average amount of accumulated expenditures ($40,000). Capitalized interest equals the smaller of the total interest incurred or the avoidable interest. Thus, capitalized interest equals $40,000. SFAS 34 para. 12-15

Choice "a" is incorrect. Interest on other borrowing is capitalized only if total interest incurred is less than avoidable interest. SFAS 34 para. 15

Choice "c" is incorrect. Although interest on specific construction debt equals $50,000, only avoidable interest can be capitalized. SFAS 34 para. 12

Choice "d" is incorrect. Total interest incurred will be capitalized if it is less than the avoidable interest. SFAS 34 para. 15

**CPA-00137 Type1 M/C A-D Corr Ans: A PM#4 F 4-03**

53. CPA-00137 PI Nov 93 #22 Page 34

Merry Co. purchased a machine costing $125,000 for its manufacturing operations and paid shipping costs of $20,000. Merry spent an additional $10,000 testing and preparing the machine for use. What amount should Merry record as the cost of the machine?

a. $155,000
b. $145,000
c. $135,000
d. $125,000

**CPA-00137 Explanation**
Choice "a" is correct. The cost of the machine should include all costs that are reasonable and necessary to get the asset in the condition or location for its intended use.

| | |
|---|---|
| Cost | $ 125,000 |
| Shipping | 20,000 |
| Testing | 10,000 |
| Total cost of machine | $155,000 |

**CPA-00138 Type1 M/C A-D Corr Ans: C PM#5 F 4-03**

54. CPA-00138 Th May 93 #26 Page 34

A building suffered uninsured fire damage. The damaged portion of the building was refurbished with higher quality materials. The cost and related accumulated depreciation of the damaged portion are identifiable. To account for these events, the owner should:


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a. Reduce accumulated depreciation equal to the cost of refurbishing.
b. Record a loss in the current period equal to the sum of the cost of refurbishing and the carrying amount of the damaged portion of the building.
c. Capitalize the cost of refurbishing and record a loss in the current period equal to the carrying amount of the damaged portion of the building.
d. Capitalize the cost of refurbishing by adding the cost to the carrying amount of the building.

**CPA-00138 Explanation**
Choice "c" is correct. Since the carrying value of the damaged portion of the building is known and is uninsured, the component method is used and a loss in the amount of the carrying value of the damaged portion of the building must be recognized. The refurbishing costs create a new asset (the reconstructed building) and must be capitalized.

Choice "a" is incorrect. Accumulated depreciation would be reduced if the refurbishing costs were material subsequent costs to acquisition of the asset and the refurbishment would extend the life of the asset.

Choice "b" is incorrect. Since the carrying value of the damaged portion of the building is known and is uninsured, a loss in the amount of the carrying value of the damaged portion of the building must be recognized. The costs of refurbishing are capitalized.

Choice "d" is incorrect. A loss in the amount of the carrying value of the damaged portion of the building must be recognized.

**CPA-00140 Type1 M/C A-D Corr Ans: D PM#7 F 4-03**

55. CPA-00140 FARE May 91 #23 Page 37

During 1990, Bay Co. constructed machinery for its own use and for sale to customers. Bank loans financed these assets both during construction and after construction was complete. How much of the interest incurred should be reported as interest expense in the 1990 income statement?

| | *Interest incurred for machinery for own use* | *Interest incurred for machinery held for sale* |
|---|---|---|
| a. | All interest incurred | All interest incurred |
| b. | All interest incurred | Interest incurred after completion |
| c. | Interest incurred after completion | Interest incurred after completion |
| d. | Interest incurred after completion | All interest incurred |

**CPA-00140 Explanation**
Choice "d" is correct.

**Rule:** interest costs incurred **during the construction period** of machinery to be used by a firm as a fixed asset, should be capitalized as part of the historic cost of acquiring the fixed asset. Interest costs on the fixed asset **subsequent to the construction period** as well as all interest costs on the routine manufacture of machinery for sale to customers (inventory) should be **expensed** in the income statement for the period incurred.

**CPA-04671 Type1 M/C A-D Corr Ans: D PM#9 F 4-03**

56. CPA-04671 Released 2005 Page 34

Tomson Co. installed new assembly line production equipment at a cost of $175,000. Tomson had to rearrange the assembly line and remove a wall to install the equipment. The rearrangement cost $12,000


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and the wall removal cost $3,000. The rearrangement did not increase the life of the assembly line but it did make it more efficient. What amount of these costs should be capitalized by Tomson?

a. $175,000
b. $178,000
c. $187,000
d. $190,000

**CPA-04671 Explanation**
Choice "d" is correct. The cost of equipment includes all expenditures related directly to the acquisition or construction including invoice price less cash discounts and other discounts, freight-in, installation charges and sales and Federal Excise Taxes. Cost includes all costs necessary to get the asset to its proper place, at the intended time and in condition for its intended use.

| | | |
|---|---|---|
| Cost of equipment | 175,000 | |
| Installation cost | 15,000 | (12,000 plus 3,000) |
| Capitalized cost | 190,000 | |

**CPA-04693 Type1 M/C A-D Corr Ans: A PM#10 F 4-03**

57. CPA-04693 Released 2005 Page 36

On January 2 of the current year, Cruises, Inc. borrowed $3 million at a rate of 10% for three years and began construction of a cruise ship. The note states that annual payments of principal and interest in the amount of $1.3 million are due every December 31. Cruises used all proceeds as a down payment for construction of a new cruise ship that is to be delivered two years after start of construction. What should Cruise report as interest expense related to the note in its income statement for the second year?

a. $0
b. $300,000
c. $600,000
d. $900,000

**CPA-04693 Explanation**
Choice "a" is correct. Interest incurred during the construction period should be capitalized, based on the weighted average of accumulated expenditures, as part of the cruise ship cost. Interest cost incurred before or after the construction period should be expensed as well as interest cost incurred during intentional delays in construction.

Choices "b", "c", and "d" are incorrect, per the above.

**CPA-05191 Type1 M/C A-D Corr Ans: C PM#11 F 4-03**

58. CPA-05191 Released 2006 Page 36

Cart Co. purchased an office building and the land on which it is located for $750,000 cash and an existing $250,000 mortgage. For realty tax purposes, the property is assessed at $960,000, 60% of which is allocated to the building. At what amount should Cart record the building?

a. $500,000
b. $576,000
c. $600,000
d. $960,000

**CPA-05191 Explanation**
Choice "c" is correct. The $1,000,000 total cost ($750,000 cash + $250,000 mortgage) should be allocated to the building and the land separately. There is no other information with which to perform this allocation other than the property tax assessment. So, 60% of the $1,000,000, or $600,000, is allocated to the building.

Choice "a" is incorrect. This answer is the $750,000 cash price less the $250,000 mortgage.


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Choice "b" is incorrect. This answer is computed as 60% of the assessed value of $960,000. The cost that should be allocated is the total purchase price of the land and building, **not** the assessed value.

Choice "d" is incorrect. This answer is the assessed value. Even if the assessed value were to be allocated, the full assessed value is not allocated to the building. The land has to be worth something.

**CPA-05222 Type1 M/C A-D Corr Ans: D PM#12 F 4-03**

59. CPA-05222 Released 2006 Page 35

Green Co. incurred leasehold improvement costs for its leased property. The estimated useful life of the improvements was 15 years. The remaining term of the nonrenewable lease was 20 years. These costs should be:

a. Expensed as incurred.
b. Capitalized and depreciated over 20 years.
c. Capitalized and expensed in the year in which the lease expires.
d. Capitalized and depreciated over 15 years.

**CPA-05222 Explanation**
Choice "d" is correct. Leasehold improvements are capitalized and then amortized over the lesser of the life of the improvements or the remaining term of the lease (in this question, the amortization period is the lesser of 15 or 20). The leasehold improvement costs should thus be expensed over a period of 15 years. This rule makes sense because the party making the leasehold improvements will benefit from the improvements for either the life of the improvements or the term of the lease if the term of the lease is shorter than the life of the improvements (in which case, somebody else will benefit from the improvements for the remaining life of the improvements).

Choice "a" is incorrect. Leasehold improvements are capitalized and amortized, **not** expensed as incurred.

Choice "b" is incorrect. Leasehold improvements are capitalized and then amortized over the lesser of the life of the improvements or the remaining term of the lease, which in this question is 15, **not** 20, years.

Choice "c" is incorrect. Leasehold improvements are capitalized and then amortized over the lesser of the life of the improvements or the remaining term of the lease, **not** expensed in the year in which the lease expires.

**CPA-05225 Type1 M/C A-D Corr Ans: B PM#13 F 4-03**

60. CPA-05225 Released 2006 Page 34

Miller Co. discovered that in the prior year, it failed to report $40,000 of depreciation related to a newly constructed building. The depreciation was computed correctly for tax purposes. The tax rate for the current year was 40%. What was the impact of the error on Miller's financial statements for the prior year?

a. Understatement of accumulated depreciation of $24,000.
b. Understatement of accumulated depreciation of $40,000.
c. Understatement of depreciation expense of $24,000.
d. Understatement of net income of $24,000.

**CPA-05225 Explanation**
Choice "b" is correct. An understatement (failure to report) of depreciation (expense) would certainly understate accumulated depreciation by the same amount, gross of tax. [Note that three of the answers listed are net of tax and that only one of them is gross of tax. Because there can be only one correct answer, an initial thought would be that the "odd man out" answer is probably correct.]

Choice "a" is incorrect. An understatement of depreciation (expense) would certainly understate accumulated depreciation by the same amount, gross, **not** net, of tax.


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Choice "c" is incorrect. An understatement of depreciation (expense) would certainly understate depreciation expense gross, **not** net, of tax.

Choice "d" is incorrect. An understatement of depreciation (expense) would overstate, **not** understate, net income by the amount, net of tax.

**CPA-05422 Type1 M/C A-D Corr Ans: C PM#14 F 4-03**

61. CPA-05422 Released 2007 Page 35

Oak Co., a newly formed corporation, incurred the following expenditures related to land and building:

| | |
|---|---|
| County assessment for sewer lines | $ 2,500 |
| Title search fees | 625 |
| Cash paid for land with a building to be demolished | 135,000 |
| Excavation for construction of basement | 21,000 |
| Removal of old building $21,000 less salvage of $5,000 | 16,000 |

At what amount should Oak record the land?

a. $138,125
b. $153,500
c. $154,125
d. $175,625

**CPA-05422 Explanation**
Choice "c" is correct. The cost of land includes all costs to acquire the land and get it ready for use:

| | | |
|---|---|---|
| | Cash paid for land | $135,000 |
| + | Title search fees | 625 |
| + | County assessment | 2,500 |
| + | Removal of building | 16,000 |
| | Total cost of land | $154,125 |

Choice "a" is incorrect. The removal of the building is necessary to get the land ready for use and must be included in the total land cost.

Choice "b" is incorrect. The title search fee is an acquisition cost that must be included in the total cost of the land.

Choice "d" is incorrect. The building excavation costs are costs incurred to construct the building that must be included in the total building cost, not the cost of the land.

**Depreciable Assets and Depreciation**

**CPA-00143 Type1 M/C A-D Corr Ans: B PM#2 F 4-04**

62. CPA-00143 FARE May 95 #36 Page 49

In January 1994, Vorst Co. purchased a mineral mine for $2,640,000 with removable ore estimated at 1,200,000 tons. After it has extracted all the ore, Vorst will be required by law to restore the land to its original condition at an estimated cost of $180,000. Vorst believes it will be able to sell the property afterwards for $300,000. During 1994, Vorst incurred $360,000 of development costs preparing the mine for production and removed and sold 60,000 tons of ore. In its 1994 income statement, what amount should Vorst report as depletion?

a. $135,000
b. $144,000
c. $150,000
d. $159,000

**CPA-00143 Explanation**


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Choice "b" is correct. The depletion base equals the purchase price ($2,640,000) plus the development costs ($360,000) plus the estimated restoration costs ($180,000) less the expected salvage value ($300,000). Depletion is $2.40 per ton ($2,880,000 / 1,200,000 tons). Depletion expense is $144,000 ($2.40 per ton × 60,000 tons sold).

Choice "a" is incorrect. Estimated restoration costs should be included in the calculation of the depletion base.

Choice "c" is incorrect. Estimated restoration costs and estimated salvage value should be included in the calculation of the depletion base.

Choice "d" is incorrect. Estimated salvage value should be included in the calculation of the depletion base.

**CPA-00145 Type1 M/C A-D Corr Ans: B PM#4 F 4-04**

63. CPA-00145 FARE May 94 #18 Page 45

Turtle Co. purchased equipment on January 2, 1991, for $50,000. The equipment had an estimated five-year service life. Turtle's policy for five-year assets is to use the 200% double-declining depreciation method for the first two years of the asset's life, and then switch to the straight-line depreciation method. In its December 31, 1993, balance sheet, what amount should Turtle report as accumulated depreciation for equipment?

a. $30,000
b. $38,000
c. $39,200
d. $42,000

**CPA-00145 Explanation**
Choice "b" is correct. Calculations are shown below.

| *Year* | | *Depreciation* | *Expense* | *Accumulated Depreciation* |
|---|---|---|---|---|
| 1991 | DDB | 2 × 1/5 × $50,000 | $20,000 | $20,000 |
| 1992 | DDB | 2 × 1/5 × ($50,000 – $20,000) | $12,000 | 32,000 |
| 1993 | SL | ($50,000 – $32,000) / 3 years | $ 6,000 | 38,000 |
| 1994 | SL | | $ 6,000 | 44,000 |
| 1995 | SL | | $ 6,000 | 50,000 |

Choice "a" is incorrect. The straight-line method is not used in 1991 and 1992, the first two years of service life.

Choice "c" is incorrect. Turtle switches to the straight-line method in 1993, the third year of service life.

Choice "d" is incorrect. When switching methods, book value (not original cost) and remaining life (not original life) should be used to calculate depreciation.

**CPA-00146 Type1 M/C A-D Corr Ans: A PM#5 F 4-04**

64. CPA-00146 FARE May 94 #45 Page 43

On January 2, 1993, Lem Corp. bought machinery under a contract that required a down payment of $10,000, plus 24 monthly payments of $5,000 each, for total cash payments of $130,000. The cash equivalent price of the machinery was $110,000. The machinery has an estimated useful life of ten years and estimated salvage value of $5,000. Lem uses straight-line depreciation. In its 1993 income statement, what amount should Lem report as depreciation for this machinery?

a. $10,500


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b. $11,000
c. $12,500
d. $13,000

**CPA-00146 Explanation**
Choice "a" is correct. On the transaction date, the machinery would be recorded at its fair market value ($110,000), cash would be credited ($10,000), and notes/payable would be credited for $100,000. The cash payments include interest as well as principal. Straight-line depreciation = ($110,000 cost – $5,000 salvage value) / 10 years life = $10,500.

Choice "b" is incorrect. Salvage value is included in the calculations for straight-line depreciation.

Choice "c" is incorrect. Depreciation calculations should be based on fair market value less salvage value.

Choice "d" is incorrect. Depreciation calculations should be based on fair market value.

**CPA-00147 Type1 M/C A-D Corr Ans: B PM#6 F 4-04**

65. CPA-00147 PI Nov 93 #23 Page 43

Weir Co. uses straight-line depreciation for its property, plant, and equipment, which, stated at cost, consisted of the following:

| | *12/31/92* | *12/31/91* |
|---|---|---|
| Land | $ 25,000 | $ 25,000 |
| Buildings | 195,000 | 195,000 |
| Machinery & equipment | 695,000 | 650,000 |
| | 915,000 | 870,000 |
| Less accumulated depreciation | 400,000 | 370,000 |
| | $515,000 | $500,000 |

Weir's depreciation expense for 1992 and 1991 was $55,000 and $50,000, respectively. What amount was debited to accumulated depreciation during 1992 because of property, plant, and equipment retirements?

a. $40,000
b. $25,000
c. $20,000
d. $10,000

**CPA-00147 Explanation**
Choice "b" is correct. Debits to accumulated depreciation can be determined as follows:

| | |
|---|---|
| Balance 12/31/91 | $370,000 |
| Depreciation for 1992 | 55,000 |
| Balance before retirements | 425,000 |
| Balance 12/31/92 (after retirements) | 400,000 |
| Debit for retirements | $ 25,000 |

Choice "a" is incorrect. The charge to property, plant and equipment is not used in the calculation.

Choice "c" is incorrect. Depreciation for 1992 of $55,000 must be used.

Choice "d" is incorrect. Depreciation for 1992 of $55,000 must be used. The change in machinery and equipment cannot be used since we don't know how much was purchased.

**CPA-00148 Type1 M/C A-D Corr Ans: A PM#7 F 4-04**

66. CPA-00148 Th Nov 93 #34 Page 46


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In which of the following situations is the units-of-production method of depreciation most appropriate?

a. An asset's service potential declines with use.
b. An asset's service potential declines with the passage of time.
c. An asset is subject to rapid obsolescence.
d. An asset incurs increasing repairs and maintenance with use.

**CPA-00148 Explanation**
Choice "a" is correct. Units-of-production depreciation method reflects that an asset's service potential declines with use.

Choice "b" is incorrect. Straight-line depreciation method reflects that an asset's service potential declines with the passage of time.

Choice "c" is incorrect. An accelerated depreciation method would reflect that an asset is subject to rapid obsolescence.

Choice "d" is incorrect. An accelerated depreciation method would reflect that an asset incurs increasing repairs and maintenance with use.

**CPA-00149 Type1 M/C A-D Corr Ans: C PM#8 F 4-04**

67. CPA-00149Th May 93 #27 Page 43

On January 1, 1988, Crater, Inc. purchased equipment having an estimated salvage value equal to 20% of its original cost at the end of a 10-year life. The equipment was sold December 31, 1992, for 50% of its original cost. If the equipment's disposition resulted in a reported loss, which of the following depreciation methods did Crater use?

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

**CPA-00149 Explanation**
Choice "c" is correct. After 5 years of straight-line depreciation over a 10-year life, accumulated depreciation would equal 50% of the net unrecoverable cost (80% times cost) or 40% of the original cost, leaving a book value of 60% times the original cost. When the asset was sold for 50% of its original cost, this amount was less than book value, resulting in a loss.

Choice "a" is incorrect. After 5 years of double-declining balance depreciation over a 10-year life, accumulated depreciation would equal .67232 of the original cost leaving a book value of .32768 times original cost. When the asset was sold for 50% of its original cost, this amount was greater than book value, resulting in a gain.

Choice "b" is incorrect. After 5 years of sum-of-the-years'-digits depreciation over a 10-year life, accumulated depreciation would equal .58182 of the original cost leaving a book value of .41818 times original cost. When the asset was sold for 50% of its original cost, this amount was greater than book value, resulting in a gain.

Choice "d" is incorrect. The composite method is appropriate for a collection of assets that are dissimilar in nature.

**CPA-00150 Type1 M/C A-D Corr Ans: C PM#9 F 4-04**

68. CPA-00150Th May 93 #28 Page 41

Which of the following uses the straight-line depreciation method?

| *Group depreciation* | *Composite depreciation* |
|---|---|


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

**CPA-00150 Explanation**
Choice "c" is correct. Both group and composite depreciation are based on the straight-line depreciation method. The group method is for groups of similar assets while the composite method is for a collection of dissimilar assets.

**CPA-05212 Type1 M/C A-D Corr Ans: C PM#10 F 4-04**

69. CPA-05212 Released 2006 Page 48

Cantor Co. purchased a coal mine for $2,000,000. It cost $500,000 to prepare the coal mine for extraction of the coal. It was estimated that 750,000 tons of coal would be extracted from the mine during its useful life. Cantor planned to sell the property for $100,000 at the end of its useful life. During the current year, 15,000 tons of coal were extracted and sold. What would be Cantor's depletion amount per ton for the current year?

a. $2.50
b. $2.60
c. $3.20
d. $3.30

**CPA-05212 Explanation**
Choice "c" is correct. In this question, the total cost of the mine is the purchase price ($2,000,000) plus the preparation ($500,000), net of the anticipated sales price at the end of its useful life ($100,000). The total cost is thus $2,400,000 ($2,000,000 + $500,000 - $100,000 = $2,400,000). That total cost is divided by the estimated 750,000 tons of coal, for a per unit depletion amount of $3.20. Note that the depletion amount per unit would be the same for every year unless additional expenditures were incurred.

Note that the 15,000 tons produced and sold is irrelevant because the question is asking for the depletion per ton. Often, the questions indicate that a certain number of units is produced and that a different amount is sold and ask about the depreciation expense for the period. In those questions, it is the number of units sold that count.

Choice "a" is incorrect, per the above calculation.

Choice "b" is incorrect, per the above calculation.

Choice "d" is incorrect. This answer ignores the anticipated sales price at the end of its useful life. This amount is effectively a salvage value and should be subtracted in the numerator of the depletion formula.

**Fixed Asset Impairment**

**CPA-00153 Type1 M/C A-D Corr Ans: C PM#3 F 4-05**

70. CPA-00153 PI May 93 #24 Page 51

On January 2, 1989, Reed Co. purchased a machine for $800,000 and established an annual depreciation charge of $100,000 over an eight-year life. During 1992, after issuing its 1991 financial statements, Reed concluded that: (1) the machine suffered permanent impairment of its operational value, and (2) $200,000 is a reasonable estimate of the amount expected to be recovered through use of the machine for the period January 1, 1992, through December 31, 1996. In Reed's December 31, 1992, balance sheet, the machine should be reported at a carrying amount of:

a. $0
b. $100,000
c. $160,000


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d. $400,000

**CPA-00153 Explanation**
Choice "c" is correct. When a permanent impairment has occurred, the book value is reduced with a credit to accumulated depreciation. Depreciation of the remaining balance is taken over the remaining life. The $200,000 is depreciated over 5 years, or $40,000 for 1992. The carrying amount on December 31, 1992 is $200,000 – $40,000 = $160,000.

**CPA-05238 Type1 M/C A-D Corr Ans: B PM#5 F 4-05**

71. CPA-05238 Released 2006 Page 51

Which of the following conditions must exist in order for an impairment loss to be recognized?

I. The carrying amount of the long-lived asset is less than its fair value.
II. The carrying amount of the long-lived asset is not recoverable.

a. I only.
b. II only.
c. Both I and II.
d. Neither I nor II.

**CPA-05238 Explanation**
Choice "b" is correct. A long-lived asset is impaired if the carrying amount of the asset is greater than, not less than, its fair value and if that carrying amount is not recoverable (the fair value would be recoverable, but the difference would not be). An impairment loss would then be recognized for the amount of the difference between book value and fair value.

Choices "a", "c", and "d" are incorrect per the above explanation.

**Supplemental Questions**

**CPA-00016 Type1 M/C A-D Corr Ans: C PM#1 F 4-99**

72. CPA-00016 FARE May 94 #44 Page 3

In 1993, Gar Corp. collected $300,000 as beneficiary of a Keyman life insurance policy carried on the life of Gar's controller, who had died in 1993. The life insurance proceeds are not subject to income tax. At the date of the controller's death, the policy's cash surrender value was $90,000. What amount should Gar report as revenue in its 1993 income statement?

a. $0
b. $90,000
c. $210,000
d. $300,000

**CPA-00016 Explanation**
Choice "c" is correct, $210,000.

| | |
|---|---|
| Revenue in 1993 income statement: | |
| Life insurance proceeds | $300,000 |
| Less cash surrender value (B/S asset account previously recognized) | (90,000) |
| Revenue in 1993 income statement | $210,000 |

**CPA-00165 Type1 M/C A-D Corr Ans: A PM#2 F 4-99**

73. CPA-00165 Nov 89 II #7 Page 12


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The following information pertains to Oro Corp.:

| | |
|---|---|
| Credit sales for the year ended December 31, 1988 | $450,000 |
| Credit balance in allowance for uncollectible accounts at January 1, 1988 | 10,800 |
| Bad debts written off during 1988 | 18,000 |

According to past experience, 3% of Oro's credit sales have been uncollectible. After provision is made for bad debt expense for the year ended December 31, 1988, the allowance for uncollectible accounts balance would be:

a. $6,300
b. $13,500
c. $24,300
d. $31,500

**CPA-00165 Explanation**
Choice "a" is correct. $6,300.

| Allowance for uncollectible accounts | |
|---|---|
| Balance 1-1-86 | $10,800 |
| Add: Provision for bad debts (3% × 450,000) | 13,500 |
| Subtotal | 24,300 |
| Less: Bad debt write offs | (18,000) |
| Balance 12-31-86 | $ 6,300 |

**CPA-00171 Type1 M/C A-D Corr Ans: A PM#3 F 4-99**

74. CPA-00171 Nov 89 T #7 Page 12

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

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

**CPA-00171 Explanation**
Choice "a" is correct. Aging the receivables.

Estimating bad debts on the aging analysis of accounts receivable balances focuses on the balance sheet and emphasizes the valuation of assets. It results in a good matching of revenue and expense.

Choice "b" is incorrect. The (specific) "write-off method" overstates the collectible amount of accounts receivable by not allowing for those that become uncollectible. It results in a poor matching of revenue and expense.

Choices "c" and "d" are incorrect. Estimating bad debts based on sales emphasizes the income statement and results in a good matching of revenue and expense.

**CPA-00173 Type1 M/C A-D Corr Ans: D PM#4 F 4-99**

75. CPA-00173 May 90 I #9 Page 12

The following accounts were abstracted from Roxy Co.'s unadjusted trial balance at December 31, 1989:

| | *Debit* | *Credit* |
|---|---|---|
| Accounts receivable | $1,000,000 | |
| Allowance for uncollectible accounts | 8,000 | |
| Net credit sales | | $3,000,000 |


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Roxy estimates that 3% of the gross accounts receivable will become uncollectible. After adjustment at December 31, 1989, the allowance for uncollectible accounts should have a credit balance of:

a. $90,000
b. $82,000
c. $38,000
d. $30,000

**CPA-00173 Explanation**
Choice "d" is correct. $30,000.

| | |
|---|---|
| Gross accounts receivable | $1,000,000 |
| 3% will become collectible | 3% |
| Allowance for uncollectible AR 12-31-89 | $ 30,000 **D** |

**Note**: It is important to read the question carefully. The tendency here is to compute the allowance as a % of sales.

**CPA-00177 Type1 M/C A-D Corr Ans: D PM#5 F 4-99**

76. CPA-00177 May 90 I #54 Page 12

For the year ended December 31, 1989, Beal Co. estimated its allowance for uncollectible accounts using the year-end aging of accounts receivable. The following data are available:

| | |
|---|---|
| Allowance for uncollectible accounts, 1/1/89 | $42,000 |
| Provision for uncollectible accounts during 1989 (2% on credit sales of $2,000,000) | 40,000 |
| Uncollectible accounts written off, 11/30/89 | 46,000 |
| Estimated uncollectible accounts per aging, 12/31/89 | 52,000 |

After year-end adjustment, the uncollectible accounts expense for 1989 should be:

a. $46,000
b. $48,000
c. $52,000
d. $56,000

**CPA-00177 Explanation**
Choice "d" is correct. $56,000 ($40,000 Provision + Adj of $16,000)

| Allowance for uncollectible AR | |
|---|---|
| Beginning balance | $ 42,000 |
| Add: Provision for year | $ 40,000 **D** |
| Subtotal | $ 82,000 |
| Less: Uncollectible A&R written off | ($ 46,000) |
| Ending balance before adjustment | $ 36,000 |
| Estimated uncollectible accounts per aging | $ 52,000 |
| Difference | $ 16,000 **D** |

| JE to reflect difference | *DR* | *CR* |
|---|---|---|
| Provision for uncollectible accounts (Expense) | $16,000 | |
| Allowance for uncollectible accounts | | $16,000 |

**CPA-00179 Type1 M/C A-D Corr Ans: A PM#6 F 4-99**

77. CPA-00179 Nov 90 I #5 Page 9


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On the December 31, 1989 balance sheet of Mann Co., the current receivables consisted of the following:

| | |
|---|---|
| Trade accounts receivable | $ 93,000 |
| Allowance for uncollectible accounts | (2,000) |
| Claim against shipper for goods lost in transit (November 1989) | 3,000 |
| Selling price of unsold goods sent by Mann on consignment at 130% of cost (not included in Mann's ending inventory) | 26,000 |
| Security deposit on lease of warehouse used for storing some inventories | 30,000 |
| Total | $150,000 |

At December 31, 1989, the correct total of Mann's current net receivables was:

a. $94,000
b. $120,000
c. $124,000
d. $150,000

**CPA-00179 Explanation**
Choice "a" is correct. $94,000

"Accounts receivable net" includes:

| | |
|---|---|
| Trade accounts receivable | $93,000 |
| Less: Allowance for uncollectible accounts | (2,000) |
| Add: Claim against shipper for goods lost in transit (before year end) | 3,000 |
| Total | $94,000 **A** |

Consigned goods of $26,000 is "inventory" not AR. "Security deposits" are not accounts receivable and generally are not a current asset, as is "accounts receivable."

**CPA-00260 Type1 M/C A-D Corr Ans: D PM#7 F 4-99**

78. CPA-00260 Nov 90 I #45 Page 14

Orr Co. prepared an aging of its accounts receivable at December 31, 1989 and determined that the net realizable value of the receivables was $250,000. Additional information is available as follows:

| | |
|---|---|
| Allowance for uncollectible accounts at 1/1/89 -- credit balance | $28,000 |
| Accounts written off as uncollectible during 1989 | 23,000 |
| Accounts receivable at 12/31/89 | 270,000 |
| Uncollectible accounts recovery during 1989 | 5,000 |

For the year ended December 31, 1989, Orr's uncollectible accounts expense would be:

a. $23,000
b. $20,000
c. $15,000
d. $10,000

**CPA-00260 Explanation**
Choice "d" is correct. $10,000

Allowance for Uncollectible Accounts

| | |
|---|---|
| Beginning balance | $28,000 |
| Add: Uncollectible accounts exp | $10,000 ← squeeze |
| Recovery of previous write-offs in 1989 | 5,000 |
| Subtotal | 43,000 |
| Less: Accounts written off in 1989 | (23,000) |
| Ending balance ($270,000 – 250,000) | $20,000 |


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**CPA-00261 Type1 M/C A-D Corr Ans: A PM#8 F 4-99**

79. CPA-00261 Nov 90 II #9 Page 14

Mill Co.'s allowance for uncollectible accounts was $100,000 at the end of 1989 and $90,000 at the end of 1988. For the year ended December 31, 1989, Mill reported bad debt expense of $16,000 in its income statement. What amount did Mill debit to the appropriate account in 1989 to write off actual bad debts?

a. $6,000
b. $10,000
c. $16,000
d. $26,000

**CPA-00261 Explanation**
Choice "a" is correct. $6,000.

| Allowance for Uncollectible Accounts | |
|---|---|
| Beginning balance 12-31-88 | $ 90,000 |
| Add: Bad debt expense | 16,000 |
| Subtotal | $106,000 |
| Less: Actual bad debt write-off | (6,000) ← squeeze |
| Ending balance 12-31-98 | $100,000 |

This question is typical of many multiple choice questions asking the candidate to "squeeze out" one of the 4 figures in an "accounts receivable" or "allowance for accounts receivable" account.

**CPA-00262 Type1 M/C A-D Corr Ans: C PM#9 F 4-99**

80. CPA-00262 Nov 90 T #19 Page 14

Under the allowance method of recognizing uncollectible accounts, the entry to write-off an uncollectible account:

a. Increases the allowance for uncollectible accounts.
b. Has no effect on the allowance for uncollectible accounts.
c. Has no effect on net income.
d. Decreases net income.

**CPA-00262 Explanation**
Choice "c" is correct. The entry to write-off an uncollectible account under the allowance method has no effect on net income.

| Example Journal Entry | Debit | Credit |
|---|---|---|
| Allowance for uncollectible accts | 700 | |
| Accounts receivable | | 700 |

Choices "a" and "b" are incorrect. The allowance account is decreased (not increased).

Choice "d" is incorrect. Net income is not affected by this transaction.

**CPA-00264 Type1 M/C A-D Corr Ans: C PM#10 F 4-99**

81. CPA-00264 May 91 I #8 Page 14

The following information was taken from the 1990 financial statements of Planet Corp.:

| | |
|---|---|
| Accounts receivable, January 1, 1990 | $21,600 |
| Accounts receivable, December 31, 1990 | 30,400 |


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| | |
|---|---|
| Sales on account and cash sales | 438,000 |
| Uncollectible accounts | 1,000 |

No accounts receivable were written off or recovered during the year.

If the direct method is used in the 1990 statement of cash flows, Planet should report cash collected from customers as:

a. $447,800
b. $446,800
c. $429,200
d. $428,200

**CPA-00264 Explanation**
Choice "c" is correct. $429,200.

| | |
|---|---|
| Beginning AR Jan. 1, 1990 | $ 21,600 |
| Add: Sales on account and cash sales | 438,000 |
| Subtotal | 459,600 |
| Less: AR written off | (0) |
| Cash collected from customers | (429,200) **C** ← squeeze |
| Ending AR Dec. 31, 1990 | $ 30,400 |

**CPA-00269 Type1 M/C A-D Corr Ans: A PM#11 F 4-99**

82. CPA-00269 May 91 T #9 Page 11

Bee Co. uses the direct write-off method to account for uncollectible accounts receivable. During an accounting period, Bee's cash collections from customers equal sales adjusted for the addition or deduction of the following amounts:

| | *Accounts Written-Off* | *Increase in Accounts Receivable Balance* |
|---|---|---|
| a. | Deduction | Deduction |
| b. | Addition | Deduction |
| c. | Deduction | Addition |
| d. | Addition | Addition |

**CPA-00269 Explanation**
Choice "a" is correct. Deduction - Deduction.

During an accounting period, cash collections from customers would equal sales adjusted by deducting "accounts receivable written off" and deducting the "increase in the accounts receivable balance."

Choices "b", "c", and "d" are incorrect based on the above explanation.

**CPA-00271 Type1 M/C A-D Corr Ans: A PM#12 F 4-99**

83. CPA-00271 May 91 T #10 Page 14

Gibbs Co. uses the allowance method for recognizing uncollectible accounts. Ignoring deferred taxes, the entry to record the write-off of a specific uncollectible account:

a. Affects neither net income nor working capital.
b. Affects neither net income nor accounts receivable.
c. Decreases both net income and accounts receivable.
d. Decreases both net income and working capital.

**CPA-00271 Explanation**
Choice "a" is correct. Neither net income nor working capital is affected, as the net AR remains the same.


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The JE to write off a specific uncollectible account under the "allowance method" for recognizing uncollectible account is:

| "Accounts receivable" | DR | CR |
|---|---|---|
| Allowance for uncollectible AR | $XXX | |
| Accounts receivable | | $XXX |

Net income is reduced under the "direct write off method." Working capital is reduced under the "direct write off method."

| | DR | CR |
|---|---|---|
| Bad debt expense | $XXX | |
| Accounts receivable | | $XXX |

Choices "b", "c", and "d" are incorrect, per above.

**CPA-00274 Type1 M/C A-D Corr Ans: A PM#13 F 4-99**

84. CPA-00274 May 92 T #47 Page 15

When the allowance method of recognizing uncollectible accounts is used, the entries at the time of collection of a small account previously written off would:

a. Increase the allowance for uncollectible accounts.
b. Increase net income.
c. Decrease the allowance for uncollectible accounts.
d. Have no effect on the allowance for uncollectible accounts.

**CPA-00274 Explanation**
Choice "a" is correct. A collection of a previously written-off account receivable would increase the "allowance" account, which is a credit balance account.

| Example Journal Entry | Debit | Credit |
|---|---|---|
| Cash | $1,000 | |
| Allowance for doubtful accounts | | $1,000 |

**CPA-00276 Type1 M/C A-D Corr Ans: C PM#14 F 4-99**

85. CPA-00276 Nov 92 T #11 Page 14

When the allowance method of recognizing bad debt expense is used, the allowance would decrease when a (an):

a. Account previously written off is collected.
b. Account previously written off becomes collectible.
c. Specific uncollectible account is written off.
d. Provision for uncollectible accounts is recorded.

**CPA-00276 Explanation**
Choice "c" is correct. When a specific uncollectible account is written off under the allowance method of recognizing bad debt expense, the "allowance for bad debt" account would decrease.

Choice "a" is incorrect. The "allowance for bad debt" (credit balance account) would increase, if a previously written-off account is collected (DR-Cash, CR-Allowance).

Choice "b" is incorrect. When a previously written-off account "becomes collectible," the "allowance for bad debt" account would increase (DR-Accounts Receivable, CR-Allowance).


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Choice "d" is incorrect. The recording of a provision for uncollectible accounts increases the "allowance for bad debt" account (DR-Provision for bad debts, CR-Allowance).

**CPA-00278 Type1 M/C A-D Corr Ans: A PM#15 F 4-99**

86. CPA-00278 May 93 I #37 Page 11

Fenn Stores, Inc. had sales of $1,000,000 during December 1992. Experience has shown that merchandise equaling 7% of sales will be returned within 30 days and an additional 3% will be returned within 90 days. Returned merchandise is readily resalable. In addition, merchandise equaling 15% of sales will be exchanged for merchandise of equal or greater value. What amount should Fenn report for net sales in its income statement for the month of December 1992?

a. $900,000
b. $850,000
c. $780,000
d. $750,000

**CPA-00278 Explanation**

| Return Period | Gross Sales | Return % | Sales Returns | Net Sales |
|---|---|---|---|---|
| 30 days | 1,000,000 | 7% | 70,000 | |
| 90 days | 1,000,000 | 3% | 30,000 | |
| | 1,000,000 – | | 100,000 = | 900,000 **A** |

Choice "a" is correct.

**CPA-00280 Type1 M/C A-D Corr Ans: B PM#16 F 4-99**

87. CPA-00280 May 93 I #51 Page 14

Ward Co. estimates its uncollectible accounts expense to be 2% of credit sales. Ward's credit sales for 1992 were $1,000,000. During 1992, Ward wrote off $18,000 of uncollectible accounts. Ward's allowance for uncollectible accounts had a $15,000 balance on January 1, 1992. In its December 31, 1992, income statement, what amount should Ward report as uncollectible accounts expense?

a. $23,000
b. $20,000
c. $18,000
d. $17,000

**CPA-00280 Explanation**

| | Allowance for Uncollectible Accounts | |
|---|---|---|
| Begin balance Jan 1, 1992 | $15,000 | |
| Add: Uncollectible Accounts exp (provision) (2% of credit sales of $1,000,000) | 20,000 | **B** |
| Subtotal | 35,000 | |
| Less: Write-offs | (18,000) | Not **C** |
| Ending balance Dec 31, 1992 - Derived | 17,000 | Not **D** |

Choice "b" is correct. $20,000 uncollectible accounts expense.


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The only pertinent info is the:

| | |
|---|---|
| $1,000,000 | Credit Sales |
| 2% | Uncollectible Provision |
| $ 20,000 | Uncollectible Expense **B** |

**CPA-00290 Type1 M/C A-D Corr Ans: D PM#17 F 4-99**

88. CPA-00290 Nov 89 #8 Page 21

Shipping costs incurred by a consignor on transfer of goods to a consignee should be considered as:

a. Expense to the consignee.
b. Expense to the consignor.
c. Inventory cost to the consignee.
d. Inventory cost to the consignor.

**CPA-00290 Explanation**
Choice "d" is correct. Inventory cost to the consignor (seller).

**Rule:** Consignor includes consigned goods in the hands of the consignee (potential buyer) at consignor's cost plus shipping costs to the consignee.

Choices "a" and "c" are incorrect. The consignor still holds title to the goods and they are a party of his inventory until they are sold by the consignee at which time they are expensed to cost of goods sold of the consignor.

Choice "b" is incorrect. Shipping costs incurred by a consignor should be included as a component of consigned inventory cost.

**CPA-00291 Type1 M/C A-D Corr Ans: C PM#18 F 4-99**

89. CPA-00291 Nov 90 I #7 Page 22

The following information applied to Fenn, Inc. for 1989:

| | |
|---|---|
| Merchandise purchased for resale | $400,000 |
| Freight in | 10,000 |
| Freight out | 5,000 |
| Purchase returns | 2,000 |

Fenn's 1989 inventoriable cost was:

a. $400,000
b. $403,000
c. $408,000
d. $413,000

**CPA-00291 Explanation**
Choice "c" is correct. $408,000 merchandise purchased plus freight-in, insurance, and warehousing costs (net of purchase returns and cash discounts) are inventoriable costs.

Freight out is a selling expense which is treated as a period expense, not a product (inventoriable) cost.

**CPA-00292 Type1 M/C A-D Corr Ans: C PM#19 F 4-99**

90. CPA-00292 Nov 90 II #6 Page 23

Amar Farms produced 300,000 pounds of cotton during the 1989 season. Amar sells all of its cotton to Brye Co., which has agreed to purchase Amar's entire production at the prevailing market price. Recent


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legislation assures that the market price will not fall below $.70 per pound during the next two years. Amar's costs of selling and distributing the cotton are immaterial and can be reasonably estimated. Amar reports its inventory at expected exit value. During 1989, Amar sold and delivered to Brye 200,000 pounds at the market price of $.70. Amar sold the remaining 100,000 pounds during 1990 at the market price of $.72. What amount of revenue should Amar recognize in 1989?

a. $140,000
b. $144,000
c. $210,000
d. $216,000

**CPA-00292 Explanation**
Choice "c" is correct. Agricultural products (and precious metals) may be stated at above cost by using net selling price less cost of disposal because:

1. There is a ready market for such items (i.e., $.70 price legislation).
2. There is unit-interchangeability (i.e., cotton is cotton).

| | |
|---|---|
| Pounds produced | 300,000 |
| Market price | $ .70/pound |
| Revenue recognized in 1989 | $210,000 |

In essence, revenue is recognized at time of production and not at the time of sale.

**CPA-00293 Type1 M/C A-D Corr Ans: D PM#20 F 4-99**

91. CPA-00293 Nov 91 I #12 Page 20

On December 28, 1990, Kerr Manufacturing Co. purchased goods costing $50,000. The terms were F.O.B. destination. Some of the costs incurred in connection with the sale and delivery of the goods were as follows:

| | |
|---|---|
| Packaging for shipment | $1,000 |
| Shipping | 1,500 |
| Special handling charges | 2,000 |

These goods were received on December 31, 1990. In Kerr's December 31, 1990, balance sheet, what amount of cost for these goods should be included in inventory?

a. $54,500
b. $53,500
c. $52,000
d. $50,000

**CPA-00293 Explanation**
Choice "d" is correct. $50,000 inventory cost.

**Rule:** F.O.B. destination means that title passes when received by the buyer, and that packaging, shipping, and handling are costs of the seller.

F.O.B. shipping point means that title passes when the goods leave the seller's location and that shipping is a cost of the buyer.

**CPA-00294 Type1 M/C A-D Corr Ans: A PM#21 F 4-99**

92. CPA-00294 Nov 91 #7 Page 27

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

| *Cost of* | *Ending* |
|---|---|


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| | *Goods Sold* | *Inventory* |
|---|---|---|
| a. | LIFO | FIFO |
| b. | LIFO | LIFO |
| c. | FIFO | FIFO |
| d. | FIFO | LIFO |

**CPA-00294 Explanation**
Choice "a" is correct. LIFO - FIFO.

Cost of goods sold - LIFO most closely approximates the current cost for cost of goods sold because inventory "last-in" (most recently purchased) is "first-out" (expensed currently).

Ending inventory - FIFO most closely approximates the current cost for ending inventory because inventory "first-in" (oldest purchases) is "first-out" (expensed currently) and the most recent purchases remain in ending inventory.

**CPA-00296 Type1 M/C A-D Corr Ans: A PM#22 F 4-99**

93. CPA-00296 Nov 91 #27 Page 28

Thread Co. is selecting its inventory system in preparation for its first year of operations. Thread intends to use either the periodic weighted average method or the perpetual moving average method, and to apply the lower of cost or market rule either to individual items or to the total inventory. Inventory prices are expected to generally increase throughout 1991, although a few individual prices will decrease. What inventory system should Thread select if it wants to maximize the inventory carrying amount at December 31, 1991?

| | *Inventory Method* | *Cost or Market Application* |
|---|---|---|
| a. | Perpetual | Total inventory |
| b. | Perpetual | Individual item |
| c. | Periodic | Total inventory |
| d. | Periodic | Individual item |

**CPA-00296 Explanation**
Choice "a" is correct. Perpetual - Total Inventory.

Perpetual moving average method ("perpetual") will produce a higher inventory carrying amount than periodic weighted average ("periodic") when prices are increasing.

Perpetual computes a new weighted-average cost after each purchase while periodic is based on the average price of all purchases during the period. Perpetual will thus be affected more by increasing prices, and inventory will be more reflective of current costs.

The lower of cost or market rule will result in a higher inventory cost if applied to total inventory than individual items when prices are generally increasing although a few individual prices are decreasing.

The aggregation of the inventory as a whole will "cover up" the impact that individual items with decreasing prices would have under the individual item method.

**CPA-00297 Type1 M/C A-D Corr Ans: D PM#23 F 4-99**

94. CPA-00297 May 92 I #17 Page 21

Stone Co. had the following consignment transactions during December 1991:

| | |
|---|---|
| Inventory shipped on consignment to Beta Co. | $18,000 |
| Freight paid by Stone | 900 |
| Inventory received on consignment from Alpha Co. | 12,000 |
| Freight paid by Alpha | 500 |


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No sales of consigned goods were made through December 31, 1991. Stone's December 31, 1991, balance sheet should include consigned inventory at:

a. $12,000
b. $12,500
c. $18,000
d. $18,900

**CPA-00297 Explanation**
Choice "d" is correct. $18,900 ($18,000 inventory plus $900 freight out) should be included as consigned inventory in Stone's balance sheet since Stone is consignor for the goods sent to Beta and still holds title.

Choices "a" and "b" are incorrect. Stone is the consignee for the inventory received from Alpha. As consignee, Stone does not take title and should not include these goods as inventory.

Choice "c" is incorrect. Shipping costs to the consignee should be included in the amount for Stone's consigned inventory at 12/31/91.

**CPA-00298 Type1 M/C A-D Corr Ans: B PM#24 F 4-99**

95. CPA-00298 May 92 I #18 Page 28

Anders Co. uses the moving-average method to determine the cost of its inventory. During January 1992, Anders recorded the following information pertaining to its inventory:

| | Units | Unit Cost | Total Cost |
|---|---|---|---|
| Balance on 1/1/92 | 40,000 | $5 | $200,000 |
| Sold on 1/17/92 | 35,000 | | |
| Purchased on 1/28/92 | 20,000 | 8 | 160,000 |

What amount of inventory should Anders report in its January 31, 1992, balance sheet?

a. $200,000
b. $185,000
c. $162,500
d. $150,000

**CPA-00298 Explanation**
Choice "b" is correct. $185,000 inventory cost at 1/31/92.

**Rule:** The moving-average method assumes the company has perpetual records. A new weighted-average cost is computed after each purchase and issues are priced at the latest weighted average cost.

| | Units | Unit Cost | Total Cost |
|---|---|---|---|
| Balance 1/1/92 | 40,000 | $5.00 | $200,000 |
| Sold 1/17/92 | (35,000) | 5.00 | (175,000) |
| Balance 1/17/92 | 5,000 | 5.00 | 25,000 |
| Purchased 1/28/92 | 20,000 | 8.00 | 160,000 |
| Balance 1/31/92 | 25,000 | 7.40 | 185,000 |

In this example, the next units sold would be priced at $7.40, the new weighted average cost.

**CPA-00299 Type1 M/C A-D Corr Ans: C PM#25 F 4-99**

96. CPA-00299 May 92 #23 Page 21

Southgate Co. paid the in-transit insurance premium for consignment goods shipped to Hendon Co., the consignee. In addition, Southgate advanced part of the commissions that will be due when Hendon sells the goods. Should Southgate include the in-transit insurance premium and the advanced commissions in inventory costs?


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| | *Insurance Premium* | *Advanced Commissions* |
|---|---|---|
| a. | Yes | Yes |
| b. | No | No |
| c. | Yes | No |
| d. | No | Yes |

**CPA-00299 Explanation**
Choice "c" is correct. Yes - No

Southgate (as consignor) should include in its inventory cost the cost of goods shipped to Hendon (consignee) because it still holds title to the goods.

Yes - The in-transit insurance premium is included in inventory costs because it is a cost necessary to bring the goods to their location.

No - Advanced commissions are excluded because they do not add "time" or "place" utility to the inventory. Rather, they are classified as a prepaid expense that will become commissions expense when the goods are sold.

**CPA-00300 Type1 M/C A-D Corr Ans: A PM#26 F 4-99**

97. CPA-00300 May 92 #24 Page 27

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

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

**CPA-00300 Explanation**
Choice "a" is correct. During periods of rising prices, when the FIFO inventory method is used, a perpetual inventory system results in an ending inventory cost that is the same as in a periodic inventory system.

FIFO - Companies generally use a FIFO flow of goods to prevent keeping old (obsolete) inventory on hand; thus, periodic inventory (from a physical count) would match FIFO.

LIFO - Generally not the same because generally the old inventory is disposed of on a FIFO basis. (However, piles of coal or ore are generally piled up and removed on a LIFO basis.)

**CPA-00301 Type1 M/C A-D Corr Ans: C PM#27 F 4-99**

98. CPA-00301 Nov 92 II #51 Page 32

Brad Corp. has unconditional purchase obligations associated with product financing arrangements. These obligations are reported as liabilities on Brad's balance sheet, with the related assets also recognized. In the notes to Brad's financial statements, the aggregate amount of payments for these obligations should be disclosed for each of how many years following the date of the latest balance sheet?

a. 0
b. 2
c. 5
d. 10

**CPA-00301 Explanation**


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**Rule:** The aggregate amount of payments to be made on unconditional purchase obligations should be disclosed (in a footnote to the financial statements) for each of the 5 years following the date of the latest balance sheet.

Choice "c" is correct. 5 years.

**CPA-00302 Type1 M/C A-D Corr Ans: D PM#28 F 4-99**

99. CPA-00302 Nov 92 #12 Page 21

Jel Co., a consignee, paid the freight costs for goods shipped from Dale Co., a consignor. These freight costs are to be deducted from Jel's payment to Dale when the consignment goods are sold. Until Jel sells the goods, the freight costs should be included in Jel's:

a. Cost of goods sold.
b. Freight-out costs.
c. Selling expenses.
d. Accounts receivable.

**CPA-00302 Explanation**
Choice "d" is correct. Accounts receivable.

Because these costs are recoverable by Jel (consignee) at the time of sale, Jel should carry accounts receivable from Dale (consignor) until the goods are sold and credit is taken by Jel for the freight costs paid.

Choices "a", "b", and "c" are incorrect because these are all expenses and under this consignment arrangement freight costs are the responsibility of Dale (consignor).

**CPA-00304 Type1 M/C A-D Corr Ans: C PM#29 F 4-99**

100. CPA-00304 Nov 92 #15 Page 28

Jones Wholesalers stocks a changing variety of products. Which inventory costing method will be most likely to give Jones the lowest ending inventory when its product lines are subject to specific price increases?

a. Specific identification.
b. Weighted average.
c. Dollar-value LIFO.
d. FIFO periodic.

**CPA-00304 Explanation**
Choice "c" is correct. Dollar-value LIFO most likely gives the lowest ending inventory when product lines are subject to specific price increases.

When prices increase - LIFO will normally result in the lowest ending inventory because items "last-in" (at higher prices) are expensed to cost of goods sold, while the items "first-in" (at lower prices) make up the ending inventory.

Specifically in this case, dollar value LIFO will most likely help create a lower ending inventory because with the changing variety of products, new or substitute items can be used in the same pricing group rather than become a new group priced at a newer high price.

**CPA-00305 Type1 M/C A-D Corr Ans: A PM#30 F 4-99**

101. CPA-00305 May 94 #3 Page 23

Reporting inventory at the lower of cost or market is a departure from the accounting principle of:


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a. Historical cost.
b. Consistency.
c. Conservatism.
d. Full disclosure.

**CPA-00305 Explanation**
Choice "a" is correct. Reporting inventory at the "lower of cost or market" is a departure from the accounting principle of "historical cost" because inventory is written down to market whenever it is lower.

Choices "b", "c", and "d" are incorrect. Reporting inventory at the "lower of cost or market" follows the accounting principles of "consistency" (if followed consistently between periods), "conservatism" (smallest net worth or net income), and "full disclosure."

**CPA-00306 Type1 M/C A-D Corr Ans: A PM#31 F 4-99**

102. CPA-00306 Nov 89 II #25 Page 25

The following information appeared in the accounting records of a retail store for the year ended December 31, 1988:

| | |
|---|---|
| Sales | $300,000 |
| Purchases | 140,000 |
| Inventories | |
| January 1 | 70,000 |
| December 31 | 100,000 |
| Sales commissions | 10,000 |

The gross margin was:

a. $190,000
b. $180,000
c. $160,000
d. $150,000

**CPA-00306 Explanation**
Choice "a" is correct. $190,000.

| | | |
|---|---|---|
| Sales: | | $300,000 |
| Less: Cost of sales: | | |
| Beginning inventory Jan. 1 | $ 70,000 | |
| Add: Purchases | 140,000 | |
| Subtotal | 210,000 | |
| Less: Ending inventory | (100,000) | |
| Cost of sales | | (110,000) |
| Gross margin | | $190,000 |
| | | **A** |

Note: The sales commissions of $10,000 is a selling expense.

**CPA-00307 Type1 M/C A-D Corr Ans: C PM#32 F 4-99**

103. CPA-00307 May 90 I #10 Page 10

On June 1, 1989, Pitt Corp. sold merchandise with a list price of $5,000 to Burr on account. Pitt allowed trade discounts of 30% and 20%. Credit terms were 2/15, n/40 and the sale was made FOB shipping point. Pitt prepaid $200 of delivery costs for Burr as an accommodation. On June 12, 1989, Pitt received from Burr a remittance in full payment amounting to:


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a. $2,744
b. $2,940
c. $2,944
d. $3,140

**CPA-00307 Explanation**
Choice "c" is correct. $2,944

| | | Balance Subject to Discount |
|---|---|---|
| Cost of merchandise sold | $ 5,000 | |
| Trade discount % | 30% | |
| Trade discount amount | $ 1,500 | |
| Balance | 3,500 | $ 3,500 |
| | 20% | |
| Trade discount amount | $ 700 | |
| Balance | 2,800 | 2,800 |
| Cash discount % | 2% | |
| Cash discount | $ 56 | |
| Balance | | 2,744 |
| Add: Loan of delivery cost | | 200 |
| Expected remittance | | $ 2,944 |

**CPA-00308 Type1 M/C A-D Corr Ans: A PM#33 F 4-99**

104. CPA-00308 May 90 I #13 Page 31

Union Corp. uses the first-in, first-out retail method of inventory valuation. The following information is available:

| | *Cost* | *Retail* |
|---|---|---|
| Beginning inventory | $12,000 | $30,000 |
| Purchases | 60,000 | 110,000 |
| Net additional markups | | 10,000 |
| Net markdowns | | 20,000 |
| Sales revenue | | 90,000 |

If the lower of cost or market rule is disregarded, what would be the estimated cost of the ending inventory?

a. $24,000
b. $20,800
c. $20,000
d. $19,200

**CPA-00308 Explanation**
Choice "a" is correct. $24,000 cost method

| | (FIFO) | | |
|---|---|---|---|
| | Cost | Retail | |
| Begin inventory | 12 | 30 | |
| Purchases | 60 | 110 | |
| Markups | | 10 | |
| Markdowns | | (20) | |
| Net additions | 60 | 100 | ÷ = 60% |
| Total available | | 130 | |


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| | | | |
|---|---|---|---|
| Sales | | | (90) |
| Ending inventory | 24 | = | 40 |

**A**

**Note:** FIFO uses "net additions" and excludes "open inventory."

**CPA-00311 Type1 M/C A-D Corr Ans: B PM#34 F 4-99**

105. CPA-00311 May 90 I #14 Page 10

West Retailers purchased merchandise with a list price of $20,000, subject to trade discounts of 20% and 10%, with no cash discounts allowable. West should record the cost of this merchandise as:

a. $14,000
b. $14,400
c. $15,600
d. $20,000

**CPA-00311 Explanation**
Choice "b" is correct. $14,400

| | | Balance Subject to Discount |
|---|---|---|
| Cost of merchandise | $20,000 | |
| Trade discount % | 20% | |
| Trade discount amount | 4,000 | |
| Balance | 16,000 | $16,000 |
| | 10% | |
| Trade discount amount | 1,600 | (1,600) |
| Balance | | $14,400 |

**CPA-00312 Type1 M/C A-D Corr Ans: A PM#35 F 4-99**

106. CPA-00312 Nov 90 T #15 Page 22

How should the following costs affect a retailer's inventory?

| | *Freight In* | *Interest on Inventory Loan* |
|---|---|---|
| a. | Increase | No effect |
| b. | Increase | Increase |
| c. | No effect | Increase |
| d. | No effect | No effect |

**CPA-00312 Explanation**
Choice "a" is correct. Freight in increases inventory cost for retail inventory and other inventory as freight in is a cost of inventory. Interest on the inventory loan has no effect because interest is a period expense.

Choices "b", "c", and "d" are incorrect, per above rule.

**CPA-00313 Type1 M/C A-D Corr Ans: A PM#36 F 4-99**

107. CPA-00313 Nov 90 T #16 Page 30

The retail inventory method includes which of the following in the calculation of both cost and retail amounts of goods available for sale?

a. Purchase returns.


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b. Sales returns.
c. Net markups.
d. Freight in.

**CPA-00313 Explanation**
Choice "a" is correct. Purchase returns are included in both the retail column and cost column.

**Note:** It's important to memorize the retail worksheet format.

Choices "b" and "c" are incorrect. Sales returns and net markups appear only in the retail column as they both are below the "total available for sale" line.

Choice "d" is incorrect. Freight in appears only in the cost column.

**CPA-00314 Type1 M/C A-D Corr Ans: C PM#37 F 4-99**

108. CPA-00314 Nov 91 I #13 Page 60

In 1989, Cobb adopted the dollar-value LIFO inventory method. At that time, Cobb's ending inventory had a base-year cost and an end-of-year cost of $300,000. In 1990, the ending inventory had a $400,000 base-year cost and a $440,000 end-of-year cost. What dollar-value LIFO inventory cost would be reported in Cobb's December 31, 1990, balance sheet?

a. $440,000
b. $430,000
c. $410,000
d. $400,000

**CPA-00314 Explanation**
Choice "c" is correct. $410,000 dollar-value LIFO inventory cost at 12-31-90.

| Year | End-of-Year Inventory Cost | | Base-Year Inventory Cost | = | Annual Cost Index | × | Annual Increments (Layers) | = | 12-31-90 $-Value LIFO Cost | |
|---|---|---|---|---|---|---|---|---|---|---|
| 1990 | $440,000 | ÷ | $400,000 | = | 1.1 | × | $100,000 | = | $110,000 | |
| 1989 | 300,000 | ÷ | 300,000 | = | 1.0 | × | 300,000 | = | 300,000 | |
| 1990 | Increment | | $100,000 | | | | 400,000 | | 410,000 | **C** |

**CPA-00316 Type1 M/C A-D Corr Ans: B PM#38 F 4-99**

109. CPA-00316 Nov 91 T #28 Page 60

When the double extension approach to the dollar value LIFO inventory method is used, the inventory layer added in the current year is multiplied by an index number. Which of the following correctly states how components are used in the calculation of this index number?

a. In the numerator, the average of the ending inventory at base year cost and at current year cost.
b. In the numerator, the ending inventory at current year cost; in the denominator, the ending inventory at base year cost.
c. In the numerator, the ending inventory at base year cost; in the denominator, the ending inventory at current year cost.
d. In the denominator, the average of the ending inventory at base year cost and at current year cost.

**CPA-00316 Explanation**
Choice "b" is correct.


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$$\text{Index} = \frac{\text{Ending Inventory at Current Year Cost}}{\text{Ending Inventory at Base Year Cost}}$$

**CPA-00319 Type1 M/C A-D Corr Ans: D PM#39 F 4-99**

110. CPA-00319 May 92 I #49 Page 30

Hutch, Inc. uses the conventional retail inventory method to account for inventory. The following information relates to 1991 operations:

| | | *Average* |
|---|---|---|
| | *Cost* | *Retail* |
| Beginning inventory and purchases | $600,000 | $920,000 |
| Net markups | | 40,000 |
| Net markdowns | | 60,000 |
| Sales | | 780,000 |

What amount should be reported as cost of sales for 1991?
a. $480,000
b. $487,500
c. $520,000
d. $525,000

**CPA-00319 Explanation**
Choice "d" is correct. $525,000 cost of sales for 1991.

| | Cost | | Retail |
|---|---|---|---|
| Beg inven & purchases | $600,000 | | $920,000 |
| Net markups | | | 40,000 |
| Total available (cost ratio line) | 600,000 | ÷ | 960,000 = 62.5% |
| Sales | | | (780,000) |
| Net markdowns | | | (60,000) |
| Ending inventory | (75,000) | = | 120,000 |
| Cost of sales | $525,000 | | |

**CPA-00323 Type1 M/C A-D Corr Ans: B PM#40 F 4-99**

111. CPA-00323 Nov 93 I #46 Page 46

On January 2, 1992, Emme Co. sold equipment with a carrying amount of $480,000 in exchange for a $600,000 non-interest bearing note due January 2, 1995. There was no established exchange price for the equipment. The prevailing rate of interest for a note of this type at January 2, 1992, was 10%. The present value of 1 at 10% for three periods is 0.75.

In Emme's 1992 income statement, what amount should be reported as interest income?

a. $9,000
b. $45,000
c. $50,000
d. $60,000

**CPA-00323 Explanation**
**Rule:** A non-interest bearing note should be recorded at its present value calculated using the prevailing market interest rate. The market interest rate is then used to calculate interest on the note.

Face amount of non-interest bearing note $600,000


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| | |
|---|---|
| Present value factor at 10% for 3 periods | .75 |
| Carrying amount at 1-2-92 | 450,000 |
| Interest rate | × 10% |
| Interest income for 1992 | $ 45,000 |

Choice "b" is correct. $45,000 interest income for 1992.

**CPA-00327 Type1 M/C A-D Corr Ans: A PM#41 F 4-99**

112. CPA-00327 Nov 90 #22 Page 4

Which of the following is generally associated with payables classified as accounts payable?

| | *Periodic Payment of Interest* | *Secured by Collateral* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | No |
| d. | Yes | Yes |

**CPA-00327 Explanation**

Choice "a" is correct. No - No. Neither "periodic payment of interest" nor "secured by collateral" are generally associated with payables classified as accounts payable.

A liability that requires the periodic payment of interest should be classified as an accrued liability or debt.

A liability that is secured by collateral should be classified as a loan payable.

**CPA-00328 Type1 M/C A-D Corr Ans: A PM#42 F 4-99**

113. CPA-00328 Nov 92 I #21 Page 4

Rabb Co. records its purchases at gross amounts but wishes to change to recording purchases net of purchase discounts. Discounts available on purchases recorded from October 1, 1991, to September 30, 1992, totaled $2,000. Of this amount, $200 is still available in the accounts payable balance. The balances in Rabb's accounts as of and for the year ended September 30, 1992, before conversion are:

| | |
|---|---|
| Purchases | $100,000 |
| Purchase discounts taken | 800 |
| Accounts payable | 30,000 |

What is Rabb's accounts payable balance as of September 30, 1992, after the conversion?

a. $29,800
b. $29,200
c. $28,800
d. $28,200

**CPA-00328 Explanation**

Choice "a" is correct. $29,800.

| | |
|---|---|
| Accounts payable at "gross" amounts before adjustment for purchase discounts | $30,000 |
| Purchase discounts in AP balance, available; but not yet taken | <200> |
| Accounts payable net of purchase discounts | $ 29,800 |

**CPA-00329 Type1 M/C A-D Corr Ans: A PM#43 F 4-99**

114. CPA-00329 May 90 I #5 Page 18


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Garr Co. received a $60,000, 6-month, 10% interest-bearing note from a customer. After holding the note for two months, Garr was in need of cash and discounted the note at the United Local Bank at 12%. The amount of cash Garr received from the bank was:

a. $60,480
b. $60,630
c. $61,740
d. $62,520

**CPA-00329 Explanation**
Choice "a" is correct. $60,480 cash proceeds received from bank.

| | | Approach I Net Proceeds At Discount | Approach II Net Interest Revenue (Expense) |
|---|---|---|---|
| Face of note | 60,000 | $60,000 | |
| Int Rt on note 10% × 1/2 yr | × 5% | | |
| | | 3,000 | $3,000 |
| Maturity value of note | 63,000 | 63,000 | |
| Disc by bank - 12% × 4/12 yr | 4% | | |
| | | (2,520) | (2,520) |
| Proceeds from bank | | $60,480 | |
| | | **A** | |
| Net interest income (expense) | | | $ 480 |

**CPA-00330 Type1 M/C A-D Corr Ans: B PM#44 F 4-99**

115. CPA-00330 May 90 T #8 Page 18

A company issued a short-term note payable with a stated 12 percent rate of interest to a bank. The bank charged a .5 % loan origination fee and remitted the balance to the company. The effective interest rate paid by the company in this transaction would be:

a. Equal to 12.5%.
b. More than 12.5%.
c. Less than 12.5%.
d. Independent of 12.5%.

**CPA-00330 Explanation**
Choice "b" is correct. Effective interest rate paid of more than 12.5%.

The effective interest rate paid by the company would include all costs charged by the bank such as the .5% loan origination fee.

Since the loan origination fee was taken out up front, the company's effective interest rate is more than 12.5% (12% interest rate + .5% loan origination fee) due to the loss to the company of the time value of the money involved.

Illustration:

$$\frac{\text{12\% Int. Rate} + \text{.5\% Loan Orig. Fee}}{\text{100\% Face of N/P} - \text{.5\% Loan Orig. Fee Upfront}} = \frac{12.5\%}{99.5\%} = 12.563\%$$


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**CPA-00331 Type1 M/C A-D Corr Ans: C PM#45 F 4-99**

116. CPA-00331 Nov 90 I #13 Page 18

On September 1, 1988, Cobb Co. issued a note payable to National Bank in the amount of $900,000, bearing interest at 12%, and payable in three equal annual principal payments of $300,000. On this date, the bank's prime rate was 11%. The first payment for interest and principal was made on September 1, 1989. At December 31, 1989, Cobb should record accrued interest payable of:

a. $36,000
b. $33,000
c. $24,000
d. $22,000

**CPA-00331 Explanation**
Choice "c" is correct. $24,000 accrued interest payable at 12-31-89.

| | |
|---|---|
| Original note amount at 9-1-88 | $900,000 |
| Principal payment on 9-1-89 | (300,000) |
| Balance | 600,000 |
| Interest rate and time (12% × 4/12) | × 4% |
| Accrued interest payable at 12-31-89 | $ 24,000 |

**CPA-00332 Type1 M/C A-D Corr Ans: A PM#46 F 4-99**

117. CPA-00332 Nov 91 I #54 Page 18

Loeb Corp. frequently borrows from the bank in order to maintain sufficient operating cash. The following loans were at a 12% interest rate, with interest payable at maturity. Loeb repaid each loan on its scheduled maturity date.

| *Date of Loan* | *Amount* | *Maturity Date* | *Term of Loan* |
|---|---|---|---|
| 11/1/89 | $ 5,000 | 10/31/90 | 1 Year |
| 2/1/90 | 15,000 | 7/31/90 | 6 Months |
| 5/1/90 | 8,000 | 1/31/91 | 9 Months |

Loeb records interest expense when the loans are repaid. As a result, interest expense of $1,500 was recorded in 1990. If no correction is made, by what amount would 1990 interest expense be understated?

a. $540
b. $620
c. $640
d. $720

**CPA-00332 Explanation**
Choice "a" is correct. 1990 interest paid in cash is understated by $540 ($2040 – $1500).

| Loan | Term in | Interest at | Paid in | Accrual for 1990 | |
|---|---|---|---|---|---|
| Amount | Months | Maturity | 1990 | Months | Amount |
| $ 5,000 | 12 | $600 | $ 600 | 10 | $ 500 |
| 15,000 | 6 | 900 | 900 | 6 | 900 |
| 8,000 | 9 | 720 | - | 8 | 640 |
| | | | *$1,500* | | *$2,040* |

**CPA-00333 Type1 M/C A-D Corr Ans: D PM#47 F 4-99**

118. CPA-00333 May 92 I #15 Page 18


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On December 31, 1991, Jet Co. received two $10,000 notes receivable from customers in exchange for services rendered. On both notes, interest is calculated on the outstanding principal balance at the annual rate of 3% and payable at maturity. The note from Hart Corp., made under customary trade terms, is due in nine months and the note from Maxx, Inc. is due in five years. The market interest rate for similar notes on December 31, 1991, was 8%. The compound interest factors to convert future values into present values at 8% follow:

| | |
|---|---|
| Present value of $1 due in nine months: | .944 |
| Present value of $1 due in five years: | .680 |

At what amounts should these two notes receivable be reported in Jet's December 31, 1991, balance sheet?

| | *Hart* | *Maxx* |
|---|---|---|
| a. | $9,440 | $6,800 |
| b. | $9,652 | $7,820 |
| c. | $10,000 | $6,800 |
| d. | $10,000 | $7,820 |

**CPA-00333 Explanation**
Choice "d" is correct. $10,000 (Hart) and $7,820 (Maxx).

**Rule:** Trade notes and accounts receivable with customary trade terms **not** exceeding one year may be recorded at face amount.

| | Hart | Maxx |
|---|---|---|
| Face amount of note | $10,000 | $10,000 |
| Interest rate | | 3% |
| Annual interest | | 300 |
| Term of note | | 5 |
| Interest | | 1,500 |
| Principal | | 10,000 |
| Amount due at maturity | | 11,500 |
| Present value factor | | × .680 |
| Present value of notes | $10,000 | $ 7,820 |

"Customary Trade Terms"

**CPA-00337 Type1 M/C A-D Corr Ans: C PM#48 F 4-99**

119. CPA-00337 May 92 I #41 Page 18

Ace Co. sold to King Co. a $20,000, 8%, 5-year note that required five equal annual year-end payments. This note was discounted to yield a 9 % rate to King. The present value factors of an ordinary annuity of $1 for five periods are as follows:

| | |
|---|---|
| 8% | 3.992 |
| 9% | 3.890 |

What should be the total interest revenue earned by King on this note?

a. $9,000
b. $8,000
c. $5,560
d. $5,050

**CPA-00337 Explanation**
Choice "c" is correct. $5,560 total interest revenue.


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| | |
|---|---|
| Annual payments = $20,000 ÷ 3.992 = | $ 5,010 |
| Five equal payments of principal and interest. | × 5 |
| Total payments | 25,050 |
| Discounted note = $5,010 × 3.890 = | (19,490) |
| Total interest over five years | $ 5,560 |

**CPA-00339 Type1 M/C A-D Corr Ans: B PM#49 F 4-99**

120. CPA-00339 May 92 T #21 Page 18

On August 15, 1991, Benet Co. sold goods for which it received a note bearing the market rate of interest on that date. The four-month note was dated July 15, 1991. Note principal, together with all interest, is due November 15, 1991. When the note was recorded on August 15, which of the following accounts increased?

a. Unearned discount.
b. Interest receivable.
c. Prepaid interest.
d. Interest revenue.

**CPA-00339 Explanation**

Choice "b" is correct. "Interest receivable" increased on the date of sale of the goods, August 15.

Example: Assume $1000 note bearing interest at 12%. At 8-15-91 (one month after the note date of 7-15-91) the JE would be:

| | DR | CR |
|---|---|---|
| Note receivable | 1000 | |
| Interest receivable (1,000 × 12% × 1/12) | 10 | |
| Revenue | | 1010 |

Choice "a" is incorrect. The note is recorded at FV and excludes future interest.

Choice "c" is incorrect. No interest is prepaid; interest is paid at maturity.

Choice "d" is incorrect. Benet Co. will earn interest revenue only over the period it holds the note (August 15 - November 15).

**CPA-00340 Type1 M/C A-D Corr Ans: C PM#50 F 4-99**

121. CPA-00340 Nov 92 I #22 Page 18

On August 1, 1991, Vann Corp.'s $500,000, one year, noninterest-bearing note due July 31,1992, was discounted at Homestead Bank at 10.8%. Vann uses the straight-line method of amortizing bond discount. What amount should Vann report for notes payable in its December 31, 1991, balance sheet?

a. $500,000
b. $477,500
c. $468,500
d. $446,000

**CPA-00340 Explanation**

| | |
|---|---|
| Face amount of note | $500,000 |
| Discount (500,000 × 10.8% × 12/12) | (54,000) |
| Proceeds at 8/1/91 when discounted | 446,000 |
| S.L. Amortization of discount for Aug 91 - Dec 91 ($54,000 × 5/12) | 22,500 |
| Carrying amount at 12/31/91 | $468,500 |

Choice "c" is correct. $468,500 carrying value of notes payable on the December 31,1991, balance sheet.


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**CPA-00342 Type1 M/C A-D Corr Ans: B PM#51 F 4-99**

122. CPA-00342 Nov 92 T #4 Page 18

After being held for 40 days, a 120-day 12% interest-bearing note receivable was discounted at a bank at 15%. The proceeds received from the bank equal:

a. Maturity value less the discount at 12%.
b. Maturity value less the discount at 15%.
c. Face value less the discount at 12%.
d. Face value less the discount at 15%.

**CPA-00342 Explanation**
Choice "b" is correct. Maturity value less the discount at 15%. The discount is always applied on the maturity value.

Choice "a" is incorrect. The discount is taken at the discount rate (15%), **not** the note rate (12%).

Choice "c" is incorrect. The maturity value is used, **not** face value, and the discount rate (15%) is used, not note rate (12%).

Choice "d" is incorrect. The maturity value is used, **not** face value.

**CPA-00343 Type1 M/C A-D Corr Ans: C PM#52 F 4-99**

123. CPA-00343 Nov 92 T #9 Page 18

Pie Co. uses the installment sales method to recognize revenue. Customers pay the installment notes in 24 equal monthly amounts, which include 12% interest. What is an installment note's receivable balance six months after the sale?

a. 75% of the original sales price.
b. Less than 75% of the original sales price.
c. The present value of the remaining monthly payments discounted at 12%.
d. Less than the present value of the remaining monthly payments discounted at 12%.

**CPA-00343 Explanation**
Choice "c" is correct. The present value of the remaining monthly payments discounted at 12% equals the installment note receivable balance at any time.

Choice "a" is incorrect. Because the early loan payments are mostly interest, with little principal pay down, the balance will be more than 75% of the original price.

Choice "b" is incorrect. Because the balance will be more than 75% of the loan balance.

Choice "d" is incorrect. Because the balance will always be the present value of the remaining monthly payments discounted at 12%.

**CPA-00347 Type1 M/C A-D Corr Ans: A PM#53 F 4-99**

124. CPA-00347 Nov 93 I #47 Page 18

On January 2, 1992, Emme Co. sold equipment with a carrying amount of $480,000 in exchange for a $600,000 non-interest bearing note due January 2, 1995. There was no established exchange price for the equipment. The prevailing rate of interest for a note of this type at January 2, 1992, was 10%. The present value of 1 at 10% for three periods is 0.75.

In Emme's 1992 income statement, what amount should be reported as gain (loss) on sale of machinery?

a. ($30,000) loss.
b. $30,000 gain.


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c. $120,000 gain.
d. $270,000 gain.

**CPA-00347 Explanation**
Choice "a" is correct. ($30,000) loss in 1992 on sale of machinery.

| | |
|---|---|
| Proceeds on sale ($600,000 × .75) | $450,000 |
| Carrying amount of equipment on 1-2-92 | (480,000) |
| Loss on sale in 1992 income statement | $(30,000) **A** |

**CPA-00354 Type1 M/C A-D Corr Ans: C PM#54 F 4-99**

125. CPA-00354 Nov 93 T #33 Page 18

Which of the following is reported as interest expense?

a. Pension cost interest.
b. Postretirement healthcare benefits interest.
c. Imputed interest on non-interest bearing note.
d. Interest incurred to finance construction of machinery for own use.

**CPA-00354 Explanation**
Choice "c" is correct. Imputed interest on non-interest bearing note is reported as interest expense.

Choice "a" is incorrect. Pension cost interest is a component of pension plan expense.

Choice "b" is incorrect. Post retirement healthcare benefits interest is part of post retirement benefit expense.

Choice "d" is incorrect. Interest incurred to finance construction of machinery for own use is capitalized as part of the cost of the machinery.

**CPA-00355 Type1 M/C A-D Corr Ans: D PM#55 F 4-99**

126. CPA-00355 May 94 #30 Page 18

The discount resulting from the determination of a note payable's present value should be reported on the balance sheet as a (an):

a. Addition to the face amount of the note.
b. Deferred charge separate from the note.
c. Deferred credit separate from the note.
d. Direct reduction from the face amount of the note.

**CPA-00355 Explanation**
Choice "d" is correct. The discount on a note payable should be reported on the balance sheet as a direct reduction from the face amount of the note.

Choice "a" is incorrect. A discount is a reduction; a premium would be an addition.

Choice "b" is incorrect. The discount should **not** be shown separately as a deferred charge. By directly reducing the face of the note, the note payable is shown at its "present" value.

Choice "c" is incorrect. A deferred credit is appropriate for "deferred revenue," not a notes payable "present value."

**CPA-00356 Type1 M/C A-D Corr Ans: B PM#56 F 4-99**

127. CPA-00356 Nov 94 #22 Page 18


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House Publishers offered a contest in which the winner would receive $1,000,000, payable over 20 years. On December 31, 1993, House announced the winner of the contest and signed a note payable to the winner for $1,000,000, payable in $50,000 installments every January 2. Also on December 31, 1993, House purchased an annuity for $418,250 to provide the $950,000 prize monies remaining after the first $50,000 installment, which was paid on January 2, 1994.

In its December 31, 1993, balance sheet, what amount should House report as note payable-contest winner, net of current portion?

a. $368,250
b. $418,250
c. $900,000
d. $950,000

**CPA-00356 Explanation**
Choice "b" is correct. $418,250 note payable at Dec 31, 1993, net of current portion (of $50,000 paid on Jan 2, 1994).

$418,250 (the amount of the annuity purchased) is the present value of the 19 payments of $50,000, after the first payment. The first payment of $50,000 has a present value of $50,000 and is classified as current.

**CPA-00357 Type1 M/C A-D Corr Ans: C PM#57 F 4-99**

128. CPA-00357 Nov 94 #23 Page 18

House Publishers offered a contest in which the winner would receive $1,000,000, payable over 20 years. On December 31, 1993, House announced the winner of the contest and signed a note payable to the winner for $1,000,000, payable in $50,000 installments every January 2. Also on December 31, 1993, House purchased an annuity for $418,250 to provide the $950,000 prize monies remaining after the first $50,000 installment, which was paid on January 2, 1994.

In its 1993 income statement, what should House report as contest prize expense?

a. $0
b. $418,250
c. $468,250
d. $1,000,000

**CPA-00357 Explanation**
Choice "c" is correct. $468,250 contest prize expense.

| | |
|---|---|
| First payment on 1/2/94 | $ 50,000 |
| Present value of 19 subsequent payments | 418,250 |
| Contest prize expense in 1993 income statement | $468,250 |

**CPA-00358 Type1 M/C A-D Corr Ans: B PM#58 F 4-99**

129. CPA-00358 Nov 94 #38 Page 18

Leaf Co. purchased from Oak Co. a $20,000, 8%, 5-year note that required five equal annual year-end payments of $5,009. The note was discounted to yield a 9% rate to Leaf. At the date of purchase, Leaf recorded the note at its present value of $19,485. What should be the total interest revenue earned by Leaf over the life of this note?

a. $5,045
b. $5,560
c. $8,000
d. $9,000

**CPA-00358 Explanation**


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| | |
|---|---|
| Total payments – $5,009 × 5 = | $25,045 |
| Principal paid at present value | (19,485) |
| Interest revenue | $ 5,560 |

Choice "b" is correct. $5,560 total interest revenue over the life of this 5-year note.

Choice "a" is incorrect, ($25,045 – $20,000 = $5,045) because the $20,000 is merely a face amount, not the amount paid.

Choice "c" is incorrect, ($20,000 × 8% × 5 years = $8,000) because the principal amount was paid down each year and the market rate of 9% would be used, not the "face" rate of 8%.

Choice "d" is incorrect, ($20,000 × 9% × 5 years = $9,000) because the principal amount was paid down each year.

**CPA-00359 Type1 M/C A-D Corr Ans: B PM#59 F 4-99**

130. CPA-00359 May 90 T #6 Page 3

The premium on a three-year insurance policy expiring on December 31, 1991 was paid in total on January 2, 1989. If the company has a six-month operating cycle, then on December 31, 1989, the prepaid insurance reported as a current asset would be for:

a. 6 months.
b. 12 months.
c. 18 months.
d. 24 months.

**CPA-00359 Explanation**
Choice "b" is correct. 12 months.

The minimum operating cycle for purposes of reporting a "prepaid" current asset is one year.

Choices "a", "c", and "d" are incorrect. (Only) one year of a prepaid item such as insurance which may be prepaid for the next 2 years would be reported as "current."

**CPA-00360 Type1 M/C A-D Corr Ans: D PM#60 F 4-99**

131. CPA-00360 Nov 91 I #1 Page 4

Gar, Inc.'s trial balance reflected the following liability account balances at December 31, 1990:

| | |
|---|---|
| Accounts payable | $19,000 |
| Bonds payable, due 1991 | 34,000 |
| Deferred income tax payable | 4,000 |
| Discount on bonds payable | 2,000 |
| Dividends payable on 2/15/91 | 5,000 |
| Income tax payable | 9,000 |
| Notes payable, due 1/19/92 | 6,000 |

The deferred income tax payable is based on temporary differences that will reverse in 1992 and 1993.

In Gar's December 31, 1990, balance sheet, the current liabilities total was:

a. $71,000
b. $69,000
c. $67,000
d. $65,000

**CPA-00360 Explanation**
Choice "d" is correct. $65,000 total current liabilities.


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The current liabilities consist of all payables due within one year.

| | | |
|---|---|---|
| Accounts payable | $19,000 | |
| Bonds payable, due 1991 | 34,000 | |
| Discount on bonds payable | (2,000) | Tricky!! |
| Dividends payable, due 2/15/91 | 5,000 | **D** |
| Income tax payable | 9,000 | |
| Total current liabilities | $65,000 | |

The "deferred income tax payable" of $4,000 is a separate "deferred category" on the balance sheet, and is not considered a current item.

The "notes payable" due 1/19/92 are due after one year and are considered a long-term liability.

**CPA-00361 Type1 M/C A-D Corr Ans: C PM#61 F 4-99**

132. CPA-00361 Nov 91 I #21 Page 4

At December 31, 1990, Cain, Inc. owed notes payable of $1,750,000, due on May 15, 1991. Cain expects to retire this debt with proceeds from the sale of 100,000 shares of its common stock. The stock was sold for $15 per share on March 10, 1991, prior to the issuance of the year-end financial statements. In Cain's December 31, 1990, balance sheet, what amount of the notes payable should be excluded from current liabilities?

a. $0
b. $250,000
c. $1,500,000
d. $1,750,000

**CPA-00361 Explanation**
Choice "c" is correct. $1,500,000 should be excluded from current liabilities because 100,000 shares of common stock were sold at $15 per share. The remaining $250,000 should be included in current liabilities because current assets will be used to pay off the balance.

**Rule:** Long-term debt that matures within one year should be classified as a current liability, unless retirement is to be accomplished with other than current assets.

**CPA-00362 Type1 M/C A-D Corr Ans: A PM#62 F 4-99**

133. CPA-00362 Nov 92 T #13 Page 5

At October 31, 1992, Dingo, Inc. had cash accounts at three different banks. One account balance is segregated solely for a November 15, 1992, payment into a bond sinking fund. A second account, used for branch operations, is overdrawn. The third account, used for regular corporate operations, has a positive balance. How should these accounts be reported in Dingo's October 31, 1992, classified balance sheet?

a. The segregated account should be reported as a noncurrent asset, the regular account should be reported as a current asset, and the overdraft should be reported as a current liability.
b. The segregated and regular accounts should be reported as current assets, and the overdraft should be reported as a current liability.
c. The segregated account should be reported as a noncurrent asset, and the regular account should be reported as a current asset net of the overdraft.
d. The segregated and regular accounts should be reported as current assets net of the overdraft.

**CPA-00362 Explanation**
Choice "a" is correct. The segregated bank account (at bank #1) to be used to pay a current maturity of a long-term bond sinking fund debt should be classified as a noncurrent asset, not "cash."


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The regular account (at bank #3) should be reported as a current asset.

The overdraft (at bank #2) should be reported as a current liability because no legal right of offset exists at different banks.

Choices "b", "c", and "d" are incorrect, per explanation above.

**CPA-00363 Type1 M/C A-D Corr Ans: A PM#63 F 4-99**

134. CPA-00363 May 93 I #1 Page 5

The following is Gold Corp.'s June 30, 1992, trial balance:

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

Additional Information:

- Checks amounting to $30,000 were written to vendors and recorded on June 29, 1992, resulting in a cash overdraft of $10,000. The checks were mailed on July 9, 1992.
- Land held for resale was sold for cash on July 15, 1992.
- Gold issued its financial statements on July 31, 1992.

In its June 30, 1992, balance sheet, what amount should Gold report as current assets?

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

**CPA-00363 Explanation**
Answer:

| Current Assets | Current Assets at 6-30-92 |
|---|---|
| Cash overdraft | $ (10,000) |
| Add back checks not mailed until July 9, 1992 | 30,000 |
| Cash, as adjusted | 20,000 |
| Accounts receivable, net | 35,000 |
| Inventory | 58,000 |
| Prepaid expenses | 12,000 |
| Land held for resale and sold for cash 7-15-92 | 100,000 |
| Current assets at June 30, 1992 | $225,000 |

Choice "a" is correct. $225,000 current assets in June 30, 1992, balance sheet.

**Note:** Checks are **not** considered a disbursement until mailed because they are still under the control of the company.

**CPA-00364 Type1 M/C A-D Corr Ans: A PM#64 F 4-99**


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135. CPA-00364 Nov 93 I #1 Page 4

Mill Co.'s trial balance included the following account balances at December 31, 1992:

| | |
|---|---|
| Accounts payable | $15,000 |
| Bonds payable, due 1993 | 25,000 |
| Discount on bonds payable, due 1993 | 3,000 |
| Dividends payable 1/31/93 | 8,000 |
| Notes payable, due 1994 | 20,000 |

What amount should be included in the current liability section of Mill's December 31, 1992, balance sheet?

a. $45,000
b. $51,000
c. $65,000
d $78,000

**CPA-00364 Explanation**
Choice "a" is correct. $45,000 should be included in the current liability section of the Dec. 31, 1992, balance sheet.

| | | |
|---|---|---|
| Current Liabilities | | |
| Accounts Payable | | $15,000 |
| Bonds payable, due 1993 | 25,000 | |
| Less discount on bonds | (3,000) | 22,000 |
| Dividends payable 1/31/93 | | 8,000 |
| Total current liabilities | | $45,000 |
| Long-Term Liabilities | | |
| Notes payable, due 1994 | | 20,000 |

**CPA-00365 Type1 M/C A-D Corr Ans: A PM#65 F 4-99**

136. CPA-00365 Nov 94 #8 Page 3

The following trial balance of Trey Co. at December 31, 1993, has been adjusted except for income tax expense.

| | *Dr.* | *Cr.* |
|---|---|---|
| Cash | $ 550,000 | |
| Accounts receivable, net | 1,650,000 | |
| Prepaid taxes | 300,000 | |
| Accounts Payable | | $ 120,000 |
| Common stock | | 500,000 |
| Additional paid-in capital | | 680,000 |
| Retained earnings | | 630,000 |
| Foreign currency translation adjustment | 430,000 | |
| Revenues | | 3,600,000 |
| Expenses | 2,600,000 | |
| | $5,530,000 | $5,530,000 |

Additional information
- During 1993, estimated tax payments of $300,000 were charged to prepaid taxes. Trey has not yet recorded income tax expense. There were no differences between financial statement and income tax income, and Trey's tax rate is 30%.
- Included in accounts receivable is $500,000 due from a customer. Special terms granted to this customer require payment in equal semiannual installments of $125,000 every April 1 and October 1.

In Trey's December 31, 1993, balance sheet, what amount should be reported as total current assets?

a. $1,950,000


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b. $2,200,000
c. $2,250,000
d. $2,500,000

**CPA-00365 Explanation**
Choice "a" is correct. $1,950,000 total current assets.

| Income Statement | |
|---|---|
| Revenues | $3,600 |
| Expenses | (2,600) |
| Pretax income | 1,000 |
| Tax at 30% | (300) **3** |
| Net income | $ 700 **2** |

| Current Assets | Prelim | AJE Dr (Cr) | Final |
|---|---|---|---|
| Cash | 550 | | 550 |
| A/R | 1,650 | (250) | 1,400 |
| Prepaid tax | 300 | (300) **1** | 0 |
| Total curr | 2,500 | (550) | 1,950 |

**CPA-00366 Type1 M/C A-D Corr Ans: C PM#66 F 4-99**

137. CPA-00366 Nov 91 I #17 Page 18

On July 1, 1991, Lee Co. sold goods in exchange for a $200,000, 8-month, noninterest-bearing note receivable. At the time of the sale, the note's market rate of interest was 12%. What amount did Lee receive when it discounted the note at 10% on September 1, 1991?

a. $194,000
b. $193,800
c. $190,000
d. $188,000

**CPA-00366 Explanation**
Choice "c" is correct. $190,000 cash received when the note was discounted at the bank on September 1, 1991.

| | |
|---|---|
| Face amount of note (noninterest-bearing) | $ 200,000 |
| Bank discount: 10% × 6/12 = 5% | (10,000) |
| Proceeds from bank | $190,000 |

**CPA-00367 Type1 M/C A-D Corr Ans: C PM#67 F 4-99**

138. CPA-00367 May 90 I #15 Page 35

On December 1, 1989, East Co. purchased a tract of land as a factory site for $300,000. The old building on the property was razed, and salvaged materials resulting from demolition were sold. Additional costs incurred and salvage proceeds realized during December 1989 were as follows:

| | |
|---|---|
| Cost to raze old building | $25,000 |
| Legal fees for purchase contract and to record ownership | 5,000 |
| Title guarantee insurance | 6,000 |
| Proceeds from sale of salvaged materials | 4,000 |

In East's December 31, 1989 balance sheet, what amount should be reported as land?

a. $311,000


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b. $321,000
c. $332,000
d. $336,000

**CPA-00367 Explanation**
Choice "c" is correct. $332,000 should be reported as land on 12-31-89 BS.

Cost of land includes all costs necessary to put it in the place and condition for construction of the building as follows:

| | |
|---|---|
| Purchase price | $300,000 |
| Cost to raze old building | 25,000 |
| Legal fees for purchase contract and to record ownership | 5,000 |
| Title guaranty insurance | 6,000 |
| Subtotal | $336,000 |
| Less proceeds from sales of salvaged materials | (4,000) |
| Total cost of land | $332,000 |

**CPA-00368 Type1 M/C A-D Corr Ans: D PM#68 F 4-99**

139. CPA-00368 May 90 I #16 Page 34

On June 18, 1989, Dell Printing Co. incurred the following costs for one of its printing presses:

| | |
|---|---|
| Purchase of collating and stapling attachment | $84,000 |
| Installation of attachment | 36,000 |
| Replacement parts for overhaul of press | 26,000 |
| Labor and overhead in connection with overhaul | 14,000 |

The overhaul resulted in a significant increase in production. Neither the attachment nor the overhaul increased the estimated useful life of the press. What amount of the above costs should be capitalized?

a. $0
b. $84,000
c. $120,000
d. $160,000

**CPA-00368 Explanation**
Choice "d" is correct. $160,000. All the costs should be capitalized.

**Rule:** Capitalize all costs necessary to put a fixed asset in place, in the required condition, at the proper time for its intended use.

The collating and stapling attachment along with related installation costs should be capitalized.

**Rule:** Capitalize costs that improve the quality, efficiency, or productive capacity of a fixed asset.

**CPA-00369 Type1 M/C A-D Corr Ans: B PM#69 F 4-99**

140. CPA-00369 May 90 #5 Page 35

Land was purchased to be used as the site for the construction of a plant. A building on the property was sold and removed by the buyer so that construction on the plant could begin. The proceeds from the sale of the building should be:

a. Classified as other income.
b. Deducted from the cost of the land.
c. Netted against the costs to clear the land and expensed as incurred.
d. Netted against the costs to clear the land and amortized over the life of the plant.

**CPA-00369 Explanation**


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Choice "b" is correct. The proceeds from the sale of the building should be deducted from the cost of the land.

**Rule:** Cost of land includes all costs necessary to put the land in place and condition for construction of the plant. Any proceeds from the sale of any existing buildings (or standing timber, or soil) or scrap are deducted from the cost of the land.

Choice "a" is incorrect. The proceeds are a part of the cost of the land, not other income.

Choices "c" and "d" are incorrect. Costs to clear the land are capitalized, not expensed or amortized.

**CPA-00370 Type1 M/C A-D Corr Ans: D PM#70 F 4-99**

141. CPA-00370 May 91 #23 Page 38

During 1990, Bay Co. constructed machinery for its own use and for sale to customers. Bank loans financed these assets both during construction and after construction was complete. How much of the interest incurred should be reported as interest expense in the 1990 income statement?

| | *Interest Incurred for Machinery for Own Use* | *Interest Incurred for Machinery Held for Sale* |
|---|---|---|
| a. | All interest incurred | All interest incurred |
| b. | All interest incurred | Interest incurred after completion |
| c. | Interest incurred after completion | Interest incurred after completion |
| d. | Interest incurred after completion | All interest incurred |

**CPA-00370 Explanation**

Choice "d" is correct. Interest incurred after completion / All interest incurred

**Rule:** Interest costs incurred during the construction period of machinery to be used by a firm as a fixed asset should be capitalized as part of the historic cost of acquiring the fixed asset. Interest costs on the fixed asset subsequent to the construction period as well as all interest costs on the manufacture of machinery for sale to customers (inventory) should be expensed in the income statement for the period incurred.

**CPA-00374 Type1 M/C A-D Corr Ans: B PM#72 F 4-99**

142. CPA-00374 May 92 I #45 Page 46

On July 1, 1991, one of Rudd Co.'s delivery vans was destroyed in an accident. On that date, the van's carrying value was $2,500. On July 15, 1991, Rudd received and recorded a $700 invoice for a new engine installed in the van in May 1991, and another $500 invoice for various repairs. In August, Rudd received $3,500 under its insurance policy on the van, which it plans to use to replace the van. What amount should Rudd report as gain (loss) on disposal of the van in its 1991 income statement?

a. $1,000
b. $300
c. $0
d. $(200)

**CPA-00374 Explanation**

Choice "b" is correct. $300 gain.


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**Rule:** Gains or losses on disposal of fixed assets (including involuntary conversions) are recognized during the period incurred based on recorded amount (NBV). Any insurance proceeds must be included in the determination:

| | |
|---|---|
| NBV of truck on July 15, 1991 | $ 2,500 |
| Add accrued costs for new engine installed May 1991 | 700 |
| Adjusted NBV | $ 3,200 |
| Less insurance proceeds | $ 3,500 |
| Gain on disposal | $ 300 |

Note: Repairs of $500 would have been expensed and would not have become part of the NBV.

**CPA-00375 Type1 M/C A-D Corr Ans: B PM#73 F 4-99**

143. CPA-00375 May 92 #11 Page 34

Derby Co. incurred costs to modify its building and to rearrange its production line. As a result, an overall reduction in production costs is expected. However, the modifications did not increase the building's market value, and the rearrangement did not extend the production line's life. Should the building modification costs and the production line rearrangement costs be capitalized?

| | *Building Modification Costs* | *Production Line Rearrangement Costs* |
|---|---|---|
| a. | Yes | No |
| b. | Yes | Yes |
| c. | No | No |
| d. | No | Yes |

**CPA-00375 Explanation**
Choice "b" is correct. Yes - Yes.

**Rule:** Expense ordinary repairs but capitalize expenditures, which are "additions" or "benefit several periods" or "improve efficiency" as is the case in this question.

**CPA-00376 Type1 M/C A-D Corr Ans: B PM#74 F 4-99**

144. CPA-00376 Nov 89 I #52 Page 43

On January 1, 1987, Aker Corp. acquired a machine at a cost of $200,000. It was to be depreciated on the straight line method over a five-year period with no residual value. Because of a bookkeeping error, no depreciation was recognized in Aker's 1987 financial statements. The oversight was discovered during the preparation of Aker's 1988 financial statements. Depreciation expense on this machine for 1988 should be:

a. $0
b. $40,000
c. $50,000
d. $80,000

**CPA-00376 Explanation**
Choice "b" is correct. $40,000.

Only one year of depreciation expense should be recorded in 1988 ($200,000 ÷ 5 = $40,000 per year).

The $40,000 depreciation expense not recorded in 1987 should be treated as a "prior period adjustment" in 1988 because it is a correction of an error. Accordingly, the beginning retained earnings of 1988 should be adjusted, net of tax.

Example (assume 1988 net income of $1,000,000 and a tax rate of 40%):


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| Retained earnings at the beginning of the year: | 1988 | |
|---|---|---|
| As previously reported | $2,024,000 | (Assume) |
| Prior period adjustment, Net of tax (note 2) | (24,000) | ($40,000 – $16,000) |
| As restated | $2,000,000 | |
| Net income (1988) | 1,000,000 | |
| Subtotal | 3,000,000 | |
| Dividends declared (assume) | (500,000) | |
| Retained earnings at end of year | $2,500,000 | |

**CPA-00377 Type1 M/C A-D Corr Ans: B PM#75 F 4-99**

145. CPA-00377 May 90 #20 Page 44

A fixed asset with a five-year estimated useful life and no residual value is sold at the end of the second year of its useful life. How would using the sum-of-the-year's-digits method of depreciation instead of the double declining balance method of depreciation affect a gain or loss on the sale of the fixed asset?

| | *Gain* | *Loss* |
|---|---|---|
| a. | Decrease | Decrease |
| b. | Decrease | Increase |
| c. | Increase | Decrease |
| d. | Increase | Increase |

**CPA-00377 Explanation**

Choice "b" is correct. Decrease, Increase.

| | | | S/L | SYD | DDB |
|---|---|---|---|---|---|
| Cost | | | 100 | 100 | 100 |
| Less salvage (residual value) | | | (0) | (0) | NA |
| Depreciable base | | | 100 | 100 | 100 |
| First year depreciation | | | | | |
| S/L | 100 ÷ 5 yrs | = | 20 | | |
| SYD | 100 × 5/15 | = | | 33 1/3 | |
| DDB | 100 ÷ 5 yrs × 2 | = | | | 40 |
| Second year depreciation | | | | | |
| S/L | 100 ÷ 5 yrs | = | 20 | | |
| SYD | 100 × 4/15 | = | | 26 2/3 | |
| DDB | 100 | | | | |
| | (40) | | | | |
| | 60 ÷ 5 years × 2 | = | | | 24 |
| Accumulated depreciation – 2nd yr | | | 40 | 60 | 64 |
| Cost | | | 100 | 100 | 100 |
| Net book value at sale | | | 60 | 40 | 36 |
| Selling price | | | 38 | 38 | 38 |
| Gain (loss) on sale | | | (22) | (2) | 2 |

After two years, SYD results in higher NBV than ddb, and, therefore, a decreased gain, or an increased loss.

**CPA-00378 Type1 M/C A-D Corr Ans: B PM#76 F 4-99**


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146. CPA-00378 May 90 #21 Page 43

Net income is understated if, in the first year, estimated salvage value is excluded from the depreciation computation when using the:

| | *Straight-Line Method* | *Production or Use Method* |
|---|---|---|
| a. | Yes | No |
| b. | Yes | Yes |
| c. | No | No |
| d. | No | Yes |

**CPA-00378 Explanation**
Choice "b" is correct. Yes - Yes.

**Rule:** In all depreciation methods except declining balance, salvage value is subtracted from an asset's cost in arriving at the depreciation base. If salvage value is improperly excluded from the depreciation computation, depreciation will be overstated and net income under-stated for both the straight-line method and the production or use method (and sum-of-year's-digits method).

**CPA-00379 Type1 M/C A-D Corr Ans: B PM#77 F 4-99**

147. CPA-00379 Nov 90 II #5 Page 51

On July 1, 1986, Rey Corp. purchased computer equipment at a cost of $360,000. This equipment was estimated to have a six-year life with no residual value and was depreciated by the straight-line method. On January 3,1989, Rey determined that this equipment could no longer process data efficiently, that its value had been permanently impaired, and that $70,000 could be recovered over the remaining useful life of the equipment. What carrying amount should Rey report on its December 31, 1989 balance sheet for this equipment?

a. $0
b. $50,000
c. $70,000
d. $150,000

**CPA-00379 Explanation**
Choice "b" is correct. $50,000 carrying amount in Dec. 31, 1989 BS.

This is a change in "accounting estimate" that should be reported in the period of change and future periods. The net carrying value as of Jan. 3, 1989 is estimated to be $70,000 and would be depreciated over the remaining useful life of 3.5 years ($70,000/3.5 = $20,000/year). The carrying amount would therefore be $50,000 as of Dec. 31, 1989.

Choice "a" is incorrect. $0, since the computer still has value.

Choice "c" is incorrect. $70,000 would be the revised carrying value at the beginning of 1989.

Choice "d" is incorrect. $150,000 would be the carrying amount based on the original cost of $360,000 without considering the impairment in value.

**CPA-00380 Type1 M/C A-D Corr Ans: D PM#78 F 4-99**

148. CPA-00380 Nov 90 #14 Page 43

The graph below depicts three depreciation expense patterns over time.


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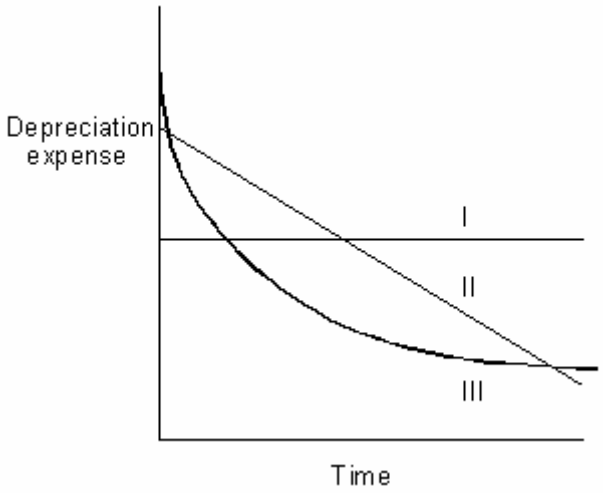


Which depreciation expense pattern corresponds to the sum-of-the-years'-digits method and which corresponds to the double-declining balance method?

| | *Sum-of-the-Year's-Digits* | Double-Declining *Balance* |
|---|---|---|
| a. | III | II |
| b. | II | I |
| c. | I | III |
| d. | II | III |

**CPA-00380 Explanation**
Choice "d" is correct. II Sum-of-the-Year's-Digits, and

III Double-Declining Balance

**Rule:** Straight-line depreciation is the same each year, as shown by pattern I.

Sum-of-the-Year's-Digits depreciation starts at a level higher than straight line and declines at a constant rate to the depreciation base, as shown by pattern II.

Double-Declining Balance depreciation starts at a level higher than SYD and declines rapidly to the depreciation base, but not at a constant rate, as shown by pattern III.

**CPA-00383 Type1 M/C A-D Corr Ans: A PM#79 F 4-99**

149. CPA-00383 Nov 91 I #16 Page 43

On January 1, 1989, Bay Co. acquired a land lease for a 21-year period with no option to renew. The lease required Bay to construct a building in lieu of rent. The building, completed on January 1, 1990, at a cost of $840,000, will be depreciated using the straight-line method. At the end of the lease, the building's estimated market value will be $420,000. What is the building's carrying amount in Bay's December 31, 1990, balance sheet?

a. $798,000
b. $800,000
c. $819,000
d. $820,000

**CPA-00383 Explanation**
Choice "a" is correct. $798,000


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**Rule:** Depreciable property constructed on leased land is depreciated over the life of the property or the term of the lease, whichever is shorter.

Annual depreciation = building costs $840,000 / remaining term of land lease 20 years = $42,000 per year

| | |
|---|---|
| Building cost | $840,000 |
| Less 1990 depreciation | (42,000) |
| Carrying amount at 12/31/90 | $ 798,000 "a" |

**CPA-00384 Type1 M/C A-D Corr Ans: A PM#80 F 4-99**

150. CPA-00384 May 92 #15 Page 46

What factor must be present to use the units-of-production (activity) method of depreciation?

a. Total units to be produced can be estimated.
b. Production is constant over the life of the asset.
c. Repair costs increase with use.
d. Obsolescence is expected.

**CPA-00384 Explanation**
Choice "a" is correct. Total units to be produced can be estimated.

**Rule:** Under the units-of-production depreciation method, the cost of a fixed asset is allocated to expense based on the number of units produced during the period relative to the total number of units expected to be produced over the asset's life. Accordingly, the total number of units over the asset's life must be able to be estimated.

**CPA-00385 Type1 M/C A-D Corr Ans: B PM#81 F 4-99**

151. CPA-00385 May 92 #16 Page 43

A machine with a 5-year estimated useful life and an estimated 10% salvage value was acquired on January 1, 1988. On December 31, 1991, accumulated depreciation, using the sum-of-the-years' digits method, would be:

a. (Original cost less salvage value) multiplied by 1/15.
b. (Original cost less salvage value) multiplied by 14/15.
c. Original cost multiplied by 14/15.
d. Original cost multiplied by 1/15.

**CPA-00385 Explanation**
Choice "b" is correct. (Original cost less salvage value) multiplied by 14/15.

| SYD – 5 Years | | SYD – Yrs 1988-91 | |
|---|---|---|---|
| Yr | 1 | 1988 | 5 |
| Yr | 2 | 1989 | 4 |
| Yr | 3 | 1990 | 3 |
| Yr | 4 | 1991 | 2 |
| Yr | 5 | | 14 |
| | 15 | | |

Accumulated depreciation = 14/15 × (original cost less salvage value)

**CPA-00387 Type1 M/C A-D Corr Ans: D PM#82 F 4-99**

152. CPA-00387 Nov 93 I #60 Page 43


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On January 2, 1989, Union Co. purchased a machine for $264,000 and depreciated it by the straight-line method using an estimated useful life of eight years with no salvage value. On January 2, 1992, Union determined that the machine had a useful life of six years from the date of acquisition and will have a salvage value of $24,000. An accounting change was made in 1992 to reflect the additional data. The accumulated depreciation for this machine should have a balance at December 31, 1992, of:

a. $176,000
b. $160,000
c. $154,000
d. $146,000

**CPA-00387 Explanation**

| | Depr-able Cost | | Usfl Life | | Annl Dprn | | Yrs Elpsd | | Accum Dprn | |
|---|---|---|---|---|---|---|---|---|---|---|
| Original | $264 | ÷ | 8 Yrs | = | $33 | × | 3 yrs | = | $99 | ('89-'91) |
| Accum deprec | (99) | | | | | | | | | |
| NBV 12/31/91 | 165 | | | | | | | | | |
| Salvage | <24> | | | | | | | | | |
| Revised | 141 | ÷ | 3 Yrs | = | 47 | × | 1 yr | = | 47 | (1992) |

Balance, 12/31/92 $146 **D**

Choice "d" is correct. $146,000 accumulated depreciation balance at Dec. 31, 1992.

**CPA-00390 Type1 M/C A-D Corr Ans: C PM#83 F 4-99**

153. CPA-00390 Nov 97 #10 Page 43

Ichor Co. reported equipment with an original cost of $379,000 and $344,000, and accumulated depreciation of $153,000 and $128,000, respectively, in its comparative financial statements for the years ended December 31, 1995, and 1994. During 1995, Ichor purchased equipment costing $50,000, and sold equipment with a carrying value of $9,000. What amount should Ichor report as depreciation expense for 1995?

a. $19,000
b. $25,000
c. $31,000
d. $34,000

**CPA-00390 Explanation**

Choice "c" is correct. $31,000.

| Fixed Assets | | | Accumulated Depreciation | |
|---|---|---|---|---|
| Beginning Balance 12/31/94 | $344,000 | | Beginning Balance 12/31/94 | $128,000 |
| Add Purchases | $ 50,000 | | Add Deprec. Exp © | $ 31,000 |
| Subtotal | $394,000 | | Subtotal | $159,000 |
| Less Equipment Sold – Squeeze | ($ 15,000) | less NBV $9,000 = | Less Accum. Deprec. on equip. sold | $ 6,000 |
| Ending balance 12/31/95 | $379,000 | | Ending balance 12/31/95 | $153,000 |

Remember to use the account analysis format!


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**CPA-00393 Type1 M/C A-D Corr Ans: A PM#84 F 4-99**

154. CPA-00393 PI Nov 93 #47 Page 46

On January 2, 1992, Emme Co. sold equipment with a carrying amount of $480,000 in exchange for a $600,000 noninterest bearing note due January 2, 1995. There was no established exchange price for the equipment. The prevailing rate of interest for a note of this type at January 2, 1992, was 10%. The present value of 1 at 10% for three periods is 0.75.

In Emme's 1992 income statement, what amount should be reported as gain (loss) on sale of machinery?

a. ($30,000) loss.
b. $30,000 gain.
c. $120,000 gain.
d. $270,000 gain.

**CPA-00393 Explanation**
Choice "a" is correct. The gain or loss on the sale is computed as follows:

| | |
|---|---|
| Selling price (present value of note) | $450,000 |
| Less: Carrying amount | 480,000 |
| Loss on sale | $ 30,000 |

Choice "b" is incorrect. When an asset's value exceeds the proceeds received, a loss is recognized, not a gain.

Choice "c" is incorrect. The present value of the note, not the face amount, should be used since it is noninterest bearing.

Choice "d" is incorrect. The present value of the note is determined by multiplying, not dividing, the face amount of the note by the present value factor.

**CPA-04328 Type1 M/C L,B,E Corr Ans: L PM#85 F 4-99**

155. CPA-04328 PI Nov 92 #4 (a) 1 Page 3

During 1992, Sloan, Inc. began a project to construct new corporate headquarters. Sloan purchased land with an existing building for $750,000. The land was valued at $700,000 and the building at $50,000. Sloan planned to demolish the building and construct a new office building on the site. This question represents an expenditure by Sloan for this project.

Select from the following list the appropriate accounting treatment for this expenditure.

- Purchase of land for $700,000.

B. Classify as building and depreciate.
E. Expense.
L. Classify as land and do not depreciate.

**CPA-04328 Explanation**
**Choice "L" is correct.** When land is purchased, it should be classified as such (Land) and not depreciated. Land is assumed not to waste away and thus does not have a limited life.

**CPA-04329 Type1 M/C L,B,E Corr Ans: E PM#86 F 4-99**

156. CPA-04329 PI Nov 92 #4 (a) 2 Page 3

During 1992, Sloan, Inc. began a project to construct new corporate headquarters. Sloan purchased land with an existing building for $750,000. The land was valued at $700,000 and the building at $50,000. Sloan planned to demolish the building and construct a new office building on the site. This question represents an expenditure by Sloan for this project.


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Select from the following list the appropriate accounting treatment for this expenditure.

- Interest of $147,000 on construction financing incurred after completion of construction.

B. Classify as building and depreciate.
E. Expense.
L. Classify as land and do not depreciate.

**CPA-04329 Explanation**
**Choice "E" is correct.** Interest on the financing during the construction phase of a capital asset (building) is capitalized. However, once the construction is completed, the interest is then considered an expense.

**CPA-04331 Type1 M/C L,B,E Corr Ans: B PM#87 F 4-99**

157. CPA-04331 PI Nov 92 #4 (a) 3 Page 3

During 1992, Sloan, Inc. began a project to construct new corporate headquarters. Sloan purchased land with an existing building for $750,000. The land was valued at $700,000 and the building at $50,000. Sloan planned to demolish the building and construct a new office building on the site. This question represents an expenditure by Sloan for this project.

Select from the following list the appropriate accounting treatment for this expenditure.

- Interest of $186,000 on construction financing paid during construction.

B. Classify as building and depreciate.
E. Expense.
L. Classify as land and do not depreciate.

**CPA-04331 Explanation**
**Choice "B" is correct.** Interest on the financing during the construction phase of a capital asset (building) is capitalized as part of the cost of the asset. The interest, along with other construction costs, is then depreciated over the useful life of the building.

**CPA-04333 Type1 M/C L,B,E Corr Ans: L PM#88 F 4-99**

158. CPA-04333 PI Nov 92 #4 (a) 4 Page 3

During 1992, Sloan, Inc. began a project to construct new corporate headquarters. Sloan purchased land with an existing building for $750,000. The land was valued at $700,000 and the building at $50,000. Sloan planned to demolish the building and construct a new office building on the site. This question represents an expenditure by Sloan for this project.

Select from the following list the appropriate accounting treatment for this expenditure.

- Purchase of building for $50,000.

B. Classify as building and depreciate.
E. Expense.
L. Classify as land and do not depreciate.

**CPA-04333 Explanation**
**Choice "L" is correct.** Since Sloan planned to demolish the existing building, the cost allocated to the building is treated as part of the cost of the land. Sloan wanted the land but had no option to buy the land without the building, so the cost of the land includes the cost of the existing building.

**CPA-04335 Type1 M/C L,B,E Corr Ans: L PM#89 F 4-99**


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159. CPA-04335 PI Nov 92 #4 (a) 5 Page 3

During 1992, Sloan, Inc. began a project to construct new corporate headquarters. Sloan purchased land with an existing building for $750,000. The land was valued at $700,000 and the building at $50,000. Sloan planned to demolish the building and construct a new office building on the site. This question represents an expenditure by Sloan for this project.

Select from the following list the appropriate accounting treatment for this expenditure.

- $18,500 payment of delinquent real estate taxes assumed by Sloan on purchase.

B. Classify as building and depreciate.
E. Expense.
L. Classify as land and do not depreciate.

**CPA-04335 Explanation**
**Choice "L" is correct.** The purchase price of the land included the payment of delinquent real estate taxes assumed by Sloan. Sloan agreed to the payment of the real estate taxes as part of the cost of obtaining the land.

**CPA-04336 Type1 M/C L,B,E Corr Ans: B PM#90 F 4-99**

160. CPA-04336 PI Nov 92 #4 (a) 6 Page 3

During 1992, Sloan, Inc. began a project to construct new corporate headquarters. Sloan purchased land with an existing building for $750,000. The land was valued at $700,000 and the building at $50,000. Sloan planned to demolish the building and construct a new office building on the site. This question represents an expenditure by Sloan for this project.

Select from the following list the appropriate accounting treatment for this expenditure.

- $12,000 liability insurance premium during the construction period.

B. Classify as building and depreciate.
E. Expense.
L. Classify as land and do not depreciate.

**CPA-04336 Explanation**
**Choice "B" is correct.** All costs associated with the construction of the building should be capitalized as the cost of the building and depreciated over the useful life of the building. Thus, liability insurance premium during construction period is included in the cost of the building. Other construction costs include direct labor, direct materials, overhead, building permits, and professional fees.

**CPA-04337 Type1 M/C L,B,E Corr Ans: L PM#91 F 4-99**

161. CPA-04337 PI Nov 92 #4 (a) 7 Page 3

During 1992, Sloan, Inc. began a project to construct new corporate headquarters. Sloan purchased land with an existing building for $750,000. The land was valued at $700,000 and the building at $50,000. Sloan planned to demolish the building and construct a new office building on the site. This question represents an expenditure by Sloan for this project.

Select from the following list the appropriate accounting treatment for this expenditure.

- $65,000 cost of razing existing building.

B. Classify as building and depreciate.
E. Expense.
L. Classify as land and do not depreciate.

**CPA-04337 Explanation**


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**Choice "L" is correct.** All costs associated with preparing the land for its intended use are included in the cost of the land. The cost of razing the building is classified as land costs. If there were any salvage value of the building razed, these receipts would decrease the cost of the land.

**CPA-00033 Type1 M/C A-D Corr Ans: C PM#92 F 4-99**

162. CPA-00033 FARE R99 #5 Page 5

Trans Co. had the following balances at December 31, 1999:

| | |
|---|---|
| Cash in checking account | $ 35,000 |
| Cash in money market account | 75,000 |
| U.S. Treasury bill, purchased 11/1/1999, maturing 1/31/2000 | 350,000 |
| U.S. Treasury bill, purchased 12/1/1999, maturing 3/31/2000 | 400,000 |

Trans's policy is to treat as cash equivalents all highly-liquid investments with a maturity of three months or less when purchased. What amount should Trans report as cash and cash equivalents in its December 31, 1999, balance sheet?

a. $110,000
b. $385,000
c. $460,000
d. $860,000

**CPA-00033 Explanation**

Choice "c" is correct. Trans should report $460,000 as cash and cash equivalents in its December 31, 1999, balance sheet.

| | | |
|---|---|---|
| Cash in checking account | $ 35,000 | |
| Cash in money market account | 75,000 | |
| U.S. Treasury bill maturing 1/31/00 | 350,000 | [Original maturity period of 3 months] |
| U.S. Treasury bill maturing 3/31/00 | -- | [Original maturity period of 4 months] |
| Cash and cash quivalents | **$460,000** | |

Choice "a" is incorrect, as the U.S. Treasury bill maturing on 1/31/00 is a cash equivalent because it had an original maturity period of three months or less, which is Trans' stated policy for cash equivalents.

Choice "b" is incorrect, as cash in a money market account is considered cash.

Choice "d" is incorrect, as the U.S. Treasury bill maturing on 3/31/00 is NOT a cash equivalent because it had an original maturity period of more than 3 months, which is Trans' stated policy for cash equivalents.

**CPA-00141 Type1 M/C A-D Corr Ans: A PM#92 F 4-99**

163. CPA-00141 FARE Nov 90 #13 Page 34

A building suffered uninsured water and related damage. The damaged portion of the building was refurbished with upgraded materials. The cost and related accumulated depreciation of the damaged portion are identifiable. To account for these events, the owner should:

a. Capitalize the cost of refurbishing and record a loss in the current period equal to the carrying amount of the damaged portion of the building.
b. Capitalize the cost of refurbishing by adding the cost to the carrying amount of the building.
c. Record a loss in the current period equal to the cost of refurbishing and continue to depreciate the original cost of the building.
d. Record a loss in the current period equal to the sum of the cost of refurbishing and the carrying amount of the damaged portion of the building.

**CPA-00141 Explanation**


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Choice "a" is correct. Capitalize the cost of refurbishing and record a loss in the current period equal to the carrying amount of the damaged portion of the building.

**Rule:** the net book value (both cost and related depreciation) of fixed assets lost in fire, flood, etc. Should be removed from the accounts and a loss recognized (but adjusted for any insurance proceeds). The costs of replacement assets are charged to the fixed assets account. This is similar to **"component depreciation."**

Choices "b", "c", and "d" are incorrect, per the above explanation.

**CPA-04338 Type1 M/C L,B,E Corr Ans: E PM#92 F 4-99**

164. CPA-04338 PI Nov 92 #4 (a) 8 Page 3

During 1992, Sloan, Inc. began a project to construct new corporate headquarters. Sloan purchased land with an existing building for $750,000. The land was valued at $700,000 and the building at $50,000. Sloan planned to demolish the building and construct a new office building on the site. This question represents an expenditure by Sloan for this project.

Select from the following list the appropriate accounting treatment for this expenditure.

- Moving costs of $136,000.

B. Classify as building and depreciate.
E. Expense.
L. Classify as land and do not depreciate.

**CPA-04338 Explanation**
**Choice "E" is correct.** Moving costs are not construction costs and, thus, cannot be capitalized as part of the building costs. Moving costs are expenses in the period incurred.


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# CPA PassMaster Questions–Financial 5
# Export Date: 10/30/08


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**Present Values & Annuities**

**CPA-05223 Type1 M/C A-D Corr Ans: B PM#12 F 5-01**

1. CPA-05223 Released 2006 Page 3

On January 1 of the current year, Lean Co. made an investment of $10,000. The following is the present value of $1.00 discounted at a 10% interest rate:

| *Periods* | *Present value of $1.00 discounted at 10%* |
|---|---|
| 1 | .909 |
| 2 | .826 |
| 3 | .751 |

What amount of cash will Lean accumulate in two years?

a. $12,000
b. $12,107
c. $16,250
d. $27,002

**CPA-05223 Explanation**
Choice "b" is correct. The problem with this question is that there is a discount rate but not an interest rate available. The normal present value formula can be expressed as:

Present value = Future amount x present value factor

$10,000 = Future amount x .826 (the present value factor is the discount rate for 2 years)

Future amount = $10,000 / .826 = $12,107

Choice "a" is incorrect. If the interest rate, rather than the discount rate, was 10% and the interest was not compounded, the $10,000 would accumulate to $12,000 ($1,000 of interest each year). However, that calculation does not coincide with the facts of the question (the discount rate is 10% and the interest is compounded).

Choice "c" is incorrect. If Lean had invested $10,000 at a rate around 10%, it is not expected that the investment could accumulate to anything like $16,250. $10,000 invested at 10% would only amount to slightly more than $12,000.

Choice "d" is incorrect, per the above calculation and explanation.

**Accounting for Leases**

**CPA-00395 Type1 M/C A-D Corr Ans: B PM#1 F 5-02**

2. CPA-00395 FARE R03 #2 Page 16

Douglas Co. leased machinery with an economic useful life of six years. For tax purposes, the depreciable life is seven years. The lease is for five years, and Douglas can purchase the machinery at fair value at the end of the lease. What is the depreciable life of the leased machinery for financial reporting?

a. Zero.
b. Five years.
c. Six years.
d. Seven years.

**CPA-00395 Explanation**
Choice "b" is correct. Assets acquired under capital lease are depreciated using the same theory as purchased assets. The purchase option is for " fair value." It is not a "bargain purchase option" therefore


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the assumption cannot be made that Douglas Co. will acquire the machine at the end of the lease period. At the inception of the lease, the best estimate of economic life to Douglas is the five-year lease term.

Choice "a" is incorrect. Assets acquired under capital lease must be depreciated over their projected economic lives.

Choice "c" is incorrect. Although the machine has a projected life of six years, the best estimate of useful life to Douglas is the five-year lease term.

Choice "d" is incorrect. Tax life is not used for financial accounting purposes.

**CPA-00396 Type1 M/C A-D Corr Ans: A PM#2 F 5-02**

3. CPA-00396 FARE R99 #19 Page 12

Cott, Inc. prepared an interest amortization table for a five-year lease payable with a bargain purchase option of $2,000, exercisable at the end of the lease. At the end of the five years, the balance in the leases payable column of the spreadsheet was zero. Cott has asked Grant, CPA, to review the spreadsheet to determine the error. Only one error was made on the spreadsheet. Which of the following statements represents the best explanation for this error?

a. The beginning present value of the lease did **not** include the present value of the bargain purchase option.
b. Cott subtracted the annual interest amount from the lease payable balance instead of adding it.
c. The present value of the bargain purchase option was subtracted from the present value of the annual payments.
d. Cott discounted the annual payments as an ordinary annuity, when the payments actually occurred at the beginning of each period.

**CPA-00396 Explanation**

Choice "a" is correct. Cott, Inc. made the error of not including the present value of the bargain purchase option in the beginning present value of the lease that it used on the schedule. A bargain purchase option payment is included as part of the minimum lease payments to be discounted to the date of inception of the lease because it is a future cash flow that is considered certain. When the spreadsheet showed zero at the bottom, Cott, Inc. still was required to make the bargain purchase option payment of $2,000, yet there was no liability left on the books to pay. The $2,000 should have been capitalized as part of the cost of the equipment (or whatever was purchased under the capital lease).

Choice "b" is incorrect. Interest is neither subtracted nor added to the lease payable balance, which is maintained at the present value (or carrying value) of the lease. Interest is in a separate column on the spreadsheet for the effective interest method calculation.

Choice "c" is incorrect. If the present value of the bargain purchase option were subtracted from the present value of the annual payments, the balance could not have been zero at the end of five years, it would have been a debit balance (i.e., negative).

Choice "d" is incorrect. This option would have caused the amount capitalized at the lease inception to be lower than it should have been (i.e., the present value of an ordinary annuity for the same interest rate and amount of payments is lower than the present value of an annuity due). However, the schedule would not have become zero at the end because the interest calculation would have been based on the date of payment, which was not consistent with the method of discounting used to produce the schedule.

**CPA-00398 Type1 M/C A-D Corr Ans: B PM#4 F 5-02**

4. CPA-00398 FARE Nov 95 #11 Page 27

In a sale-leaseback transaction, a gain resulting from the sale should be deferred at the time of the sale-leaseback and subsequently amortized when:

I. The seller-lessee has transferred substantially all the risks of ownership.
II. The seller-lessee retains the right to substantially all of the remaining use of the property.


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a. I only.
b. II only.
c. Both I and II.
d. Neither I nor II.

**CPA-00398 Explanation**
Choice "b" is correct. Recognition of a gain resulting from the sale in a sale-leaseback should be deferred when the seller-lessee retains the right to substantially all of the remaining use of the property (as in a capital lease). SFAS 28 para. 3

Choice "a" is incorrect. When the seller-lessee transfers substantially all the risks of ownership (as in a true sale), any gain resulting from the sale should be recognized immediately.

Choice "c" is incorrect. When the seller-lessee transfers substantially all the risks of ownership, any gain resulting from the sale should be recognized rather than being deferred.

Choice "d" is incorrect. Recognition of the gain should be deferred when the seller-lessee retains the right to substantially all of the remaining use of the property.

**CPA-00399 Type1 M/C A-D Corr Ans: C PM#5 F 5-02**

5. CPA-00399 FARE Nov 95 #12 Page 17

A six-year capital lease entered into on December 31, 1994, specified equal minimum annual lease payments due on December 31 of each year. The first minimum annual lease payment, paid on December 31, 1994, consists of which of the following?

| | *Interest expense* | *Lease liability* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |

**CPA-00399 Explanation**
Choice "c" is correct. The debt was incurred on December 31, 1994. The initial payment was made on December 31, 1994. No interest expense is recognized since no time has passed between when the debt was incurred and the payment was made. Thus, the full amount of the payment reduces the lease liability.

Choice "a" is incorrect. When payment is made on the same day as a debt is incurred, no interest expense is recognized since no time has passed since the debt was incurred.

Choice "b" is incorrect. Since no interest has accrued and the full payment reduces the liability.

Choice "d" is incorrect. Since no interest has accrued and the full payment reduces the liability.

**CPA-00400 Type1 M/C A-D Corr Ans: A PM#6 F 5-02**

6. CPA-00400 FARE Nov 95 #29 Page 25

Glade Co. leases computer equipment to customers under direct-financing leases. The equipment has no residual value at the end of the lease and the leases do not contain bargain purchase options. Glade wishes to earn 8% interest on a five-year lease of equipment with a fair value of $323,400. The present value of an annuity due of $1 at 8% for five years is 4.312. What is the total amount of interest revenue that Glade will earn over the life of the lease?

a. $51,600
b. $75,000
c. $129,360
d. $139,450


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**CPA-00400 Explanation**
Choice "a" is correct. The fair value of the equipment is equal the present value of the future cash flows.

PV = annual rents x annuity due PV factor [n = 5, i = 8%]
$323,400 = annual rents x 4.312
Thus, annual rents = $75,000

Total cash flows = 5 x $75,000 = $375,000 and total interest revenue equals $51,600 [$375,000 total cash flows less $323,400 present value of cash flows]. SFAS 13 para. 18 and 25

**CPA-00401 Type1 M/C A-D Corr Ans: D PM#7 F 5-02**

7. CPA-00401 FARE Nov 95 #34 Page 8

When should a lessor recognize in income a nonrefundable lease bonus paid by a lessee on signing an operating lease?

a. When received.
b. At the inception of the lease.
c. At the expiration of the lease.
d. Over the life of the lease.

**CPA-00401 Explanation**
Choice "d" is correct. Since the lease bonus is nonrefundable, it represents income attributable to the lease term. Therefore, recognition is deferred and recognized equally over the life of the lease.

Choice "a" is incorrect. Recognition of revenue when cash is received violates normal accrual accounting procedures.

Choice "b" is incorrect. Recognition of revenue when cash is received (i.e., at the inception of the lease) violates normal accrual accounting procedures.

Choice "c" is incorrect. The bonus is an integral part of the lease agreement and must be allocated over the life of the lease. If the amount were a deposit that was not refunded, then recognition would be at the expiration of the lease.

**CPA-00402 Type1 M/C A-D Corr Ans: C PM#8 F 5-02**

8. CPA-00402 FARE May 95 #28 Page 24

Farm Co. leased equipment to Union Co. on July 1, 1994, and properly recorded the sales-type lease at $135,000, the present value of the lease payments discounted at 10%. The first of eight annual lease payments of $20,000 due at the beginning of each year was received and recorded on July 3, 1994. Farm had purchased the equipment for $110,000. What amount of interest revenue from the lease should Farm report in its 1994 income statement?

a. $0
b. $5,500
c. $5,750
d. $6,750

**CPA-00402 Explanation**
Choice "c" is correct. The initial lease receivable equals $135,000. After the first lease payment is received two days later, the lease receivable equals $115,000 ($135,000 less $20,000). 1994 interest revenue equals $5,750 ($115,000 x 10% x 6/12). SFAS 13 para. 17

Choice "a" is incorrect. Interest revenue on the lease receivable should be accrued. SFAS 13 para. 17

Choice "b" is incorrect. Interest is not calculated on the cost of the assets. SFAS 13 para. 17

Choice "d" is incorrect. The $20,000 payment received July 3 should be deducted from the receivable balance before calculating interest. SFAS 13 para. 17


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**CPA-00403 Type1 M/C A-D Corr Ans: A PM#9 F 5-02**

9. CPA-00403 FARE Nov 94 #20 Page 15

At the inception of a capital lease, the guaranteed residual value should be:

a. Included as part of minimum lease payments at present value.
b. Included as part of minimum lease payments at future value.
c. Included as part of minimum lease payments only to the extent that guaranteed residual value is expected to exceed estimated residual value.
d. Excluded from minimum lease payments.

**CPA-00403 Explanation**
Choice "a" is correct. Guaranteed residual value is, in effect, an additional lease payment and must be included in the calculation of the present value of the minimum lease payments. SFAS 13 para. 5

Choice "b" is incorrect. Capital leases are valued at present value rather than future value. SFAS 13 para. 10

Choice "c" is incorrect. Since the guaranteed residual value is effectively an additional lease payment, its full value must be included in the calculation of the present value of the minimum lease payments. SFAS 13 para. 5

Choice "d" is incorrect. Guaranteed residual value is, in effect, an additional lease payment. SFAS 13 para. 5

**CPA-00404 Type1 M/C A-D Corr Ans: D PM#10 F 5-02**

10. CPA-00404 FARE Nov 94 #41 Page 8

As an inducement to enter a lease, Graf Co., a lessor, granted Zep, Inc., a lessee, twelve months of free rent under a five-year operating lease. The lease was effective on January 1, 1993, and provides for monthly rental payments to begin January 1, 1994. Zep made the first rental payment on December 30, 1993. In its 1993 income statement, Graf should report rental revenue in an amount equal to:

a. Zero.
b. Cash received during 1993.
c. One-fourth of the total cash to be received over the life of the lease.
d. One-fifth of the total cash to be received over the life of the lease.

**CPA-00404 Explanation**
Choice "d" is correct. Annual rental revenue equals the total rental revenue from the lease allocated over the full life of the lease. In this case, revenue equals total cash divided by five years. SFAS 13 para. 15

Choice "a" is incorrect. Since a service was provided and the revenue is realizable through future collections, revenue must be recognized in 1993.

Choice "b" is incorrect. Revenue is recognized when earned (a service is provided) and realizable (collectible in the future). Cash basis accounting would recognize revenue when cash was collected.

Choice "c" is incorrect. Revenue is recognized over the full life of the lease (five years) rather being limited to the time frame during which cash is collected.

**CPA-00405 Type1 M/C A-D Corr Ans: B PM#11 F 5-02**

11. CPA-00405 FARE May 94 #25 Page 13

In the long-term liabilities section of its balance sheet at December 31, 1992, Mene Co. reported a capital lease obligation of $75,000, net of current portion of $1,364. Payments of $9,000 were made on both January 2, 1993, and January 2, 1994. Mene's incremental borrowing rate on the date of the lease was


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11% and the lessor's implicit rate, which was known to Mene, was 10%. In its December 31, 1993, balance sheet, what amount should Mene report as capital lease obligation, net of current portion?

a. $66,000
b. $73,500
c. $73,636
d. $74,250

**CPA-00405 Explanation**
Choice "b" is correct. The smaller of the lessee's incremental borrowing rate or the lessor's implicit rate (if known) should be used. The amortization of the lease is:

| *Date* | *Cash Payment* | *Interest Expense* | *Principal Reduction* | *Lease Obligation* |
|---|---|---|---|---|
| 12/31/92 | | | | $76,364 |
| 1/2/93 | $9,000 | $7,636 | $1,364 | $75,000 |
| 12/31/93 | | | | $75,000 |
| 1/2/94 | $9,000 | $7,500 | $1,500 | $73,500 |

| *Date* | *Short-term* | *Long-term* |
|---|---|---|
| 12/31/92 | $1,364 | $75,000 |
| 1/2/93 | | |
| 12/31/93 | $1,500 | **$73,500** |
| 1/2/94 | | |

SFAS 13 para. 7, 11

**CPA-00406 Type1 M/C A-D Corr Ans: B PM#12 F 5-02**

12. CPA-00406 FARE May 94 #26 Page 10

One criterion for a capital lease is that the term of the lease must equal a minimum percentage of the leased property's estimated economic life at the inception of the lease. What is this minimum percentage?

a. 51%
b. 75%
c. 80%
d. 90%

**CPA-00406 Explanation**
Choice "b" is correct. The lease term criterion is that the lease term be greater than or equal to 75% of the economic life of the leased asset. SFAS 13 para. 7

Choice "a" is incorrect. 51% is not related to any of the capital lease criteria.

Choice "c" is incorrect. 80% is not related to any of the capital lease criteria.

Choice "d" is incorrect. If the present value of the minimum lease payments is greater than or equal to 90% of the fair value of the leased asset, then the lease is considered to be a capital lease. SFAS 13 para. 7

**CPA-00407 Type1 M/C A-D Corr Ans: B PM#13 F 5-02**

13. CPA-00407 PI Nov 93 #35 Page 13

Oak Co. leased equipment for its entire nine-year useful life, agreeing to pay $50,000 at the start of the lease term on December 31, 1991, and $50,000 annually on each December 31 for the next eight years. The present value on December 31, 1991, of the nine lease payments over the lease term, using the rate implicit in the lease which Oak knows to be 10%, was $316,500. The December 31, 1991, present value


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of the lease payments using Oak's incremental borrowing rate of 12% was $298,500. Oak made a timely second lease payment. What amount should Oak report as capital lease liability in its December 31, 1992, balance sheet?

a. $350,000
b. $243,150
c. $228,320
d. $0

**CPA-00407 Explanation**
Choice "b" is correct. Leases are capitalized if any of four criteria are met. The lease life is at least 75% of the life of the asset so it is a capital lease. The initial amount capitalized is the present value using the lessor's rate if known (10%). The following table shows the liability on 12-31-92.

| Date | Payment | Interest | Decline in Liability | Liability |
|---|---|---|---|---|
| 12-31-91 | | | | $316,500 |
| 12-31-91 | $50,000 | - | $50,000 | 266,500 |
| 12-31-92 | $50,000 | 26,650 | 23,350 | 243,150 |

SFAS 13 para. 10

Choice "a" is incorrect. The present value of the lease is used as the liability.

Choice "c" is incorrect. The lessor's rate if known (10%) is used for capital leases.

Choice "d" is incorrect. Leases are capitalized if any of four criteria are met. The lease life is at least 75% of the life of the assets so it is a capital lease.

**CPA-00408 Type1 M/C A-D Corr Ans: A PM#14 F 5-02**

14. CPA-00408 PI Nov 93 #39 Page 12

Neal Corp. entered into a nine-year capital lease on a warehouse on December 31, 1992. Lease payments of $52,000, which includes real estate taxes of $2,000, are due annually, beginning on December 31, 1993, and every December 31 thereafter. Neal does not know the interest rate implicit in the lease; Neal's incremental borrowing rate is 9%. The rounded present value of an ordinary annuity for nine years at 9% is 5.6. What amount should Neal report as capitalized lease liability at December 31, 1992?

a. $280,000
b. $291,200
c. $450,000
d. $468,000

**CPA-00408 Explanation**
Choice "a" is correct. Capital leases should be recorded at the present value of the minimum lease payment (fair market value of property is not stated). The lease payment is used. Taxes should be expensed when paid.

$50,000 x 5.6 = $280,000

SFAS 13 para. 10

Choice "b" is incorrect. The lease payment is used to compute the present value of the liability, not including executory costs, such as taxes. Executory costs are expensed when paid.

Choice "c" is incorrect. The present value of the minimum lease payment is used.

Choice "d" is incorrect. The present value of the minimum lease payments is used.


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**CPA-00409 Type1 M/C A-D Corr Ans: B PM#15 F 5-02**

15. CPA-00409 PI Nov 93 #44 Page 22

Howe Co. leased equipment to Kew Corp. on January 2, 1992, for an eight-year period expiring December 31, 1999. Equal payments under the lease are $600,000 and are due on January 2 of each year. The first payment was made on January 2, 1992. The list selling price of the equipment is $3,520,000 and its carrying cost on Howe's books is $2,800,000. The lease is appropriately accounted for as a sales-type lease. The present value of the lease payments at an imputed interest rate of 12% (Howe's incremental borrowing rate) is $3,300,000. What amount of profit on the sale should Howe report for the year ended December 31, 1992?

a. $720,000
b. $500,000
c. $90,000
d. $0

**CPA-00409 Explanation**
Choice "b" is correct. The excess of the present value of the selling price over its cost is recorded as profit.

| | |
|---|---|
| Present value of payments | $3,300,000 |
| Carrying cost | (2,800,000) |
| Profit on sale | $ 500,000 |

SFAS 13 para. 6

Choice "a" is incorrect. The excess of the selling price (present value) over its cost is recorded as profit. The list price is a distractor.

Choice "c" is incorrect. The excess of the selling price (present value) over its cost is recorded as profit.

Choice "d" is incorrect. The excess of the selling price (present value) over its cost is recorded as profit.

**CPA-00412 Type1 M/C A-D Corr Ans: B PM#18 F 5-02**

16. CPA-00412 PI Nov 93 #59 Page 6

On June 1, 1993, Oren Co. entered into a five-year nonrenewable lease, commencing on that date, for office space and made the following payments to Cant Properties:

| | |
|---|---|
| Bonus to obtain lease | $30,000 |
| First month's rent | 10,000 |
| Last month's rent | 10,000 |

In its income statement for the year ended June 30, 1993, what amount should Oren report as rent expense?

a. $10,000
b. $10,500
c. $40,000
d. $50,000

**CPA-00412 Explanation**
Choice "b" is correct. Rent expense should include the first month's rent and an allocated portion of the bonus. The last month's rent should be shown as a prepaid expense.

| | |
|---|---|
| First month's rent | $10,000 |
| Amortize bonus ($30,000 x 1/60) | 500 |
| Total | $10,500 |

Choice "a" is incorrect. The bonus should be allocated to expense on a straight-line basis over 60 months.


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Choice "c" is incorrect. The bonus should be allocated to expense on a straight-line basis over 60 months.

Choice "d" is incorrect. The bonus should be allocated to expense on a straight-line basis over 60 months. The last month's rent is shown as prepaid rent, not an expense.

**CPA-00413 Type1 M/C A-D Corr Ans: C PM#19 F 5-02**

17. CPA-00413 PI May 93 #22 Page 7

Star Co. leases a building for its product showroom. The ten-year nonrenewable lease will expire on December 31, 1997. In January 1992, Star redecorated its showroom and made leasehold improvements of $48,000. The estimated useful life of the improvements is 8 years. Star uses the straight-line method of amortization. What amount of leasehold improvements, net of amortization, should Star report in its June 30, 1992, balance sheet?

a. $45,600
b. $45,000
c. $44,000
d. $43,200

**CPA-00413 Explanation**
Choice "c" is correct. Leasehold improvements should be amortized over the lesser of the remaining life of the lease (6 years), the life of the improvement (8 years). $48,000 ÷ 6 = $8,000 amortization for a year or $4,000 for January 1992 through June 30, 1992. $48,000 - $4,000 = $44,000.

**CPA-00414 Type1 M/C A-D Corr Ans: B PM#20 F 5-02**

18. CPA-00414 PI May 93 #31 Page 27

On December 31, 1992, Dirk Corp. sold Smith Co. two airplanes and simultaneously leased them back. Additional information pertaining to the sale-leasebacks follows:

| | *Plane #1* | *Plane #2* |
|---|---|---|
| Sales price | $600,000 | $1,000,000 |
| Carrying amount, 12/31/92 | $100,000 | $550,000 |
| Remaining useful life, 12/31/92 | 10 years | 35 years |
| Lease term | 8 years | 3 years |
| Annual lease payments | $100,000 | $200,000 |

In its December 31, 1992, balance sheet, what amount should Dirk report as deferred gain on these transactions?

a. $950,000
b. $500,000
c. $450,000
d. $0

**CPA-00414 Explanation**
Choice "b" is correct. Because no present value information is given, we must assume that the Plane 1 lease is "major." It qualifies as a capital lease because it meets the 75% test (8 year term out of 10 year life is 80%). In "major" sale-leasebacks, all gain is deferred. We must also assume that the Plane 2 lease is "minor" because it will be classified as an operating lease (it fails all "OWNS" tests we are able to perform based on the given information). In "minor" sale-leasebacks, there is no deferral.

Choice "a" is incorrect. The leaseback on Plane 2 is considered minor because the lease life is less than 10% of its useful life. Therefore all gain is recognized on Plane 2.

Choice "c" is incorrect. The leaseback on Plane 2 is considered minor because the lease life is less than 10% of useful life. Therefore all gain is recognized rather than deferred on Plane 2.


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Choice "d" is incorrect. Plane 1 is a capital lease since the lease term is greater than 75% of its useful life. The gain must be deferred.

**CPA-00415 Type1 M/C A-D Corr Ans: D PM#21 F 5-02**

19. CPA-00415Th May 93 #38 Page 10

On January 1, 1990, JCK Co. signed a contract for an eight-year lease of its equipment with a 10-year life. The present value of the 16 equal semiannual payments in advance equaled 85% of the equipment's fair value. The contract had no provision for JCK, the lessor, to give up legal ownership of the equipment. Should JCK recognize rent or interest revenue in 1992, and should the revenue recognized in 1992 be the same or smaller than the revenue recognized in 1991?

| | *1992 revenues recognized* | *1992 amount recognized compared to 1991* |
|---|---|---|
| a. | Rent | The same |
| b. | Rent | Smaller |
| c. | Interest | The same |
| d. | Interest | Smaller |

**CPA-00415 Explanation**
Choice "d" is correct. Interest revenue is recognized for a capital lease, based on the discount rate times the carrying value of the lease receivable. As time passes, the lease receivable decreases and interest revenue recognized also decreases.

**CPA-00419 Type1 M/C A-D Corr Ans: C PM#23 F 5-02**

20. CPA-00419PI May 92 #34 Page 12

Robbins, Inc. leased a machine from Ready Leasing Co. The lease qualifies as a capital lease and requires 10 annual payments of $10,000 beginning immediately. The lease specifies an interest rate of 12% and a purchase option of $10,000 at the end of the tenth year, even though the machine's estimated value on that date is $20,000. Robbins' incremental borrowing rate is 14%. The present value of an annuity due of 1 at: 12% for 10 years is 6.328 and 14% for 10 years is 5.946. The present value of 1 at: 12% for 10 years is .322 and 14% for 10 years is .270.

What amount should Robbins record as lease liability at the beginning of the lease term?

a. $62,160
b. $64,860
c. $66,500
d. $69,720

**CPA-00419 Explanation**
Choice "c" is correct. The lessee should record the capital lease at the lower of (1) present value of minimum lease payments or (2) FV of asset at the inception of lease. The FV is not given. The interest rate is 12% (lessor's rate is used only if lower or the implicit rate is not known). The lease payments begin immediately (annuity due basis). The bargain purchase option must also be capitalized. The amount capitalized is:

| | |
|---|---|
| Annual payments, $10,000 x 6.328 | $63,280 |
| Bargain purchase option, $10,000 x .322 | 3,220 |
| | $66,500 |

Choice "a" is incorrect. The interest rate should be 12% since it is lower. Only when lessor's rate is lower and known to the lessee is it used.


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Choice "b" is incorrect. The interest rate should be 12% since it is lower. The bargain purchase option is $10,000, not the machine's estimated value.

Choice "d" is incorrect. The bargain purchase option is $10,000, not the machine's estimated value.

**CPA-04675 Type1 M/C A-D Corr Ans: D PM#28 F 5-02**

21. CPA-04675 Released 2005 Page 15

On January 1 of the current year, Tell Co. leased equipment from Swill Co. under a nine-year sales-type lease. The equipment had a cost of $400,000, and an estimated useful life of 15 years. Semiannual lease payments of $44,000 are due every January 1 and July 1. The present value of lease payments at 12% was $505,000, which equals the sales price of the equipment. Using the straight-line method, what amount should Tell recognize as depreciation expense on the equipment in the current year?

a. $26,667
b. $33,667
c. $44,444
d. $56,111

**CPA-04675 Explanation**
Choice "d" is correct. The lessee records the lease as an asset and a liability at the lower (lesser) of: the fair market value of the asset at the inception of the lease, or cost = present value of the minimum lease payments.

Lease should be depreciated (amortized) over the lesser of the lease or asset life if the lessee does not take ownership of the asset by the end of the lease or if there is not a bargain purchase option.

| | |
|---|---|
| Present value of minimum lease payments | $505,000 |
| ÷ Lesser of lease term or asset life | ÷ 9 |
| = Straight line depreciation expense | $ 56,111 |

**CPA-05204 Type1 M/C A-D Corr Ans: C PM#29 F 5-02**

22. CPA-05204 Released 2006 Page 12

Koby Co. entered into a capital lease with a vendor for equipment on January 2 for seven years. The equipment has no guaranteed residual value. The lease required Koby to pay $500,000 annually on January 2, beginning with the current year. The present value of an annuity due for seven years was 5.35 at the inception of the lease. What amount should Koby capitalize as leased equipment?

a. $500,000
b. $825,000
c. $2,675,000
d. $3,500,000

**CPA-05204 Explanation**
Choice "c" is correct. The amount to be capitalized for a capital lease is the present value of the minimum lease payments. In this question, the minimum lease payments are $500,000 and the present value factor is 5.35. The present value of the minimum lease payments is thus $500,000 x.5.35, or $2,675,000.

Choice "a" is incorrect. The amount to capitalize for a capital lease is certainly not the $500,000 amount of the payment.

Choice "b" is incorrect. This is the difference between the total payments of $3,500,000 and the present value of those payments of $2,675,000.

Choice "d" is incorrect. The amount to capitalize for a capital lease is not the total value of the minimum lease payments ($500,000 x 7 = $3,500,000). It is the present value of the minimum lease payments and must include the present value factor in the computation.


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**CPA-05237 Type1 M/C A-D Corr Ans: A PM#30 F 5-02**

23. CPA-05237 Released 2006 Page 10

Which of the following is a criterion for a lease to be classified as a capital lease in the books of a lessee?

a. The lease contains a bargain purchase option.
b. The lease does **not** transfer ownership of the property to the lessee.
c. The lease term is equal to 65% or more of the estimated useful life of the leased property.
d. The present value of the minimum lease payments is 70% or more of the fair market value of the leased property.

**CPA-05237 Explanation**
Choice "a" is correct. One of the four criteria (OWNS) for a lease to be classified as a capital lease on the books of a lessee is the existence of a bargain purchase option.

Choice "b" is incorrect. One of the four criteria (OWNS) for a lease to be classified as a capital lease on the books of a lessee is that the lease does transfer ownership of the leased property to the lessee at the end of the lease.

Choice "c" is incorrect. One of the four criteria (OWNS) for a lease to be classified as a capital lease on the books of a lessee is that the lease term is equal to 75%, **not** 65%, or more of the estimated useful life of the leased property.

Choice "d" is incorrect. One of the four criteria (OWNS) for a lease to be classified as a capital lease on the books of a lessee is that the present value of the minimum lease payments is 90%, **not** 70%, or more of the fair value of the leased property.

**CPA-05438 Type1 M/C A-D Corr Ans: B PM#31 F 5-02**

24. CPA-05438 Released 2007 Page 10

On January 1, year 1, Frost Co. entered into a two-year lease agreement with Ananz Co. to lease 10 new computers. The lease term begins on January 1, year 1 and ends on December 31, year 2. The lease agreement requires Frost to pay Ananz two annual lease payments of $8,000. The present value of the minimum lease payments is $13,000. Which of the following circumstances would require Frost to classify and account for the arrangement as a capital lease?

a. The economic life of the computers is three years.
b. The fair value of the computers on January 1, year 1 is $14,000.
c. Frost does **not** have the option of purchasing the computers at the end of the lease term.
d. Ownership of the computers remains with Ananz throughout the lease term and after the lease ends.

**CPA-05438 Explanation**
Choice "b" is correct. For a lessee to account for a lease is a capital lease, the terms of the lease must meet at least one of the capital lease criteria:

Ownership transfers at the end of the lease

Written option for bargain purchase

PV of minimum lease payments ≥ 90% of FV of leased property

Lease term ≥ 75% of asset useful life

If the fair value of the computers at lease inception is $14,000 and the present value of the minimum lease payments is $13,000, then the lease will be accounted for as a capital lease:

13,000/14,000 = 93%

Choice "a" is incorrect. If the economic life of the computers is 3 years and the lease term is 2 years, the lease will not be accounted for as a capital lease because the lease term is only 67% of the life of the asset.


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Choice "c" is incorrect. If Frost does not have the option to purchase the computers at a discount or bargain price at the end of the lease term, then the lease will not be accounted for as a capital lease.

Choice "d" is incorrect. If ownership does not transfer to Frost, then the lease will not be accounted for as a capital lease.

**CPA-05440 Type1 M/C A-D Corr Ans: B PM#32 F 5-02**

25. CPA-05440 Released 2007 Page 10

Bain Co. entered into a 10-year lease agreement for a new piece of equipment worth $500,000. At the end of the lease, Bain will have the option to purchase the equipment. Which of the following would require the lease to be accounted for as a capital lease?

a. The lease includes an option to purchase stock in the company.
b. The estimated useful life of the leased asset is 12 years.
c. The present value of the minimum lease payments is $400,000.
d. The purchase option at the end of the lease is at fair market value.

**CPA-05440 Explanation**

Choice "b" is correct. For a lessee to account for a lease is a capital lease, the terms of the lease must meet at least one of the capital lease criteria:

Ownership transfers at the end of the lease

Written option for bargain purchase

PV of minimum lease payments ≥ 90% of FV of leased property

Lease term ≥ 75% of asset useful life

If the lease term is 10 years and the useful life of the asset is 12 years, then the "75%" criteria is met (10/12 = 83%) and the lease will be accounted for as a capital lease.

Choice "a" is incorrect. An option to purchase stock in the lessor does not qualify a lease for capital lease treatment. To be accounted for as a capital lease, the lease must meet at least one of the criteria described above.

Choice "c" is incorrect. If the present value of the minimum lease payments is $400,000 and the fair value of the equipment is $500,000, then the lease does not meet the "90%" criteria ($400,000/$500,000 = 80%) and will not be accounted for as a capital lease.

Choice "d" is incorrect. A bargain purchase option, not a fair value purchase option, qualifies a lease for capital lease accounting.

**CPA-05456 Type1 M/C A-D Corr Ans: D PM#33 F 5-02**

26. CPA-05456 Released 2007 Page 6

Main, a pharmaceutical company, leased office space from Ash. Main took possession and began to use the building on July 1, 2000. Rent was due the first day of each month. Monthly lease payments escalated over the 5-year period of the lease as follows:

| *Period* | *Lease payment* |
|---|---|
| July 1, 2000 - September 30, 2000 | $0 - rent abatement during move-in, construction |
| October 1, 2000 - June 30, 2001 | 17,500 |
| July 1, 2001 - June 30, 2002 | 19,000 |
| July 1, 2002 - June 30, 2003 | 20,500 |
| July 1, 2003 - June 30, 2004 | 23,000 |
| July 1, 2004 - June 30, 2005 | 24,500 |

What amount would Main show as deferred rent expense at December 31, 2003?

a. $50,658
b. $52,580


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c. $68,575
d. $71,550

**CPA-05456 Explanation**
Choice "d" is correct. Rent expense must be recognized on a straight-line basis over the life of the lease. In this lease, rent expense and the balance in the deferred rent expense account are recognized as follows:

| | Total Lease Payments | | Lease Expense | | Deferred Lease Exp |
|---|---|---|---|---|---|
| July 1, 2000 - June 31, 2001 | $ 157,500 | - | 240,300 | = | $82,800 |
| July 1, 2001 - June 30, 2002 | 228,000 | - | 240,300 | = | 12,300 |
| July 1, 2002 - June 30, 2003 | 246,000 | - | 240,300 | = | (5,700) |
| July 1, 2003 - June 30, 2004 | 276,000 | - | 240,300 | = | (35,700) |
| July 1, 2004 - June 30, 2005 | 294,000 | - | 240,300 | = | (53,700) |
| | $1,201,500 / 60 months = $20,025/month x 12 = $240,300 | | | | |

Deferred lease expense at December 31, 2003 is therefore:

$82,800 + 12,300 + (5.700) + (35,700 x 6/12) = $71,550

Choices "a", "b", and "c" are incorrect, per the explanation above.

**CPA-05459 Type1 M/C A-D Corr Ans: B PM#34 F 5-02**

27. CPA-05459 Released 2007 Page 18

On January 1 ten years ago, Andrew Co. created a subsidiary for the purpose of buying an oil tanker depot at a cost of $1,500,000. Andrew expected to operate the depot for 10 years, at which time it is legally required to dismantle the depot and remove underground storage tanks. It was estimated that it would cost $150,000 to dismantle the depot and remove the tanks at the end of the depot's useful life. However, the actual cost to demolish and dismantle the depot and remove the tanks in the tenth year is $155,000.

What amount of expense related to the demolition of the depot and the removal of the tanks should Andrew recognize in its financial statements in year 10?

a. None, recognized in prior years.
b. $5,000 expense.
c. $150,000 expense.
d. $155,000 expense.

**CPA-05459 Explanation**
Choice "b" is correct. An asset retirement obligation (ARO) must be recognized at the time the oil tanker is purchased to reflect Andrew's legal obligation to dismantle the depot and remove the underground storage tanks. The ARO would be recorded at the present value of the expected obligation by debiting the oil tanker depot asset and crediting asset retirement obligation liability. Over the 10 year life of the oil tanker depot, accretion expense would be recorded so that at the end of the 10 years, the ARO liability is equal to the undiscounted total expected cost of $150,000. When the actual demolition and removal costs are incurred in year 10, the following JE would be recorded:

| | | | |
|---|---|---|---|
| DR | ARO liability | 150,000 | |
| DR | Demolition expense | 5,000 | |
| CR | Cash/AP | | 155,000 |

Choice "a" is incorrect. Because the actual demolition and retirement costs exceed the ARO, additional expense must be recorded in year 10, as described above.


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Choice "c" is incorrect. This is the amount of the ARO, not the demolition expense recognized in year 10. This amount has already been recognized in expense over the 10 years through both depreciation and accretion expense.

Choice "d" is incorrect. This is the total cost paid for demolition and removal, not the expense recognized in year 10. Only $5,000 of this cost is recognized as demolition expense in year 10. $150,000 of this amount has already been recognized in expense over the 10 years through both depreciation and accretion expense.

**Investment in Debt Securities**

**CPA-00453 Type1 M/C A-D Corr Ans: B PM#1 F 5-03**

28. CPA-00453 FARE Nov 94 #38 Page 72

Leaf Co. purchased from Oak Co. a $20,000, 8%, 5-year note that required five equal annual year-end payments of $5,009. The note was discounted to yield a 9% rate to Leaf. At the date of purchase, Leaf recorded the note at its present value of $19,485. What should be the total interest revenue earned by Leaf over the life of this note?

a. $5,045
b. $5,560
c. $8,000
d. $9,000

**CPA-00453 Explanation**
Choice "b" is correct.

| | |
|---|---|
| Total cash to be received (5 payments × $5,009) | $25,045 |
| Present value of note | 19,485 |
| Total interest revenue | $ 5,560 |

Choice "a" is incorrect. $5,045 equals the total cash flow less the face value of the note rather than the present value of the note.

Choice "c" is incorrect. $8,000 equals the total cash interest to be received (8% × $20,000 × 5 years).

Choice "d" is incorrect. $9,000 equals the face amount of the note times the discount rate for five years. This amount is irrelevant to the problem.

**CPA-00454 Type1 M/C A-D Corr Ans: D PM#2 F 5-03**

29. CPA-00454 Th May 93 #11 Page 33

In 1991, Lee Co. acquired, at a premium, Enfield, Inc. 10-year bonds classified as a held-to-maturity investment. At December 31, 1992, Enfield's bonds were quoted at a small discount. Which of the following situations is the most likely cause of the decline in the bonds' market value?

a. Enfield issued a stock dividend.
b. Enfield is expected to call the bonds at a premium, which is less than Lee's carrying amount.
c. Interest rates have declined since Lee purchased the bonds.
d. Interest rates have increased since Lee purchased the bonds.

**CPA-00454 Explanation**
Choice "d" is correct. If interest rates have increased, then the bonds' interest rate would be less attractive to investors now than when the bonds were originally issued. This would most likely cause a decline in the bonds' market value.

Choice "a" is incorrect. A large stock dividend might materially impact stock prices but most likely would have no effect on bond prices.


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Choice "b" is incorrect. Bond prices in the open market are not related to Lee's carrying amount of the bonds.

Choice "c" is incorrect. If interest rates have declined, then the bonds' interest rate would be even greater than market rates were when the bonds were originally issued. The bonds would be selling at a premium rather than a discount.

**CPA-00456 Type1 M/C A-D Corr Ans: C PM#3 F 5-03**

30. CPA-00456 May 93 T #22 Page 32

When the market value of an investment in debt securities in which the company has a positive intent and ability to hold to maturity, exceeds its carrying amount, how should each of the following assets be reported at the end of the year?

| | *Long-term marketable debt securities* | *Short-term marketable debt securities* |
|---|---|---|
| a. | Market value | Carrying amount |
| b. | Carrying amount | Market value |
| c. | Carrying amount | Carrying amount |
| d. | Market value | Market value |

**CPA-00456 Explanation**
Marketable debt securities, both "long" and "short" term, are reported at carrying amount (amortized cost) unless there is a permanent decline in market value.

Choice "c" is correct. Carrying amount, carrying amount.

**CPA-05199 Type1 M/C A-D Corr Ans: C PM#4 F 5-03**

31. CPA-05199 Released 2006 Page 33

When debt is issued at a discount, interest expense over the term of debt equals the cash interest paid:

a. Minus discount.
b. Minus discount minus par value.
c. Plus discount.
d. Plus discount plus par value.

**CPA-05199 Explanation**
Choice "c" is correct. When debt is issued at a discount, interest expense over the term of the debt equals the cash interest paid plus amortization of the discount. The Journal Entry for the amortization of the discount is as follows:

| | | |
|---|---|---|
| Dr | Interest expense | |
| Cr | | Amortization of bond discount |
| Cr | | Cash (or interest payable) |

An easy way to remember whether to add or to subtract is that the discount is a reduction (Dr) of the bond's face value or par amount (Cr). Since the discount is a Debit, the way to reduce (amortize) it is to Credit it.

Choice "a" is incorrect. When debt is issued at a discount, interest expense over the term of the debt equals the cash interest paid plus, **not** minus, amortization of the discount.

Choice "b" is incorrect. When debt is issued at a discount, interest expense over the term of the debt equals the cash interest paid plus amortization of the discount. The par value should definitely not be subtracted.


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Choice "d" is incorrect. When debt is issued at a discount, interest expense over the term of the debt equals the cash interest paid plus amortization of the discount. The par value should definitely not be added.

**CPA-05216 Type1 M/C A-D Corr Ans: C PM#5 F 5-03**

32. CPA-05216 Released 2006 Page 32

On September 30, World Co. borrowed $1,000,000 on a 9% note payable. World paid the first of four quarterly payments of $264,200 when due on December 30. In its income statement for the year, what amount should World report as interest expense?

a. $0
b. $14,200
c. $22,500
d. $30,000

**CPA-05216 Explanation**

Choice "c" is correct. In this question, World borrowed the $1,000,000 on September 30. That means 3 months of interest had accrued in the current year. The interest is $1,000,000 x .09 x 3/12 = $22,500. The payment of $264,200 will reduce the principal for the next quarterly interest payment due on March 31. The amortization table for this loan is as follows:

| | Payment | Interest | Principal | Balance |
|---|---|---|---|---|
| | | | | $1,000,000 |
| December 30 | 264,200 | 22,500 | 241,700 | 758,300 |
| March 31 | 264,200 | 17,062 | 247,138 | 511,162 |
| June 30 | 264,200 | 11,501 | 252,699 | 258,463 |
| September 30 | 264,200 | 5,815 | 258,463 | -- |

Choice "a" is incorrect. There would certainly be some interest expense for the fourth quarter of the year. So, $0 cannot be correct. $0 can sometimes be a correct answer (when, for example, a condition or a rule does not even apply), but it is not correct for this question.

Choice "b" is incorrect. The $14,200 is determined by taking the difference between the total loan payments of $1,056,800 ($264,200 x 4) and the loan amount of $1,000,000 and multiply by 3/12: ($1,056,800 - $1,000,000) x 3/12 = $14,200. This is straight-line interest recognition, which is not allowed by GAAP. The interest must be calculated using the effective interest method.

Choice "d" is incorrect. This answer is computed by $1,000,000 x .09 x 1/3 = $30,000. There are 3 months in the interest payment period, but that does not mean that the originally calculated interest expense is just divided by 3.

**Long-term Liabilities & Bonds Payable**

**CPA-00457 Type1 M/C A-D Corr Ans: D PM#1 F 5-04**

33. CPA-00457 FARE R99 #9 Page 37

Perk, Inc. issued $500,000, 10% bonds to yield 8%. Bond issuance costs were $10,000. How should Perk calculate the net proceeds to be received from the issuance?

a. Discount the bonds at the stated rate of interest.
b. Discount the bonds at the market rate of interest.
c. Discount the bonds at the stated rate of interest and deduct bond issuance costs.
d. Discount the bonds at the market rate of interest and deduct bond issuance costs.

**CPA-00457 Explanation**


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Choice "d" is correct. Perk, Inc. should calculate the net proceeds to be received from the issuance of the bonds by discounting the bonds at the market rate of interest and then deducting the bond issuance costs.

**Rule:** Discount bonds using the market rate of interest at the date of issuance.

**Rule:** Bond issuance costs are reimbursed to the underwriter before the bond proceeds are given to the issuing company (i.e., they are deducted from the bond proceeds before cash is given to the issuing company).

Choices "a", "b", and "c" are incorrect, per the above rules.

**CPA-00461 Type1 M/C A-D Corr Ans: B PM#4 F 5-04**

34. CPA-00461 FARE Nov 95 #59 Page 36

Barr Co. has total debt of $420,000 and stockholders' equity of $700,000. Barr is seeking capital to fund an expansion. Barr is planning to issue an additional $300,000 in common stock, and is negotiating with a bank to borrow additional funds. The bank is requiring a debt-to-equity ratio of .75. What is the maximum additional amount Barr will be able to borrow?

a. $225,000
b. $330,000
c. $525,000
d. $750,000

**CPA-00461 Explanation**
Choice "b" is correct. Total stockholders' equity will equal $1,000,000 after the issuance of the additional common stock [$700,000 + $300,000]. If the debt/equity ratio is restricted to .75 then debt could be as much as $750,000 [debt/$1,000,000 = .75]. Maximum additional borrowing would be $330,000 [$750,000 possible debt - $420,000 debt already recorded].

Choice "a" is incorrect. Total common stock is used to compute the debt/equity ratio.

Choice "c" is incorrect. The ending stockholders' equity is used to compute the debt/equity ratio.

Choice "d" is incorrect. The question asks for the maximum additional amount that could be borrowed, not the total possible debt.

**CPA-00465 Type1 M/C A-D Corr Ans: B PM#6 F 5-04**

35. CPA-00465 FARE May 95 #20 Page 47

On January 2, 1994, Nast Co. issued 8% bonds with a face amount of $1,000,000 that mature on January 2, 2000. The bonds were issued to yield 12%, resulting in a discount of $150,000. Nast incorrectly used the straight-line method instead of the effective interest method to amortize the discount. How is the carrying amount of the bonds affected by the error?

| | *At* December 31, 1994 | *At* January 2, 2000 |
|---|---|---|
| a. | Overstated | Understated |
| b. | Overstated | No effect |
| c. | Understated | Overstated |
| d. | Understated | No effect |

**CPA-00465 Explanation**
Choice "b" is correct. The maturity date is 6 years from the issuance date. Annual straight-line amortization of the discount equals $25,000 [$150,000/6 years]. At the end of 1994, using straight-line amortization, the bond carrying value equals $875,000 [$1,000,000 face value less $125,000 ($150,000 – $25,000) unamortized discount]. Using effective interest amortization, 1994 interest expense is $102,000


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[$850,000 × 12%], interest paid is $80,000 [$1,000,000 × 8%], discount amortized is $22,000 [$102,000 – $80,000]. Thus, the discount balance is $128,000 [$150,000 – $22,000] and the bond carrying value is $872,000 [$1,000,000 – $128,000]. At December 31, 1994, the bond carrying value is overstated using straight-line amortization [$875,000 vs. $872,000]. At January 2, 2000, the bond carrying value will be the maturity value, regardless of the amortization method used, since this is the maturity date.

Choice "a" is incorrect. At January 2, 2000, the bond carrying value will be the maturity value, regardless of the amortization method used, since this is the maturity date.

Choice "c" is incorrect. At December 31, 1994, the bond carrying value is overstated using straight-line amortization [$875,000 vs. $872,000]. At January 2, 2000, the bond carrying value will be the maturity value, regardless of the amortization method used, since this is the maturity date.

Choice "d" is incorrect. At December 31, 1994, the bond carrying value is overstated using straight-line amortization [$875,000 vs. $872,000].

**CPA-00469 Type1 M/C A-D Corr Ans: B PM#7 F 5-04**

36. CPA-00469 FARE Nov 94 #22 Page 39

House Publishers offered a contest in which the winner would receive $1,000,000, payable over 20 years. On December 31, 1993, House announced the winner of the contest and signed a note payable to the winner for $1,000,000, payable in $50,000 installments every January 2. Also on December 31, 1993, House purchased an annuity for $418,250 to provide the $950,000 prize monies remaining after the first $50,000 installment, which was paid on January 2, 1994.

In its December 31, 1993, balance sheet, what amount should House report as note payable-contest winner, net of current portion?

a. $368,250
b. $418,250
c. $900,000
d. $950,000

**CPA-00469 Explanation**

Choice "b" is correct. Noninterest bearing notes payable are reported at the present value of future cash flows. The present value of the noncurrent future cash flows totaling $950,000 equals $418,250 (creating a discount on notes payable of $531,750). The present value of the current portion ($50,000 due January 2, 1994) of the liability is $50,000.

Choice "a" is incorrect. The $418,250 is already net of the $50,000 currently due.

Choice "c" is incorrect. The present value of the noncurrent future cash flows is the correct amount to be reported rather than the face value of the note payable less the $50,000 due January 2, 1994 and due January 2, 1995.

Choice "d" is incorrect. The present value of the noncurrent future cash flows is the correct amount to be reported rather than the face value of the note payable less the $50,000 due January 2, 1994.

**CPA-00472 Type1 M/C A-D Corr Ans: B PM#10 F 5-04**

37. CPA-00472 FARE May 94 #29 Page 48

On January 1, 1994, Oak Co. issued 400 of its 8%, $1,000 bonds at 97 plus accrued interest. The bonds are dated October 1, 1993, and mature on October 1, 2003. Interest is payable semiannually on April 1 and October 1. Accrued interest for the period October 1, 1993, to January 1, 1994, amounted to $8,000. On January 1, 1994, what amount should Oak report as bonds payable, net of discount?

a. $380,300
b. $388,000
c. $388,300
d. $392,000


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**CPA-00472 Explanation**
Choice "b" is correct. January 1, 1994 is the issuance date of the bonds and on that date, the bonds will be reported at their issuance price of $388,000 (97% x $400,000).

Choice "a" is incorrect. On the issuance date, the bonds are reported at their issuance price.

Choice "c" is incorrect. On the issuance date, the bonds are reported at their issuance price.

Choice "d" is incorrect. On the issuance date, the bonds are reported at their issuance price.

**CPA-00474 Type1 M/C A-D Corr Ans: B PM#12 F 5-04**

38. CPA-00474 FARE May 94 #43 Page 33

Jent Corp. purchased bonds at a discount of $10,000. Subsequently, Jent sold these bonds at a premium of $14,000. During the period that Jent held this investment, amortization of the discount amounted to $2,000. What amount should Jent report as gain on the sale of bonds?

a. $12,000
b. $22,000
c. $24,000
d. $26,000

**CPA-00474 Explanation**
Choice "b" is correct. The bonds' book value equals the bond face value less the unamortized discount. The unamortized discount = $10,000 - $2,000 = $8,000, so the book value equals face value - $8,000. The selling price of the bonds is face value + $14,000. The gain on the sale equals the selling price (face value + $14,000) minus the book value (face value - $8,000) = $22,000.

Choice "a" is incorrect. The premium less the amortized discount is not the proper calculation of the gain.

Choice "c" is incorrect. This calculation ignores the $2,000 amortization of discount.

Choice "d" is incorrect. In this calculation, the $2,000 amortization of discount is included as a decrease in book value rather than an increase.

**CPA-00475 Type1 M/C A-D Corr Ans: D PM#13 F 5-04**

39. CPA-00475 FARE May 94 #46 Page 49

A bond issued on June 1, 1993, has interest payment dates of April 1 and October 1. Bond interest expense for the year ended December 31, 1993, is for a period of:

a. Three months.
b. Four months.
c. Six months.
d. Seven months.

**CPA-00475 Explanation**
Choice "d" is correct. Interest expense is recognized for the entire period from bond issuance (June 1) through the fiscal year end (December 31).

Choice "a" is incorrect. Three months would only be the time period from October 1 (most recent interest payment date) through December 31 (fiscal year end). This amount represents the interest accrual.

Choice "b" is incorrect. Four months would only be the time period from June 1 (issuance date) through October 1 (first interest payment date after issuance).

Choice "c" is incorrect. Six months would only be the time period from June 30 through December 31 and the bond was issued on June 1.


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**CPA-00480 Type1 M/C A-D Corr Ans: C PM#16 F 5-04**

40. CPA-00480 PI Nov 93 #33 Page 56

On December 30, 1992, Fort, Inc. issued 1,000 of its 8%, 10-year, $1,000 face value bonds with detachable stock warrants at par. Each bond carried a detachable warrant for one share of Fort's common stock at a specified option price of $25 per share. Immediately after issuance, the market value of the bonds without the warrants was $1,080,000 and the market value of the warrants was $120,000. In its December 31, 1992, balance sheet, what amount should Fort report as bonds payable?

a. $1,000,000
b. $975,000
c. $900,000
d. $880,000

**CPA-00480 Explanation**
Choice "c" is correct. The net bonds payable is $1,000,000 less $100,000 or $900,000. The issuance of bonds with detachable stock warrants would be recorded as:

| | | |
|---|---|---|
| Cash | 1,000,000 | |
| Discount | 100,000 | |
| Paid-in-capital, warrants* | | 100,000 |
| Bonds payable | | 1,000,000 |

*$120,000 / ($1,080,000 + $120,000) = 10%
10% × $1,000,000 = $100,000

APB 14 para. 16

Choice "a" is incorrect. The bonds would have a contra account for the discount.

Choice "b" is incorrect. The value of the warrants and bonds are used to determine the net bonds payable.

Choice "d" is incorrect. The value of the warrants and bonds are used to determine the net bonds payable.

**CPA-00482 Type1 M/C A-D Corr Ans: D PM#17 F 5-04**

41. CPA-00482 PI Nov 93 #34 Page 41

On January 2, 1992, Gill Co. issued $2,000,000 of 10-year, 8% bonds at par. The bonds, dated January 1, 1992, pay interest semiannually on January 1 and July 1. Bond issue costs were $250,000. What amount of bond issue costs are unamortized at June 30, 1993?

a. $237,500
b. $225,000
c. $220,800
d. $212,500

**CPA-00482 Explanation**
Choice "d" is correct. Bond issue costs are recorded as deferred charges, and amortized over the life of the related debt. Amortization usually follows the straight-line method. Amortization for 1 1/2 years should have been recorded.

| | |
|---|---|
| Balances 1-2-92 | $250,000 |
| Amortization (250,000 x 1/10 x 1 1/2 yr) | (37,500) |
| Balance 6-30-93 | $212,500 |

Choice "a" is incorrect. Bond issue costs are recorded as deferred charges, and amortized over the life of the related debt. Amortization usually follows the straight-line method. Amortization for 1 1/2 years should have been recorded.


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Choice "b" is incorrect. Bond issue costs are recorded as deferred charges, and amortized over the life of the related debt. Amortization usually follows the straight-line method. Amortization for 1 1/2 years should have been recorded.

Choice "c" is incorrect. Bond issue costs are recorded as deferred charges, and amortized over the life of the related debt. Amortization usually follows the straight-line method. Amortization for 1 1/2 years should have been recorded.

**CPA-00485 Type1 M/C A-D Corr Ans: C PM#18 F 5-04**

42. CPA-00485 PI Nov 93 #36 Page 45

Webb Co. has outstanding a 7%, 10-year $100,000 face-value bond. The bond was originally sold to yield 6% annual interest. Webb uses the effective interest rate method to amortize bond premium. On June 30, 1992, the carrying amount of the outstanding bond was $105,000. What amount of unamortized premium on bond should Webb report in its June 30, 1993, balance sheet?

a. $1,050
b. $3,950
c. $4,300
d. $4,500

**CPA-00485 Explanation**
Choice "c" is correct. The unamortized premium is amortized over the life of the bond using the 6% yield rate. The following chart shows the unamortized premiums:

| *Date* | *Interest Expense* | *Interest Paid* | *Premium Amortized* | *Unamortized Premium* |
|---|---|---|---|---|
| 6-30-92 | | | | $5,000 |
| 6-30-93 | $6,300 | $7,000 | $700 | 4,300 |

**Note:** $6,300 =

| | |
|---|---|
| Carrying amount of note at beginning of period | $105,000 |
| x 6% effective interest rate | 6% |
| Interest expense for period | $6,300 |

APB 21 para. 16

**Note:** If interest had been paid and premium amortized every 6 months, the unamortized premium would have been approximately $4,290.

Choice "a" is incorrect. The unamortized premium is amortized over the life of the bond using the 6% yield rate.

Choice "b" is incorrect. The unamortized premium is amortized over the life of the bond using the 6% yield rate.

Choice "d" is incorrect. The effective interest, not straight-line, method is being used.

**CPA-00487 Type1 M/C A-D Corr Ans: B PM#19 F 5-04**

43. CPA-00487 PI Nov 93 #37 Page 54

On July 1, 1992, after recording interest and amortization, York Co. converted $1,000,000 of its 12% convertible bonds into 50,000 shares of $1 par value common stock. On the conversion date the carrying amount of the bonds was $1,300,000, the market value of the bonds was $1,400,000, and York's common stock was publicly trading at $30 per share. Using the book value method, what amount of additional paid-in capital should York record as a result of the conversion?

a. $950,000
b. $1,250,000


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c. $1,350,000
d. $1,500,000

**CPA-00487 Explanation**
Choice "b" is correct. Under the book value method, the conversion of debt requires credits to common stock and paid-in capital equal to the book (carrying) value of the bonds. No gain or loss is recorded. The journal entry would be:

| | | |
|---|---|---|
| Bonds payable | 1,000,000 | |
| Bond premium | 300,000 | |
| Common stock (par) | | 50,000 |
| Add, paid-in capital (to balance) | | 1,250,000 |

APB 14 para. 12

**CPA-00488 Type1 M/C A-D Corr Ans: C PM#20 F 5-04**

44. CPA-00488 PI Nov 93 #40 Page 58

On June 2, 1988, Tory, Inc. issued $500,000 of 10%, 15-year bonds at par. Interest is payable semiannually on June 1 and December 1. Bond issue costs were $6,000. On June 2, 1993, Tory retired half of the bonds at 98. What is the net amount that Tory should use in computing the gain or loss on retirement of debt?

a. $249,000
b. $248,500
c. $248,000
d. $247,000

**CPA-00488 Explanation**
Choice "c" is correct. The amount used to compute a gain or loss on bond retirement is the carrying amount of the bond and the pro rata portion of bond issue cost.

| | |
|---|---|
| Original carrying amount | $500,000 |
| Bond issue cost ($6,000 x 10/15) | (4,000) |
| Net carrying amount 6-2-93 | 496,000 |
| Portion retired | x 50% |
| Amount used to compute gain/loss | $248,000 |

SFAS 4, para 8

Choice "a" is incorrect. The total bond issue cost balance on 6-2-93 is $6,000 less 5/15 of $6,000 or $4,000. One-half of this should be written off when the bonds are retired.

Choice "b" is incorrect. The total bond issue cost balance on 6-2-93 is $6,000 less 5/15 of $6,000 or $4,000. One-half of this should be written off when the bonds are retired.

Choice "d" is incorrect. The total bond issue cost balance on 6-2-93 is $6,000 less 5/15 of $6,000 or $4,000. One-half of this should be written off when the bonds are retired.

**CPA-00489 Type1 M/C A-D Corr Ans: C PM#21 F 5-04**

45. CPA-00489 PI May 93 #2 Page 34

On December 31, 1992, Largo, Inc. had a $750,000 note payable outstanding, due July 31, 1993. Largo borrowed the money to finance construction of a new plant. Largo planned to refinance the note by issuing long-term bonds. Because Largo temporarily had excess cash, it prepaid $250,000 of the note on January 12, 1993. In February 1993, Largo completed a $1,500,000 bond offering. Largo will use the bond offering proceeds to repay the note payable at its maturity and to pay construction costs during 1993. On March 3, 1993, Largo issued its 1992 financial statements. What amount of the note payable should Largo include in the current liabilities section of its December 31, 1992, balance sheet?


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a. $750,000
b. $500,000
c. $250,000
d. $0

**CPA-00489 Explanation**
Choice "c" is correct. Short-term debt that is expected to be refinanced is classified as long-term to the extent of post-balance sheet refinancing. Support must exist for the refinancing. The $250,000 was paid prior to refinancing and should be included as a current liability. SFAS 6 para. 10, 11

Choice "a" is incorrect. The $750,000 is expected to be refinanced with long-term bonds. The bonds were issued prior to issuance of the financial statements, so the $500,000 outstanding can be classified as long-term.

Choice "b" is incorrect. The $750,000 is expected to be refinanced with long-term bonds. The bonds were issued prior to issuance of the financial statements, so the $500,000 outstanding can be classified as long-term.

Choice "d" is incorrect. The $500,000 meets the criteria for refinancing on a long-term basis and is therefore not a current liability. The $250,000 was paid prior to refinancing and is classified at year-end as a current liability.

**CPA-00501 Type1 M/C A-D Corr Ans: A PM#23 F 5-04**

46. CPA-00501 PI May 93 #15 Page 33

On July 1, 1992, York Co. purchased as a held-to-maturity investment $1,000,000 of Park, Inc.'s 8% bonds for $946,000, including accrued interest of $40,000. The bonds were purchased to yield 10% interest. The bonds mature on January 1, 1999, and pay interest annually on January 1. York uses the effective interest method of amortization. In its December 31, 1992, balance sheet, what amount should York report as investment in bonds?

a. $911,300
b. $916,600
c. $953,300
d. $960,600

**CPA-00501 Explanation**
Choice "a" is correct. The carrying amount of the bonds is $906,000 on July 1, 1992 ($946,000 - $40,000). The discount is amortized for 6 months (July 1 to December 31):

| | |
|---|---|
| Interest revenue ($906,000 x 10% x 6/12) | $ 45,300 |
| Interest receivable ($1,000,000 x 8% x 6/12) | (40,000) |
| Discount amortized | $ 5,300 |

The carrying amount on December 31, 1992, is $906,000 + $5,300 = $911,300.

Choice "b" is incorrect. The discount should be amortized for 6 months, not 1 year.

Choice "c" is incorrect. The discount to be amortized is based on a cost of $906,000. The original journal entry is:

| | | |
|---|---|---|
| Investment | 906,000* | |
| Accrued interest received | 40,000 | |
| Cash | | 946,000 |

* or, investment $1,000,000 and a discount of $94,000.

Choice "d" is incorrect. The carrying amount of the bonds is $906,000 on July 1. Only 6 months of amortization is recorded (July 1 to December 31).


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**CPA-00503 Type1 M/C A-D Corr Ans: B PM#24 F 5-04**

47. CPA-00503PI May 93 #16 Page 49

The following information relates to the held-to-maturity investments that Fall Corp. placed in trust as required by the underwriter of its bonds:

| | |
|---|---|
| Bond sinking fund balance, 12/31/91 | $ 450,000 |
| 1992 additional investment | 90,000 |
| Dividends on investments | 15,000 |
| Interest revenue | 30,000 |
| Administration costs | 5,000 |
| Carrying amount of bonds payable | 1,025,000 |

What amount should Fall report in its December 31, 1992, balance sheet related to its noncurrent investment for bond sinking fund requirements?

a. $585,000
b. $580,000
c. $575,000
d. $540,000

**CPA-00503 Explanation**
Choice "b" is correct. Bond sinking funds are accounted for in their own account including investments plus revenues less expenses.

| | |
|---|---|
| Balance, 12/31/91 | $450,000 |
| Investment | 90,000 |
| Dividend revenue | 15,000 |
| Interest revenue | 30,000 |
| Administration cost | (5,000) |
| Balance | $ 580,000 |

**CPA-00505 Type1 M/C A-D Corr Ans: B PM#25 F 5-04**

48. CPA-00505Th May 93 #18 (Adapted) Page 58

Weald Co. took advantage of market conditions to refund debt. This was the fifth refunding operation carried out by Weald within the last four years. The excess of the carrying amount of the old debt over the amount paid to extinguish it should be reported as a (an):

a. Deferred credit to be amortized over life of new debt.
b. Part of continuing operations.
c. Extraordinary gain, net of income taxes.
d. Extraordinary loss, net of income taxes.

**CPA-00505 Explanation**
Choice "b" is correct. Many companies and agencies extinguish (or refund) long-term debt prior to maturity as a method of managing financial risk. In this case, the refunding is not considered an extraordinary event because it does not meet the criteria of APBO No. 30. The gain (retirement price less carrying amount of the old debt) will be included as part of continuing operations.

Choice "a" is incorrect. Gains or losses on early retirement of debt must be recognized at the time of the transaction.

Choice "c" is incorrect. The gain is not an extraordinary item, per the above discussion.

Choice "d" is incorrect. There is a gain on the refunding, not a loss, and the classification does not meet the extraordinary item criteria of APBO No. 30.

**CPA-00512 Type1 M/C A-D Corr Ans: D PM#26 F 5-04**


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49. CPA-00512 PI May 93 #32 Page 56

On March 1, 1992, Evan Corp. issued $500,000 10% nonconvertible bonds at 103, due on February 28, 2002. Each $1,000 bond was issued with 30 detachable stock warrants, each of which entitled the holder to purchase, for $50, one share of Evan's $25 par common stock. On March 1, 1992, the market price of each warrant was $4. By what amount should the bond issue proceeds increase stockholders' equity?

a. $0
b. $15,000
c. $45,000
d. $60,000

**CPA-00512 Explanation**
Choice "d" is correct. Stockholders' equity is increased by the value of the warrants. There are 500 bonds with 30 warrants worth $4 each. 500 x 30 x $4 = $60,000. APB 14 para. 15

Choice "a" is incorrect. Stockholders' equity is increased by the value of the warrants.

Choice "b" is incorrect. There are 15,000 warrants. Their value increases stockholders' equity.

Choice "c" is incorrect. There are 500 bonds ($500,000 ÷ $1,000) and each has 30 warrants worth $4 each.

**CPA-00513 Type1 M/C A-D Corr Ans: C PM#27 F 5-04**

50. CPA-00513 May 92 I #16 Page 46

On December 1, 1991, Tigg Mortgage Co. gave Pod Corp. a $200,000, 12% loan. Pod received proceeds of $194,000 after the deduction of a $6,000 nonrefundable loan origination fee. Principal and interest are due in 60 monthly installments of $4,450, beginning January 1, 1992. The repayments yield an effective interest rate of 12% at a present value of $200,000 and 13.4% at a present value of $194,000. What amount of accrued interest receivable should Tigg include in its December 31, 1991, balance sheet?

a. $4,450
b. $2,166
c. $2,000
d. $0

**CPA-00513 Explanation**
Choice "c" is correct. $2,000 accrued interest receivable in December 31, 1991 BS.

$$200{,}000 \times 12\% \times 1/12 = 2{,}000$$

While the calculation based on proceeds received of $194,000 ($194{,}000 \times 13.4\% \times 1/12$) equals interest earned of $2166, only $2000 is a receivable, since the $166 difference is amortization of deferred interest income.

**CPA-00515 Type1 M/C A-D Corr Ans: B PM#28 F 5-04**

51. CPA-00515 May 91 T #4 Page 48

An investor purchased a bond classified as a long-term investment between interest dates at a discount. At the purchase date, the carrying amount of the bond is more than the:

| | *Cash paid to seller* | *Face amount of bond* |
|---|---|---|
| a. | No | Yes |
| b. | No | No |
| c. | Yes | No |
| d. | Yes | Yes |


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**CPA-00515 Explanation**
Choice "b" is correct. No - No.

The carrying value is less than the cash paid by the investor because accrued interest is included in the cash.

The carrying value is less than the face amount of the bond because it was purchased at a discount.

**CPA-00516 Type1 M/C A-D Corr Ans: D PM#29 F 5-04**

52. CPA-00516 Nov 90 I #4 Page 42

On October 1, 1988, Park Co. purchased 200 of the $1,000 face value, 10% bonds of Ott, Inc., for $220,000, including accrued interest of $5,000. The bonds, which mature on January 1, 1995, pay interest semiannually on January 1 and July 1. Park used the straight-line method of amortization and appropriately recorded the bonds as a long-term investment. On Park's December 31, 1989 balance sheet, the bonds should be reported at:

a. $215,000
b. $214,400
c. $214,200
d. $212,000

**CPA-00516 Explanation**
Choice "d" is correct. $212,000 carrying value on the balance sheet at 12-31-89.

| | |
|---|---|
| Purchase price, including interest | $220,000 |
| Less accrued interest | (5,000) |
| | 215,000 |
| S/L amortization of bond premium ($15,000 x 15/75) | (3,000) |
| Carrying value at 12-31-89 | $212,000 |

**CPA-00517 Type1 M/C A-D Corr Ans: B PM#30 F 5-04**

53. CPA-00517 May 90 I #3 Page 41

On April 1, 1989, Saxe, Inc. purchased $200,000 face value, 9% U.S. Treasury Notes for $198,500, including accrued interest of $4,500. The notes mature July 1, 1990, and pay interest semiannually on January 1 and July 1. Saxe uses the straight-line method of amortization. The notes were sold on December 1, 1989 for $206,500, including accrued interest of $7,500. In its October 31, 1989 balance sheet, the carrying amount of this investment should be:

a. $194,000
b. $196,800
c. $197,200
d. $199,000

**CPA-00517 Explanation**
Choice "b" is correct. $196,800 carrying amount of investment at 10/31/89.

| | |
|---|---|
| Purchase price, including interest | $198,500 |
| Less accrued interest receivable | 4,500 |
| Purchase price, including discount @ 4/1/89 | 194,000 |
| Face value | 200,000 |
| Discount | 6,000 |
| 15 months from purchase to maturity | + 15 |
| Monthly amortization | $400 |
| 4/1/89 to 10/31/89 – 7 months | × 7 |
| Amortization to 10/31/89 | 2,800 |


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| | |
|---|---|
| Purchase price, from above at 4/1/89 | 194,000 |
| Carrying amount at 10/31/89 | 196,800 **B** |

**CPA-04656 Type1 M/C A-D Corr Ans: D PM#31 F 5-04**

54. CPA-04656 Released 2005 Page 48

On June 1 of the current year, Cross Corp. issued $300,000 of 8% bonds payable at par with interest payment dates of April 1 and October 1. In its income statement for the current year ended December 31, what amount of interest expense should Cross report?

a. $6,000
b. $8,000
c. $12,000
d. $14,000

**CPA-04656 Explanation**
Choice "d" is correct. Interest expense is calculated from the date the bond is issued. Interest would be calculated from June 1 through December 31 (7 months).

$300,000 x 8% = $24,000 annual interest cost

$24,000 /12 = $2,000 per month

$2,000 x 7 = $14,000 interest expense

**CPA-04678 Type1 M/C A-D Corr Ans: C PM#32 F 5-04**

55. CPA-04678 Released 2005 Page 44

Album Co. issued 10-year $200,000 debenture bonds on January 2. The bonds pay interest semiannually. Album uses the effective interest method to amortize bond premiums and discounts. The carrying value of the bonds on January 2 was $185,953. A journal entry was recorded for the first interest payment on June 30, debiting interest expense for $13,016 and crediting cash for $12,000. What is the annual stated interest rate for the debenture bonds?

a. 6%
b. 7%
c. 12%
d. 14%

**CPA-04678 Explanation**
Choice "c" is correct. GAAP interest expense = Carrying value at the **beginning** of the period x effective periodic interest rate algebraically changes to:

$$\frac{\text{GAAP interest expense}}{\text{Carrying value at beginning of period}} = \text{Periodic interest rate}$$

$$\frac{13{,}016}{185{,}953} = 7\% \text{ for } \tfrac{1}{2} \text{ year} \times 2 \text{ for } 14\% \text{ Periodic interest}$$

The question is asking for the "Stated Interest" not GAAP Interest.

Stated interest = amount stated on Bond: thus $12,000/200,000 = 6% x 2 = 12%

**CPA-05205 Type1 M/C A-D Corr Ans: D PM#33 F 5-04**

56. CPA-05205 Released 2006 Page 35

Godart Co. issued $4,500,000 notes payable as a scrip dividend that matured in five years. At maturity, each shareholder of Godart's three million shares will receive payment of the note principal plus interest.


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The annual interest rate was 10%. What amount should be paid to the stockholders at the end of the fifth year?

a. $450,000
b. $2,250,000
c. $4,500,000
d. $6,750,000

**CPA-05205 Explanation**
Note: For purposes of this question, to clarify the question, we are assuming that what the examiners mean is that each shareholder will receive his/her "portion" of the note receivable plus interest; however, the interpretation does not really make any difference because the question is what amount should be paid to the stockholders (in total). Further, there is nothing about a note that automatically says the interest on the note has to be simple interest. Many notes are short-term (less than a year), and the issue thus never arises.

Choice "d" is correct. The annual interest rate on the notes is 10% assumed to be non-compounding (the question does not say that, or indicate it in any way, but it is the only way to get the answer that the examiners have provided). Simple interest each year is $450,000 ($4,500,000 x .10), and 5 years of this interest is $2,250,000. The note principal plus interest is thus $4,500,000 plus $2,250,000, or $6,750,000.

Choice "a" is incorrect. $450,000 is only one year's worth of interest, and the time period in this question is five years. This answer also ignores the principal. The stockholders would really be unhappy.

Choice "b" is incorrect. This answer ignores the principal and includes just the interest in the payment to the stockholders. The question says that the shareholders will receive principal PLUS interest.

Choice "c" is incorrect. This answer ignores the interest and just includes the principal in the payment to the stockholders. The question says that the shareholders will receive principal PLUS interest.

**CPA-05435 Type1 M/C A-D Corr Ans: A PM#34 F 5-04**

57. CPA-05435 Released 2007 Page 44

Foley Co. is preparing the electronic spreadsheet below, to amortize the discount on its 10-year, 6%, $100,000 bonds payable. Bonds were issued on December 31 to yield 8%. Interest is paid annually. Foley uses the effective interest method to amortize bond discounts.

| | A | B | C | D | E |
|---|---|---|---|---|---|
| **1** | *Year* | *Cash paid* | *Interest expense* | *Discount amortization* | *Carrying amount* |
| **2** | 1 | | | | $86,580 |
| **3** | 2 | $6,000 | | | |

Which formula should Foley use in cell E3 to calculate the bonds' carrying amount at the end of Year 2?

a. E2 + D3
b. E2 - D3
c. E2 + C3
d. E2 - C3

**CPA-05435 Explanation**
Choice "a" is correct. When the effective interest amortization method is used to amortize a bond issued at a discount, the ending carrying amount of the bond is equal to the beginning carrying amount plus the discount amortized during the current period. The carrying amount of Foley's bond at the end of Year 2 is therefore the beginning carrying amount found in cell E2 plus the Year 2 discount amortization found in cell D3.

Choice "b" is incorrect. When computing the ending carrying amount of a bond issued at a discount, the discount amortized during the current period is added to, not subtracted from, the beginning carrying


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amount. Amortization is subtracted when computing the ending carrying value of a bond issued at a premium.

Choice "c" is incorrect. Discount amortization, not interest expense, is added to the beginning carrying amount to determine the ending carrying amount of a bond issued at a discount.

Choice "d" is incorrect. Discount amortization, not interest expense, is added to, and not subtracted from, the beginning carrying amount to determine the ending carrying amount of a bond issued at a discount.

**CPA-05461 Type1 M/C A-D Corr Ans: A PM#35 F 5-04**

58. CPA-05461 Released 2007 Page 53

Which of the following is generally associated with the terms of convertible debt securities?

a. An interest rate that is lower than nonconvertible debt.
b. An initial conversion price that is less than the market value of the common stock at time of issuance.
c. A noncallable feature.
d. A feature to subordinate the security to nonconvertible debt.

**CPA-05461 Explanation**
Choice "a" is correct. The interest rate on convertible debt is generally lower than nonconvertible debt because of the value of the conversion feature.

Choice "b" is incorrect. The conversion price is generally greater than the market value of the common stock at the time of issuance.

Choice "c" is incorrect. This is not a typical feature of convertible debt securities.

Choice "d" is incorrect. Convertible debt is not typically subordinate to nonconvertible debt.

**Troubled Debt Restructurings**

**CPA-00519 Type1 M/C A-D Corr Ans: A PM#1 F 5-05**

59. CPA-00519 FARE R02 #9 Page 63

For a troubled debt restructuring involving only a modification of terms, which of the following items specified by the new terms would be compared to the carrying amount of the debt to determine if the debtor should report a gain on restructuring?

a. The total future cash payments.
b. The present value of the debt at the original interest rate.
c. The present value of the debt at the modified interest rate.
d. The amount of future cash payments designated as principal repayments.

**CPA-00519 Explanation**
Choice "a" is correct. Carrying amount - Total future cash payments = Gain.

**CPA-00520 Type1 M/C A-D Corr Ans: C PM#2 F 5-05**

60. CPA-00520 FARE R01 #10 (Adapted) Page 62

Ace Corp. entered into a troubled debt restructuring agreement with National Bank. National agreed to accept land with a carrying amount of $75,000 and a fair value of $100,000 in exchange for a note with a carrying amount of $150,000. This transaction meets the criteria for classification as an extraordinary item under APBO No. 30. Disregarding income taxes, what amount should Ace report as extraordinary gain in its income statement?

a. $0
b. $25,000
c. $50,000


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d. $75,000

**CPA-00520 Explanation**
Choice "c" is correct. $50,000 is reported as extraordinary gain related to a troubled debt restructuring agreement in which the transaction met the criteria for extraordinary classification and treatment according to APBO No. 30 and SFAS No. 145. The calculation is as follows:

| | |
|---|---|
| Cancellation of debt | $150,000 |
| Less: FMV asset exchanged | (100,000) |
| Extraordinary gain on restructuring | $ 50,000 |
| | |
| FMV asset exchanged | $100,000 |
| NBV asset exchanged | (75,000) |
| Ordinary gain on disposal/exchange | $ 25,000 |

**CPA-00522 Type1 M/C A-D Corr Ans: C PM#3 F 5-05**

61. CPA-00522 FARE R99 #14 (Adapted) Page 62

Casey Corp. entered into a troubled debt restructuring agreement with First State Bank. First State agreed to accept land with a carrying amount of $85,000 and a fair value of $120,000 in exchange for a note with a carrying amount of $185,000. This transaction meets the criteria for classification as an extraordinary item under APBO No. 30. Disregarding income taxes, what amount should Casey report as extraordinary gain in its income statement?

a. $0
b. $35,000
c. $65,000
d. $100,000

**CPA-00522 Explanation**
Choice "c" is correct. Casey Corp. should report $65,000 (without regard to income taxes) as extraordinary gain in its income statement.

**Rule:** In a troubled debt restructuring, if the debtor achieves full settlement of the debt by transferring assets having a fair market value that is less than the amount of the debt, extraordinary gain is recognized for the difference between the carrying value of the payable at the date of transfer and the fair market value of the asset at the date of the transfer and if the transaction meets all criteria for classification and treatment as an extraordinary item according to APBO No. 30 and SFAS No. 145.

| | |
|---|---|
| Carrying value of the debt at the date of transfer | $ 185,000 |
| Fair market value of the land at the date of transfer | (120,000) |
| Extraordinary gain | $ 65,000 |

Choices "a", "b", and "d" are incorrect, per the above rule.

**CPA-00526 Type1 M/C A-D Corr Ans: C PM#4 F 5-05**

62. CPA-00526 R96 #7 Page 67

When a loan receivable is impaired but foreclosure is **not** probable, which of the following may the creditor use to measure the impairment?

I. The loan's observable market price.
II. The fair value of the collateral if the loan is collateral dependent.

a. I only.
b. II only.
c. Either I or II.


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d. Neither I nor II.

**CPA-00526 Explanation**
Choice "c" is correct. SFAS No. 114 states that a loan is impaired when it is probable that a creditor will be unable to collect all amounts due (including both principal and interest) according to the contractual terms of the loan agreement. When a loan is impaired and foreclosure is not probable, the creditor should measure impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate. However, as a practical expedient, the creditor may measure impairment based on (1) a loan's observable market price, or (2) the fair value of the collateral if the loan is collateral dependent. If foreclosure of a loan is probable, impairment must be measured based on the fair value of the collateral.

Choices "a", "b", and "d" are incorrect. Both the loan's observable market price and the fair value of collateral can be used to measure impairment.

**CPA-00534 Type1 M/C A-D Corr Ans: D PM#7 F 5-05**

63. CPA-00534 Nov 91 I #43 (Adapted) Page 62

During 1990, Colt Co. experienced financial difficulties and is likely to default on a $1,000,000, 15%, 3-year note dated January 1, 1989, payable to Cain National Bank. On December 31, 1990, the bank agreed to settle the note and unpaid 1990 interest of $150,000 for $820,000 cash payable on January 31, 1991. The event is deemed extraordinary per the criteria of APBO No. 30. What is the amount of gain, before income taxes, from the debt restructuring?

a. $0
b. $150,000
c. $180,000
d. $330,000

**CPA-00534 Explanation**
Choice "d" is correct. $330,000. The gain is an extraordinary item because it meets the criteria of APBO No. 30. The amount of the gain, before taxes, is calculated as follows:

| | |
|---|---|
| Principal | $1,000,000 |
| Interest accrued | 150,000 |
| Net carrying amount | 1,150,000 |
| Settlement price - cash | (820,000) |
| Gain from debt restructuring, before tax | $ 330,000 |

Choice "a" is incorrect. Gain should be recognized in the period in which settlement is reached and should be reported net of tax in this case because the transaction qualifies as an extraordinary item.

Choices "b" and "c" are incorrect. Gain from debt restructuring should consider both the principal balance outstanding and the related accrued interest.

**CPA-00535 Type1 M/C A-D Corr Ans: C PM#8 F 5-05**

64. CPA-00535 Nov 91 I #52 (Adapted) Page 63

In 1985, May Corp. acquired land by paying $75,000 down and signing a note with a maturity value of $1,000,000. On the note's due date, December 31, 1990, May owed $40,000 of accrued interest and $1,000,000 principal on the note. May was in financial difficulty and was unable to make any payments. This situation was unusual and infrequent for May Corp., and is considered material. May and the bank agreed to amend the note as follows:

- The $40,000 of interest due on December 31, 1990, was forgiven.
- The principal of the note was reduced from $1,000,000 to $950,000 and the maturity date extended 1 year to December 31, 1991.


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- May would be required to make one interest payment totaling $30,000 on December 31, 1991.

As a result of the troubled debt restructuring, May should report a gain, before taxes, in its 1990 income statement of:

a. $40,000
b. $50,000
c. $60,000
d. $90,000

**CPA-00535 Explanation**
Choice "c" is correct. $60,000 extraordinary gain, before taxes.*

| | | |
|---|---|---|
| Face value of note payable | | $1,000,000 |
| Accrued interest at date of restructuring | | 40,000 |
| | | 1,040,000 |
| Fair value of restructured debt: principal after reduction | 950,000 | |
| Interest payment required | 30,000 | (980,000) |
| Extraordinary gain on debt restructuring | | 60,000 |

* Note that the gain is classified as extraordinary because it meets the criteria of APBO No. 30.

**CPA-00762 Type1 M/C A-D Corr Ans: D PM#9 F 5-05**

65. CPA-00762 May 92 I #53 (Adapted) Page 62

Nu Corp. agreed to give Rand Co. a machine in full settlement of a note payable to Rand. The machine's original cost was $140,000. The note's face amount was $110,000. On the date of the agreement:

- The note's carrying amount was $105,000, and its present value was $96,000.
- The machine's carrying amount was $109,000, and its fair value was $96,000.

This situation was not unusual or infrequent for Nu Corp.

What amount of gains (losses) should Nu recognize, and how should these be classified in its income statement?

| | *Extraordinary* | *Other* |
|---|---|---|
| a. | $(4,000) | $0 |
| b. | $9,000 | $(13,000) |
| c. | $5,000 | $(4,000) |
| d. | $0 | $(4,000) |

**CPA-00762 Explanation**
Choice "d" is correct. $9,000 ordinary gain on extinguishment of long-term debt, and $(13,000) ordinary loss on disposal of machine, netting to an ordinary loss of $4,000.

| | Note | Machine |
|---|---|---|
| Carrying amount | $105,000 | $109,000 |
| Present value | 96,000 | 96,000 |
| Ordinary gain on extinguishment f L/T debt | $ 9,000 | |
| Ordinary loss on disposal of machine | | $ 13,000 |
| Net loss | | $ (4,000) |

**CPA-00371 Type1 M/C A-D Corr Ans: C PM#9 F 5-05**

66. CPA-00371 Nov 91 I #57 Page 62

E & S partnership purchased land for $500,000 on May 1, 1987, paying $100,000 cash and giving a $400,000 note payable to Big State Bank. E & S made three annual payments on the note totaling $179,000, which included interest of $89,000. E & S then defaulted on the note. Title to the land was transferred by E & S to Big State, which canceled the note, releasing the partnership from further liability.


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At the time of the default, the fair value of the land approximated the note balance. In E & S's 1990 income statement, the amount of the loss should be:

a. $279,000
b. $221,000
c. $190,000
d. $100,000

**CPA-00371 Explanation**
Choice "c" is correct. $190,000 loss on disposal of land.

| | | |
|---|---|---|
| Original cost of land: | | |
| Cash payment | | $100,000 |
| Note payable | | 400,000 |
| Total May 1, 1987 | | 500,000 |
| Less FMV of land transferred to bank Upon default on the note: | | |
| Original note payable | $400,000 | |
| Less principal payments ($179,000-$89,000 interest) | (90,000) | 310,000 |
| Loss on disposal of land | | $190,000 |

**Liabilities (required homework reading)**

**CPA-00444 Type1 M/C A-D Corr Ans: A PM#1 F 5-06**

67. CPA-00444 FARE R02 #4 Page 71

Jole Co. lent $10,000 to a major supplier in exchange for a non interest-bearing note due in three years and a contract to purchase a fixed amount of merchandise from the supplier at a 10% discount from prevailing market prices over the next three years. The market rate for a note of this type is 10%. On issuing the note, Jole should record:

| | *Discount on note receivable* | *Deferred charge* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |

**CPA-00444 Explanation**
Choice "a" is correct. In this transaction, $10,000 is exchanged for a non-interest bearing note receivable and a commitment to purchase merchandise at a 10% discount. In order to correctly account for the transaction, interest must be imputed on the non-interest bearing note, which will result in the recognition of a discount on the note receivable, and the purchase commitment must be recognized, which will result in the recognition of a deferred charge.

It is important to note that no calculations or journal entries are necessary to answer this question. Despite the fact that the question does present numeric facts, it is a conceptual question. However, to clarify the transaction, the following journal entry is presented for illustrative purposes, assuming that the face value of the note receivable is $10,000, the present value of the note receivable is $7,500 (calculated using a PV factor of 0.7513 based on 3 periods at 10%) and the fair value of the purchase commitment is $2,500.

| | | | |
|---|---|---|---|
| DR | Notes receivable | 10,000 | |
| DR | Deferred charge | 2,500 | |
| CR | Cash | | 10,000 |


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| | | |
|---|---|---|
| CR | Discount on note receivable | 2,500 |

The note receivable will be reported on the balance sheet at its present value of $7,500 ($10,000 NR - 2,500 discount).

The discount on notes receivable will be amortized to interest revenue over the next three years using the effective interest method. The deferred charge will reduce the amount paid for future purchases.

| | |
|---|---|
| Merchandise Inventory | 25,000 (Fair Value) |
| Cash | 22,500 |
| Deferred charge | 2,500 |

**CPA-00445 Type1 M/C A-D Corr Ans: D PM#2 F 5-06**

68. CPA-00445 FARE Nov 94 #18 Page 71

In its 1993 financial statements, Cris Co. reported interest expense of $85,000 in its income statement and cash paid for interest of $68,000 in its cash flow statement. There was no prepaid interest or interest capitalization either at the beginning or end of 1993. Accrued interest at December 31, 1992, was $15,000. What amount should Cris report as accrued interest payable in its December 31, 1993, balance sheet?

a. $2,000
b. $15,000
c. $17,000
d. $32,000

**CPA-00445 Explanation**

| | *Accrued Interest Payable* |
|---|---|
| Beg bal 12/31/92 | 15,000 |
| Add: interest expense | 85,000 |
| Subtotal | 100,000 |
| Less: interest paid | (68,000) |
| Ending balance 12/31/93 | 32,000 |

Choice "d" is correct, $32,000 accrued interest payable at Dec. 31, 1993.

**CPA-00447 Type1 M/C A-D Corr Ans: C PM#3 F 5-06**

69. CPA-00447 PI Nov 93 #31 Page 74

On September 1, 1991, Brak Co. borrowed on a $1,350,000 note payable from Federal Bank. The note bears interest at 12% and is payable in three equal annual principal payments of $450,000. On this date, the bank's prime rate was 11%. The first annual payment for interest and principal was made on September 1, 1992. At December 31, 1992, what amount should Brak report as accrued interest payable?

a. $54,000
b. $49,500
c. $36,000
d. $33,000

**CPA-00447 Explanation**

Choice "c" is correct. The interest rate in the note, 12%, represents a fair and adequate compensation and should be used. Accrued interest payable on December 31, 1992 is computed as follows for 4 months:


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| | |
|---|---|
| Carrying amount, 9/1/91 | $1,350,000 |
| Less: Principal payment, 9/1/92 | 450,000 |
| Carrying amount, 9/1/92 | $ 900,000 |
| 12/31/92 Interest payable is: $900,000 x 12% x 4/12 = | $ 36,000 |

Choice "a" is incorrect. Interest is computed on the balance due after applying the September 1, 1992 payment.

Choice "b" is incorrect. The interest rate in the note, 12%, represents a fair and adequate compensation and should be used. Interest is computed on the balance due after applying the September 1, 1992 payment.

Choice "d" is incorrect. The interest rate in the note, 12%, represents a fair and adequate compensation and should be used.

**CPA-00449 Type1 M/C A-D Corr Ans: D PM#4 F 5-06**

70. CPA-00449 FARE May 94 #30 Page 39

The discount resulting from the determination of a note payable's present value should be reported on the balance sheet as a (an):

a. Addition to the face amount of the note.
b. Deferred charge separate from the note.
c. Deferred credit separate from the note.
d. Direct reduction from the face amount of the note.

**CPA-00449 Explanation**

Choice "d" is correct. Although the discount is a separate account from the note payable account, the note payable is reported on the balance sheet at the net of the note payable face value less the unamortized discount.

Choice "a" is incorrect. A premium resulting from the determination of a note payable's present value would be added to the face amount of the note.

Choice "b" is incorrect. The discount is not a deferred charge on its own; it is related directly to the issuance of the note payable and must be combined with the face value of the note payable when reported on the balance sheet.

Choice "c" is incorrect. The discount account will have a debit balance rather than a credit balance.

**CPA-00451 Type1 M/C A-D Corr Ans: B PM#5 F 5-06**

71. CPA-00451 PI Nov 93 #27 Page 71

On December 31, 1992, Roth Co. issued a $10,000 face value note payable to Wake Co. in exchange for services rendered to Roth. The note, made at usual trade terms, is due in nine months and bears interest, payable at maturity, at the annual rate of 3%. The market interest rate is 8%. The compound interest factor of $1 due in nine months at 8% is .944. At what amount should the note payable be reported in Roth's December 31, 1992, balance sheet?

a. $10,300
b. $10,000
c. $9,652
d. $9,440

**CPA-00451 Explanation**

Choice "b" is correct. Normally interest is imputed when no (or an unreasonably low) rate is stated. An exception exists for receivables and payables arising from transactions with customers or suppliers in the normal course of business when the trade terms do not exceed one year. The note is recorded at $10,000.


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Choice "a" is incorrect. Normally interest is imputed when no, or an unreasonably low, rate is stated. An exception exists for receivables and payables arising from transactions with customers or suppliers in the normal course of business when the trade terms do not exceed one year.

Choice "c" is incorrect. Normally interest is imputed when no, or an unreasonably low, rate is stated. An exception exists for receivables and payables arising from transactions with customers or suppliers in the normal course of business when the trade terms do not exceed one year.

Choice "d" is incorrect. Normally interest is imputed when no, or an unreasonably low, rate is stated. An exception exists for receivables and payables arising from transactions with customers or suppliers in the normal course of business when the trade terms do not exceed one year.

**CPA-04773 Type1 M/C A-D Corr Ans: A PM#6 F 5-06**

72. CPA-04773 Released 2005 Page 69

As of December 15, 2002, Aviator had dividends in arrears of $200,000 on its cumulative preferred stock. Dividends for 2002 of $100,000 have not yet been declared. The board of directors plan to declare cash dividends on its preferred and common stock on January 16, 2003. Aviator paid an annual bonus to its CEO based on the company's annual profits. The bonus for 2002 was $50,000, and it will be paid on February 10, 2003. What amount should Aviator report as current liabilities on its balance sheet at December 31, 2002?

a. $50,000
b. $150,000
c. $200,000
d. $350,000

**CPA-04773 Explanation**
Choice "a" is correct. Under the matching principle, expenses are recognized when an entity's economic benefits are used up. In the case of the CEO bonus of $50,000, that was clearly earned (used up) in 2002 and should be accrued for accordingly. The dividends were not declared in 2002 and as such should not be accrued for. Upon declaration, they become a debt of the corporation (credit to dividends payable) and are debited to retained earnings.

Choices "b", "c", and "d" are incorrect, per the above.

**CPA-05448 Type1 M/C A-D Corr Ans: B PM#7 F 5-06**

73. CPA-05448 Released 2007 Page 71

On December 31, 1999, Key Co. received two $10,000 non-interest-bearing notes from customers in exchange for services rendered. The note from Alpha Co., which is due in nine months, was made under customary trade terms, but the note from Omega Co., which is due in two years, was not. The market interest rate for both notes at the date of issuance is 8%. The present value of $1 due in nine months at 8% is .944. The present value of $1 due in two years at 8% is .857. At what amounts should these two notes receivable be reported in Key's December 31, 1999, balance sheet?

| | *Alpha* | *Omega* |
|---|---|---|
| a. | $9,440 | $8,570 |
| b. | $10,000 | $8,570 |
| c. | $9,440 | $10,000 |
| d. | $10,000 | $10,000 |

**CPA-05448 Explanation**
Choice "b" is correct. Because the term of the Alpha note does not exceed one year, it is recorded at its face amount of $10,000, while the two-year Omega note must be reported at the present value of the obligation calculated using the market interest rate of 8%:

$$\$10,000 \times 0.857 = \$8,570$$


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Choice "a" is incorrect. Because the term of the Alpha note does not exceed one year, it is recorded at its face amount of $10,000.

Choice "c" is incorrect. Because the term of the Alpha note does not exceed one year, it is recorded at its face amount of $10,000, while the two-year Omega note must be reported at the present value of the obligation calculated using the market interest rate of 8%.

Choice "d" is incorrect. The two-year Omega note must be reported at the present value of the obligation calculated using the market interest rate of 8%.

**Supplemental Questions**

**CPA-00552 Type1 M/C A-D Corr Ans: A PM#1 F 5-99**

74. CPA-00552 May 90 I #29 Page 5

On December 30, 1989, Bart, Inc. purchased a machine from Fell Corp. in exchange for a noninterest bearing note requiring eight payments of $20,000. The first payment was made on December 30, 1989, and the others are due annually on December 30. At date of issuance, the prevailing rate of interest for this type of note was 11%. Present value factors are as follows:

| *Period* | *Present Value of Ordinary Annuity of 1 at 11%* | *Present Value of Annuity in Advance of 1 at 11%* |
|---|---|---|
| 7 | 4.712 | 5.231 |
| 8 | 5.146 | 5.712 |

On Bart's December 31, 1989 balance sheet, the note payable to Fell was:

a. $94,240
b. $102,920
c. $104,620
d. $114,240

**CPA-00552 Explanation**

Choice "a" is correct. $ 94,240 total note payable at Dec. 31, 1989 for 7 unpaid installments of $20,000 each at PV of ordinary annuity in arrears.

| | |
|---|---|
| Non-interest bearing note @ Dec. 30, 1989 | $160,000 |
| Less: payment #1 paid same day - Dec. 30, 1989 | (20,000) |
| Remaining due in 7 installments of $20,000 at the end of each succeeding year (ordinary annuity in arrears) | $140,000 |

Present value of note at 12/31/89 = $20,000 x 4.712 = $94,240

**CPA-00556 Type1 M/C A-D Corr Ans: B PM#2 F 5-99**

75. CPA-00556 Nov 90 T #46 Page 4

On November 1, 1990, a company purchased a new machine that it does not have to pay for until November 1, 1992. The total payment on November 1, 1992, 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. Present value of annuity of 1.
b. Present value of 1.
c. Future amount of annuity of 1.
d. Future amount of 1.

**CPA-00556 Explanation**


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Choice "b" is correct. The cost of the machine would be the total payment (principal and interest all due two years in the future) multiplied by the present value of 1 (at a 10% rate).

**CPA-00558 Type1 M/C A-D Corr Ans: C PM#3 F 5-99**

76. CPA-00558 Nov 91 I #9 Page 5

On March 15, 1990, Ashe Corp. adopted a plan to accumulate $1,000,000 by September 1, 1994. Ashe plans to make four equal annual deposits to a fund that will earn interest at 10% compounded annually. Ashe made the first deposit on September 1, 1990. Future value and future amount factors are as follows:

| | |
|---|---|
| Future value of 1 at 10% for 4 periods | 1.46 |
| Future amount of ordinary annuity of 1 at 10% for 4 periods | 4.64 |
| Future amount of annuity in advance of 1 at 10% for 4 periods | 5.11 |

Ashe should make four annual deposits (rounded) of:

a. $250,000
b. $215,500
c. $195,700
d. $146,000

**CPA-00558 Explanation**
Choice "c" is correct. Four annual deposits (rounded) of $195,700.

| | |
|---|---|
| Amount to be accumulated at 9-1-94 | $1,000,000 |
| Future amount of annuity in advance of 1 at 10% for 4 periods | ÷ 5.11 |
| Annual amount to be deposited | $ 195,695 |
| Rounded to | $ 195,700 |

**CPA-00559 Type1 M/C A-D Corr Ans: B PM#4 F 5-99**

77. CPA-00559 Nov 89 I #38 Page 24

On January 1, 1988, Jaffe Co. leased a machine to Pender Co. for ten years, with $10,000 payments due at the beginning of each year effective at the inception of the lease. The machine cost Jaffe $55,000. The lease is appropriately accounted for as a sales-type lease by Jaffe. The present value of the ten rent payments over the lease term discounted appropriately at 10% was $67,600. The estimated salvage value of the machine at the end of ten years is equal to the disposal costs. How much interest revenue should Jaffe record from the lease for the year ended December 31, 1988?

a. $5,500
b. $5,760
c. $6,760
d. $7,020

**CPA-00559 Explanation**
Choice "b" is correct. $5,760

| | |
|---|---|
| Present value at inception of future minimum lease pmts. | $67,600 |
| Less first payment on 1/1/88 | (10,000) |
| balance during 1988 | $57,600 |
| discount rate | x 10% |
| Interest revenue for 1988 | $ 5,760 **B** |

**CPA-00560 Type1 M/C A-D Corr Ans: B PM#5 F 5-99**

78. CPA-00560 Nov 89 #14 Page 27


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In a sale-leaseback transaction, the seller-lessee has retained the property. The gain on the sale should be recognized at the time of the sale-leaseback when the lease is classified as a (an):

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

**CPA-00560 Explanation**
Choice "b" is correct. No - Capital Lease; No - Operating Lease.

**Rule:** Any profit or loss on a "sale-leaseback" should be deferred and amortized in proportion to the amortization of the leased asset, if a capital lease**,** or in proportion to the related gross rental charged to expense over the lease term, if an operating lease, unless:

The seller-lessee retains more than a minor part but less than substantially all of the property through the leaseback and realizes a profit on the sale in excess of:

(1) The present value of the minimum lease payments over the lease term if the leaseback is classified as an operating lease, or
(2) The recorded amount of the leased asset if the leaseback is classified as a capital lease. In these cases (which were not true in the problem), the excess profit should be recognized at the date of the sale.

**CPA-00561 Type1 M/C A-D Corr Ans: D PM#6 F 5-99**

79. CPA-00561 May 90 I #31 Page 28

On December 31, 1989, Bain Corp. sold a machine to Ryan and simultaneously leased it back for one year. Pertinent information at this date follows:

| | |
|---|---|
| Sales price | $360,000 |
| Carrying amount | 330,000 |
| Present value of reasonable lease rentals ($3,000 for 12 months @ 12%) | 34,100 |
| Estimated remaining useful life | 12 years |

In Bain's December 31, 1989 balance sheet, the deferred revenue from the sale of this machine should be:

a. $34,100
b. $30,000
c. $4,100
d. $0

**CPA-00561 Explanation**
Choice "d" is correct. $0 deferred revenue in the 12-31-89 BS.

**Rule:** In a sale/leaseback where the seller-lessee retains more than a minor part, but less than substantially all of the property through the leaseback and realizes a profit in excess of the PV of minimum lease payments, the "excess portion" of the profit should be recognized immediately and the balance should be deferred.

In cases (like this one) where the seller-lessee retains only a minor portion (PV of leaseback is 10% or less of FMV of the asset sold), any gain should be recognized immediately and none deferred.

**CPA-00562 Type1 M/C A-D Corr Ans: B PM#7 F 5-99**

80. CPA-00562 May 90 I #35 Page 14


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On January 1, 1989, Day Corp. entered into a 10-year lease agreement with Ward, Inc. for industrial equipment. Annual lease payments of $10,000 are payable at the end of each year. Day knows that the lessor expects a 10% return on the lease. Day has a 12% incremental borrowing rate. The equipment is expected to have an estimated useful life of 10 years. In addition, a third party has guaranteed to pay Ward a residual value of $5,000 at the end of the lease.

The present value of an ordinary annuity of $1 at
12% for 10 years is 5.6502
10% for 10 years is 6.1446

The present value of $1 at
12% for 10 years is .3220
10% for 10 years is .3855

In Day's October 31, 1989 balance sheet, the principal amount of the lease obligation was:

a. $63,374
b. $61,446
c. $58,112
d. $56,502

**CPA-00562 Explanation**
Choice "b" is correct. $61,446 principal amount of lease obligation in 10/31/89 BS.

**Rule:** Lessee must use lower of lessee's incremental borrowing rate, or lessor's implicit interest rate to discount cash flows.

| | |
|---|---|
| Annual lease payments | $ 10,000 |
| Present value of ordinary annuity | × 6.1446 |
| Lease obligation at 10/31/89 | $ 61,446 |

**CPA-00565 Type1 M/C A-D Corr Ans: A PM#8 F 5-99**

81. CPA-00565 May 90 #11 Page 17

A lessee had a ten-year capital lease requiring equal annual payments. The reduction of the lease liability in year 2 should equal:

a. The current liability shown for the lease at the end of year 1.
b. The current liability shown for the lease at the end of year 2.
c. The reduction of the lease obligation in year 1.
d. One-tenth of the original lease liability.

**CPA-00565 Explanation**
Choice "a" is correct. The reduction of the lease liability in year 2 should equal the current liability shown for the lease at the end of year 1.

**Rule:** Capital leases should be recorded as both an asset and liability at the present value of the minimum lease payments. The asset is depreciated. The liability is amortized using the interest method. Each payment is allocated between principal and interest. The liability is reduced by the amount of principal reduction. The capitalized lease liability should be segregated between current (due within one year) and non-current (due beyond one year). Accordingly, the reduction in lease liability each year is equal to the current liability at the end of the previous year.

**CPA-00566 Type1 M/C A-D Corr Ans: D PM#9 F 5-99**

82. CPA-00566 May 90 #24 Page 7

A twenty-year property lease, classified as an operating lease, provides for a 10% increase in annual payments every five years. In the sixth year compared to the fifth year, the lease will cause the following expenses to increase:


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| | *Rent* | *Interest* |
|---|---|---|
| a. | No | Yes |
| b. | Yes | No |
| c. | Yes | Yes |
| d. | No | No |

**CPA-00566 Explanation**
Choice "d" is correct. No change in rent; no change in interest.

**Rule:** Lessee shall record an operating lease as rental expense using the straight line basis even if payments are made on some other basis, unless another systematic and rational basis is more representative. There is no interest component for an "operating lease."

**CPA-00567 Type1 M/C A-D Corr Ans: B PM#10 F 5-99**

83. CPA-00567 Nov 90 I #14 Page 8

On January 1, 1989, Glen Co. leased a building to Dix Corp. for a ten-year term at an annual rental of $50,000. At inception of the lease, Glen received $200,000 covering the first two years' rent of $100,000 and a security deposit of $100,000. This deposit will not be returned to Dix upon expiration of the lease but will be applied to payment of rent for the last two years of the lease. What portion of the $200,000 should be shown as a current and long-term liability, respectively, in Glen's December 31, 1989 balance sheet?

| | *Current Liability* | *Long-Term Liability* |
|---|---|---|
| a. | $0 | $200,000 |
| b. | $50,000 | $100,000 |
| c. | $100,000 | $100,000 |
| d. | $100,000 | $50,000 |

**CPA-00567 Explanation**
Choice "b" is correct. $50,000 Current. $100,000 Long-Term.

**Rule:** Operating lease payments to a lessor that should be deferred include:

Security deposits, prepaid rent, and the unamortized portion of non-refundable payments to the lessor for leasehold modifications.

If an item is expected to be expensed or returned within one year or less, it is classified as current; otherwise it is long term. As of December 31, 1989, Glen's liability to Dix is as follows:

| | Current | Long-term |
|---|---|---|
| Balance of January 1, 1989<br>Payment of $100,000 covering 1989 and 1990 rent income | $50,000 | - |
| Security deposit paid<br>January 1, 1989 to be applied to last two years' rent | - | $100,000 |
| Total | $50,000 | $100,000 **B** |

**CPA-00568 Type1 M/C A-D Corr Ans: A PM#11 F 5-99**

84. CPA-00568 Nov 90 I #21 Page 14

On December 31, 1989, Neal, Inc. leased machinery with a fair value of $105,000 from Frey Rentals Co. The agreement is a six-year noncancelable lease requiring annual payments of $20,000 beginning December 31, 1989. The lease is appropriately accounted for by Neal as a capital lease. Neal's incremental borrowing rate is 11%. Neal knows the interest rate implicit in the lease payments is 10%.


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- The present value of an annuity due of 1 for 6 years at 10% is 4.7908.
- The present value of an annuity due of 1 for 6 years at 11% is 4.6959.

In its December 31, 1989 balance sheet, Neal should report a lease liability of:

a. $75,816
b. $85,000
c. $93,918
d. $95,816

**CPA-00568 Explanation**
Choice "a" is correct. $75,816.

**Rule:** The present value rate used to value a capital lease is the lessor's "implicit rate," if known by the lessee and if it is less than the lessee's incremental borrowing rate. In addition, the present value of the lease cannot exceed fair market value.

| | |
|---|---|
| Annual Lease Payments | $ 20,000 |
| PV of annuity due of 1 for 6 years at 10% | x 4.7908 |
| Lease liability before 12/31/89 payment | $ 95,816 |
| Less 12/31/89 payment | (20,000) |
| Lease liability in 12/31/89 balance sheet | $ 75,816 |

**CPA-00569 Type1 M/C A-D Corr Ans: A PM#12 F 5-99**

85. CPA-00569 Nov 90 I #33 Page 24

Winn Co. manufactures equipment that is sold or leased. On December 31, 1989, Winn leased equipment to Bart for a five-year period ending December 31, 1994, at which date ownership of the leased asset will be transferred to Bart. Equal payments under the lease are $22,000 (including $2,000 executory costs) and are due on December 31 of each year. The first payment was made on December 31, 1989. Collectibility of the remaining lease payments is reasonably assured, and Winn has no material cost uncertainties. The normal sales price of the equipment is $77,000, and cost is $60,000. For the year ended December 31, 1989, what amount of income should Winn realize from the lease transaction?

a. $17,000
b. $22,000
c. $23,000
d. $33,000

**CPA-00569 Explanation**
Choice "a" is correct. $17,000 in income recognized for the year ending December 31, 1989.

**Rule:** In a sales-type lease, the difference between the fair value of the leased asset and its cost at inception is recognized as manufacturer's or dealer's profit:

| | | |
|---|---|---|
| Cash selling price of equipment | $77,000 | |
| Less cost of equipment at inception | 60,000 | |
| Profit recognized on sale | $17,000 | **A** |

**CPA-00570 Type1 M/C A-D Corr Ans: D PM#13 F 5-99**

86. CPA-00570 Nov 90 II #2 Page 7

On January 2, 1988, Ral Co. leased land and building from an unrelated lessor for a ten-year term. The lease has a renewal option for an additional ten years, but Ral has not reached a decision with regard to the renewal option. In early January of 1988, Ral completed the following improvements to the property:

| *Description* | *Estimated Life* | *Cost* |
|---|---|---|
| Sales office | 10 years | $47,000 |


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| | | |
|---|---|---|
| Warehouse | 25 years | 75,000 |
| Parking lot | 15 years | 18,000 |

Amortization of leasehold improvements for 1989 should be:

a. $7,000
b. $8,900
c. $12,200
d. $14,000

**CPA-00570 Explanation**
Choice "d" is correct. $14,000

**Rule:** Amortization of leasehold improvements should be over the life of the improvements or the remaining life of the lease, whichever is shorter. In this case, the lease term is equal to or less than each category of improvements, accordingly all improvements should be amortized over 10 years. Since there is uncertainty as to whether the lease will be renewed, the renewal option is not a factor.

| | |
|---|---|
| Sales office | $ 47,000 |
| Warehouse | 75,000 |
| Parking lot | 18,000 |
| | $140,000 |
| | ÷ 10 years = $14,000/year |

**CPA-00571 Type1 M/C A-D Corr Ans: D PM#14 F 5-99**

87. CPA-00571 Nov 90 #24 Page 27

Able sold its headquarters building at a gain, and simultaneously leased back the building. The lease was reported as a capital lease. At the time of sale, the gain should be reported as:

a. Operating income.
b. An extraordinary item, net of income tax.
c. A separate component of stockholders' equity.
d. An asset valuation allowance.

**CPA-00571 Explanation**
Choice "d" is correct. An asset valuation allowance.

**Rule:** Any profit or loss on a sale/leaseback classified as a capital lease shall be deferred and amortized in proportion to depreciation taken on the leased back asset.

Choice "a" is incorrect. The gain should be deferred.

Choice "b" is incorrect. The gain is **not** extraordinary.

Choice "c" is incorrect. The gain should be deferred and classified as an asset valuation account.

**CPA-00572 Type1 M/C A-D Corr Ans: C PM#15 F 5-99**

88. CPA-00572 Nov 90 #26 Page 24

In a lease that is recorded as a sales-type lease by the lessor, interest revenue:

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

**CPA-00572 Explanation**


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Choice "c" is correct. Unearned interest in a "sales-type lease" is amortized over the period of the lease using the "effective interest method."

Choice "a" is incorrect. Interest revenue should be deferred.

Choice "b" is incorrect. The "interest method" is more representative of the economics of the transaction than the "straight line method."

Choice "d" is incorrect. Interest revenue does arise in a sales-type lease.

**CPA-00574 Type1 M/C A-D Corr Ans: A PM#16 F 5-99**

89. CPA-00574 May 91 I #42 Page 17

On January 1, 1990, Babson, Inc. leased two automobiles for executive use. The lease requires Babson to make five annual payments of $13,000 beginning January 1, 1990. At the end of the lease term, December 31, 1994, Babson guarantees the residual value of the automobiles will total $10,000. The lease qualifies as a capital lease. The interest rate implicit in the lease is 9%. Present value factors for the 9% rate implicit in the lease are as follows:

| | |
|---|---|
| For an annuity due with 5 payments | 4.240 |
| For an ordinary annuity with 5 payments | 3.890 |
| Present value of $1 for 5 periods | 0.650 |

Babson's recorded capital lease liability immediately after the first required payment should be:

a. $48,620
b. $44,070
c. $35,620
d. $31,070

**CPA-00574 Explanation**
Choice "a" is correct. $48,620 capital lease liability after first required payment.

| | |
|---|---|
| Annual payments | $ 13,000 |
| PV of annuity due (at beginning of year) | × 4.240 |
| PV of annual payments before first required payment | 55,120 |
| Less first payment (Jan. 1, 1990) | (13,000) |
| PV of annual payments after first required payment | 42,120 |
| Add PV of guaranteed residual value (PV of $ for 5 periods 0.650 x $10,000) | 6,500 |
| Capital lease liability after first required payment | $48,620 |

**CPA-00576 Type1 M/C A-D Corr Ans: B PM#17 F 5-99**

90. CPA-00576 May 91 I #44 Page 28

On January 1, 1990, Hooks Oil Co. sold equipment with a carrying amount of $100,000, and a remaining useful life of 10 years, to Maco Drilling for $150,000. Hooks immediately leased the equipment back under a 10-year capital lease with a present value of $150,000 and will depreciate the equipment using the straight-line method. Hooks made the first annual lease payment of $24,412 in December 1990. In Hooks' December 31, 1990, balance sheet, the unearned gain on equipment sale should be:

a. $50,000
b. $45,000
c. $25,588
d. $0

**CPA-00576 Explanation**
Choice "b" is correct. $45,000 unearned gain on equipment sale at 12/31/90.


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**Rule:** Any profit on a sale-leaseback which is classified as a "capital lease" should be deferred and amortized in proportion to depreciation taken on the leased-back asset.

| | |
|---|---|
| Selling price | $ 150,000 |
| Carrying value | (100,000) |
| Gain to be deferred as of January 1, 1990 | $ 50,000 ÷ 10 years = |
| Less amortization of gain for 1990 | (5,000) |
| Deferred gain 12/31/90 | $ 45,000 **B** |

**CPA-00579 Type1 M/C A-D Corr Ans: B PM#18 F 5-99**

91. CPA-00579 May 91 I #45 Page 17

On January 1, 1990, Blaugh Co. signed a long-term lease for an office building. The terms of the lease required Blaugh to pay $10,000 annually, beginning December 30, 1990, and continuing each year for 30 years. The lease qualifies as a capital lease. On January 1, 1990, the present value of the lease payments is $112,500 at the 8% interest rate implicit in the lease. In Blaugh's December 31, 1990, balance sheet, the capital lease liability should be:

a. $102,500
b. $111,500
c. $112,500
d. $290,000

**CPA-00579 Explanation**
Choice "b" is correct. $111,500 capital lease liability at 12/31/90.

| | | |
|---|---|---|
| Present value of capital lease liability as of January 1, 1990 | | $112,500 |
| Less payment on December 30, 1990 | $10,000 | |
| Less 8% interest on PV of liability (8% x $112,500) | (9,000) | |
| Equals net payment applied to principal | | 1,000 |
| Equals liability under capital lease at December 31, 1990 | | $ 111,500 **B** |

**CPA-00580 Type1 M/C A-D Corr Ans: B PM#19 F 5-99**

92. CPA-00580 Nov 91 I #11 Page 8

On July 1, 1989, Gee, Inc. leased a delivery truck from Marr Corp. under a 3-year operating lease. Total rent for the term of the lease will be $36,000, payable as follows:

| | | |
|---|---|---|
| 12 months at $500 | = | $ 6,000 |
| 12 months at $750 | = | 9,000 |
| 12 months at $1,750 | = | 21,000 |

All payments were made when due. In Marr's June 30, 1991, balance sheet, the accrued rent receivable should be reported as:

a. $0
b. $9,000
c. $12,000
d. $21,000

**CPA-00580 Explanation**
Choice "b" is correct. $9,000.

**Rule:** For operating leases, a lessor should report rent as "income" as it becomes receivable according to the provisions of the lease. However, if the rent payments are not received in level amounts, rent revenue is recognized on a straight line basis unless another method is more appropriate (for example, hours of usage for a machine). Any difference between the cumulative amount of revenue recognized and amount received is a receivable or payable.


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Rental revenue recognized 7/1/89 - 6/30/91

| | | |
|---|---|---|
| $36,000 ÷ 36 months = $1000/mo x 24 = | | $24,000 |
| Amount of payments received | | |
| 7/1/89 - 6/30/90 | $6,000 | |
| 7/1/90 - 6/30/91 | 9,000 | $15,000 |
| Rent receivable 6/30/91 | | $ 9,000 **B** |

**CPA-00581 Type1 M/C A-D Corr Ans: A PM#20 F 5-99**

93. CPA-00581 Nov 91 I #55 Page 16

On January 1, 1990, Moul Mining Co. (lessee), entered into a 5-year lease for drilling equipment. Moul accounted for the acquisition as a capital lease for $120,000, which includes a $5,000 bargain purchase option. At the end of the lease, Moul expects to exercise the bargain purchase option. Moul estimates that the equipment's fair value will be $10,000 at the end of its 8-year life. Moul regularly uses straight-line depreciation on similar equipment. For the year ended December 31, 1990, what amount should Moul recognize as depreciation expense on the leased asset?

a. $13,750
b. $15,000
c. $23,000
d. $24,000

**CPA-00581 Explanation**
Choice "a" is correct. $13,750.

**Rule:** Capitalized equipment should be depreciated in accordance with the lessee's normal depreciation policy, not to exceed the estimated useful life, if the lease transfers ownership or contains a bargain purchase option.

| | |
|---|---|
| Capitalized value of lease | $ 120,000 |
| Less estimated salvage value | 10,000 |
| Depreciation base | $ 110,000 |
| Estimated life | ÷ 8 years |
| Equals depreciation expense | $13,750/year |

**CPA-00583 Type1 M/C A-D Corr Ans: A PM#21 F 5-99**

94. CPA-00583 Nov 91 #34 Page 17

Jay's lease payments are made at the end of each period. Jay's liability for a capital lease would be reduced periodically by the:

a. Minimum lease payment less the portion of the minimum lease payment allocable to interest.
b. Minimum lease payment plus the amortization of the related asset.
c. Minimum lease payment less the amortization of the related asset.
d. Minimum lease payment.

**CPA-00583 Explanation**
Choice "a" is correct. Minimum lease payment less the portion of the minimum lease payment allocated to interest represents the liability for a capital lease.

**Rule:** For a capital lease, the minimum lease payment is allocated between principal and interest using the interest rate inherent in the lease. The portion allocated to principal reduces the remaining capital lease liability. The process is similar to a home mortgage.

**CPA-00584 Type1 M/C A-D Corr Ans: D PM#22 F 5-99**


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95. CPA-00584 May 92 #32 Page 27

Rig Co. sold its factory at a gain, and simultaneously leased it back for 10 years. The factory's remaining economic life is 20 years. The lease was reported as an operating lease. At the time of sale, Rig should report the gain as:

a. An extraordinary item, net of income tax.
b. An asset valuation allowance.
c. A separate component of stockholders' equity.
d. A deferred credit.

**CPA-00584 Explanation**
Choice "d" is correct. A deferred credit.

**Rule:** In a sale/leaseback where the seller leases back property for a more than a minor part but less than substantially all of the remaining useful life, any gain or loss should be deferred and amortized in a proportion to the amortization of the leased asset if a capital lease, or in proportion to the related gross rental charged to expense over the lease term if an operating lease. Since this is an operating lease, the gain is classified as a deferred credit.

Choice "a" is incorrect. The gain is not "extraordinary."

Choice "b" is incorrect. An asset valuation account would be correct if this were a "capital lease."

Choice "c" is incorrect. Gains on sale-leasebacks are not classified as a separate component of stockholders' equity.

**CPA-00585 Type1 M/C A-D Corr Ans: D PM#23 F 5-99**

96. CPA-00585 May 92 #33 Page 12

For a capital lease, the amount recorded initially by the lessee as a liability should normally:

a. Exceed the total of the minimum lease payments.
b. Exceed the present value of the minimum lease payments at the beginning of the lease.
c. Equal the total of the minimum lease payments.
d. Equal the present value of the minimum lease payments at the beginning of the lease.

**CPA-00585 Explanation**
Choice "d" is correct. Equal the present value of the minimum lease payments at the beginning of the lease.

**Rule:** A lessee should record a capital lease as if he owned the asset at the present value of the minimum lease payments at the beginning of the lease (excluding any "executory costs"), not to exceed fair market value.

Choice "a" is incorrect. Liability cannot exceed the PV (not "total") of the minimum lease payments.

Choice "b" is incorrect. Liability cannot exceed the PV of the minimum lease payments.

Choice "c" is incorrect. Rule is: "PV" (not "total") of the minimum lease payments.

**CPA-00595 Type1 M/C A-D Corr Ans: B PM#24 F 5-99**

97. CPA-00595 Nov 92 I #4 Page 17

On December 30, 1991, Rafferty Corp. leased equipment under a capital lease. Annual lease payments of $20,000 are due December 31 for 10 years. The equipment's useful life is 10 years, and the interest rate implicit in the lease is 10%. The capital lease obligation was recorded on December 30, 1991, at $135,000, and the first lease payment was made on that date. What amount should Rafferty include in current liabilities for this capital lease in its December 31, 1991, balance sheet?

a. $6,500


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b. $8,500
c. $11,500
d. $20,000

**CPA-00595 Explanation**
Choice "b" is correct. $8,500 capital lease current liability at 12/31/91 (and $106,500 long-term portion)

| | | |
|---|---|---|
| Present value at December 30, 1991 (start of lease) of 10 payments at 10% | | $135,000 |
| Less first payment at start of lease | | (20,000) |
| Equals liability under capital lease at December 30, 1991 | | $115,000 |
| Payment to be made Dec. 30, 1992 | $20,000 | |
| Less 10% interest on PV lease liability (10% x $115,000) | (11,500) | |
| Equals "current liability" for Capital lease at Dec. 31, 1991 | | 8,500 |
| Total liability under capital lease at 12/31/92 | | $106,500 |

**CPA-00603 Type1 M/C A-D Corr Ans: A PM#25 F 5-99**

98. CPA-00603 Nov 92 I #8 Page 17

Harris, Inc., leased equipment under a capital lease for a period of seven years, contracting to pay $100,000 rent in advance at the start of the lease term on December 31, 1990, and $100,000 annually on December 31 of each of the next six years. The present value at December 31, 1990, of the seven rent payments over the lease term discounted at 10% (the implicit interest rate) was $535,000. Harris amortizes its liability under capital lease using the effective interest method. In its December 31, 1991, balance sheet, Harris should report a liability under capital lease of:

a. $378,500
b. $391,500
c. $437,350
d. $500,000

**CPA-00603 Explanation**
Choice "a" is correct. $378,500 liability under capital lease at December 31, 1991. (End of first year).

| | | |
|---|---|---|
| Present value at Dec 31, 1990 (start of lease) of 7 payments at 10% | | $ 535,000 |
| Less: down payment at start of lease | | (100,000) |
| Equals: liability under capital lease at December 31, 1990. | | 435,000 |
| Less: payment on Dec 31, 1991 | $100,000 | |
| Less: 10% interest on PV of liability (435,000 x 10%) | (43,500) | |
| Net payment applied to principal | | (56,500) |
| Equals: Liability under capital lease at December 31, 1991 | | $ 378,500 |

**CPA-00604 Type1 M/C A-D Corr Ans: B PM#26 F 5-99**

99. CPA-00604 Nov 92 I #26 Page 8

Barnel Corp. owns and manages 19 apartment complexes. On signing a lease, each tenant must pay the first and last months' rent and a $500 refundable security deposit. The security deposits are rarely refunded in total, because cleaning costs of $150 per apartment are almost always deducted. About 30% of the time, the tenants are also charged for damages to the apartment, which typically cost $100 to repair. If a one-year lease is signed on a $900 per month apartment, what amount would Barnel report as refundable security deposit?

a. $1,400
b. $500
c. $350
d. $320


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**CPA-00604 Explanation**
Choice "b" is correct. $500. The entire $500 is recorded as a refundable security deposit. If the tenant moves out at the end of the lease term, the deposit is taken into revenue and matched with the cleaning costs and damage repair and/or refunded to the tenant. The deposit is **not** revenue upon receipt.

Choice "a" is incorrect. The refundable security deposit is $500 and unearned income of $900 is recorded for the last month's rent.

Choice "c" is incorrect. The cleaning cost of $150 is not deducted from the security deposit until the cost is incurred.

Choice "d" is incorrect. The cleaning cost of $150 and damage repair of $30 ($100 x 30%) are not deducted from the security deposit until the cost is incurred.

**CPA-00606 Type1 M/C A-D Corr Ans: C PM#27 F 5-99**

100. CPA-00606 Nov 92 I #33 Page 14

On December 29, 1991, Action Corp. signed a 7-year capital lease for an airplane to transport its sports team around the country. The airplane's fair value was $841,500. Action made the first annual lease payment of $153,000 on December 31, 1991. Action's incremental borrowing rate was 12 %, and the interest rate implicit in the lease, which was known by Action, was 9 %. The following are the rounded present value factors for an annuity due:

| | |
|---|---|
| 9% for 7 years | 5.5 |
| 12% for 7 years | 5.1 |

What amount should Action report as capital lease liability in its December 31, 1991, balance sheet?

a. $841,500
b. $780,300
c. $688,500
d. $627,300

**CPA-00606 Explanation**
Choice "c" is correct. $688,500.

**Rule:** The present value rate used to value a capital lease is the lessor's "implicit rate" if known by the lessee and if it is less than the lessee's incremental borrowing rate. In addition, the present value of the lease cannot exceed fair market value.

| | |
|---|---|
| Annual lease payments | $ 153,000 |
| PV of annuity due of 1 for 7 years at 9% | x 5.5 |
| Lease liability before 12/31/91 payment (FMV) | 841,500 |
| Less 12/31/91 payment | (153,000) |
| Equals lease liability in 12/31/91 BS | $ 688,500 |

**CPA-00607 Type1 M/C A-D Corr Ans: C PM#28 F 5-99**

101. CPA-00607 Nov 92 I #45 Page 8

Conn Corp. owns an office building and normally charges tenants $30 per square foot per year for office space. Because the occupancy rate is low, Conn agreed to lease 10,000 square feet to Hanson Co. at $12 per square foot for the first year of a three-year operating lease. Rent for remaining years will be at the $30 rate. Hanson moved into the building on January 1, 1992, and paid the first year's rent in advance. What amount of rental revenue should Conn report from Hanson in its income statement for the year ended September 30, 1992?

a. $90,000
b. $120,000


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c. $180,000
d. $240,000

**CPA-00607 Explanation**
**Rule:** For operating leases, a lessor should report rent as "income" as it becomes receivable according to the provisions of the lease. However, if the rent payments are not received in level amounts, rent revenue is recognized on a straight line basis unless another method is more appropriate (for example, hours of usage for a machine).

| Year | Square ft | | Rate | | Total |
|---|---|---|---|---|---|
| 1992 | 10,000 | x | $12 | = | $120,000 |
| 1993 | 10,000 | x | $30 | = | 300,000 |
| 1994 | 10,000 | x | $30 | = | 300,000 |
| | | | | | $720,000 |

Rental revenue recognized 1/1/92-9/30/92:
$720,000 ÷ 36 months = $20,000/mo x 9 = $180,000

Choice "c" is correct. $180,000.

**CPA-00608 Type1 M/C A-D Corr Ans: B PM#29 F 5-99**

102. CPA-00608 Nov 92 I #55 Page 15

On January 2, 1991, Cole Co. signed an eight-year noncancelable lease for a new machine, requiring $15,000 annual payments at the beginning of each year. The machine has a useful life of 12 years, with no salvage value. Title passes to Cole at the lease expiration date. Cole use straight-line depreciation for all of its plant assets. Aggregate lease payments have a present value on January 2, 1991, of $108,000, based on an appropriate rate of interest. For 1991, Cole should record depreciation (amortization) expense for the leased machine at:

a. $0
b. $9,000
c. $13,500
d. $15,000

**CPA-00608 Explanation**
**Rule:** Capitalized equipment should be depreciated in accordance with the lessee's normal depreciation policy, not to exceed the estimated useful life, unless the lease does **not** transfer ownership or contain a bargain purchase option, in which case the shorter lease period should be used.

| | |
|---|---|
| Capitalized value of lease | $ 108,000 |
| Less estimated salvage valve | (0) |
| Depreciable base | $ 108,000 |
| Estimated life | ÷ 12 years |
| (Title passes at end of lease so asset life of 12 years is used) | |

Equals depreciation (amortization) expense $9,000 per year.

Choice "b" is correct. $9,000 depreciation (amortization) expense.

**CPA-00609 Type1 M/C A-D Corr Ans: B PM#30 F 5-99**

103. CPA-00609 Nov 92 I #56 Page 6

On December 1, 1991, Clark Co. leased office space for five years at a monthly rental of $60,000. On the same date, Clark paid the lessor the following amounts:

| | |
|---|---|
| First month's rent | $ 60,000 |
| Last month's rent | 60,000 |


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| | |
|---|---|
| Security deposit (refundable at lease expiration) | 80,000 |
| Installation of new walls and offices | 360,000 |

What should be Clark's 1991 expense relating to utilization of the office space?

a. $60,000
b. $66,000
c. $120,000
d. $140,000

**CPA-00609 Explanation**

| | |
|---|---|
| December 1991 (first month rent) | $60,000 |
| Add: Amortization of improvements (walls and offices) cost $360,000 ÷ 60 months | 6,000 |
| Total 1991 expense | $66,000 |

Choice "b" is correct. $66,000 expense relating to office space.

**CPA-00610 Type1 M/C A-D Corr Ans: C PM#31 F 5-99**

104. CPA-00610 Nov 93 I #42 Page 20

On July 1, 1992, South Co. entered into a ten-year operating lease for a warehouse facility. The annual minimum lease payments are $100,000. In addition to the base rent, South pays a monthly allocation of the building's operating expense, which amounted to $20,000 for the year ended June 30, 1993. In the notes to South's June 30, 1993, financial statements, what amounts of subsequent years' lease payments should be disclosed?

a. $100,000 per annum for each of the next five years and $500,000 in the aggregate.
b. $120,000 per annum for each of the next five years and $600,000 in the aggregate.
c. $100,000 per annum for each of the next five years and $900,000 in the aggregate.
d. $120,000 per annum for each of the next five years and $1,080,000 in the aggregate.

**CPA-00610 Explanation**

**Rule:** For operating leases having remaining lease terms in excess of one year, the future minimum rental payments required as of the last BS date should be disclosed in the aggregate and for each of the next five succeeding years.

Disclosure in June 30, 1993 BS:

| | | |
|---|---|---|
| Minimum lease expense 1994 | $100,000 | |
| Minimum lease expense 1995 | 100,000 | |
| Minimum lease expense 1996 | 100,000 | |
| Minimum lease expense 1997 | 100,000 | |
| Minimum lease expense 1998 | 100,000 | |
| Minimum lease expense 1999-2002 | 400,000 | |
| Aggregate minimum lease payments | $900,000 | **C** |

Choice "c" is correct. $100,000 per annum for each of the next five years and $900,000 in the aggregate.

**CPA-00611 Type1 M/C A-D Corr Ans: B PM#32 F 5-99**

105. CPA-00611 R98 #8 Page 7

During January 1995 Yana Co. incurred landscaping costs of $120,000 to improve leased property. The estimated useful life of the landscaping is fifteen years. The remaining term of the lease is eight years, with an option to renew for an additional four years. However, Yana has not reached a decision with regard to the renewal option. In Yana's December 31, 1995, balance sheet, what should be the net carrying amount of landscaping costs?

a. $0
b. $105,000


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c. $110,000
d. $112,000

**CPA-00611 Explanation**
Choice "b" is correct. $105,000.

**Rule:** Amortization of leasehold improvements should be over the life of the improvements or the remaining life of the lease, whichever is shorter. Since there is uncertainty as to whether the lease will be renewed, the renewal option is not a factor.

$$\frac{\text{Leasehold Improvement}}{\text{Remaining Life of Lease}} = \frac{\$120{,}000}{8 \text{ Years}} = \$15{,}000 / \text{YR}$$

| | |
|---|---|
| Leasehold improvements 1/1/95 | $120,000 |
| Less 1995 amortization | (15,000) |
| Leasehold improvements 12/31/95 | $105,000 **B** |

**CPA-00612 Type1 M/C A-D Corr Ans: A PM#33 F 5-99**

106. CPA-00612 Nov 89 I #17 Page 49

On December 31, 1988, Wall Corp. issued $100,000 maturity value, 10% bonds for $100,000 cash. The bonds are dated December 31, 1988 and mature on December 31, 1998. Interest will be paid semiannually on June 30 and December 31. In Wall's September 30, 1989 balance sheet, the amount of accrued interest expense should be:

a. $2,500
b. $5,000
c. $7,500
d. $10,000

**CPA-00612 Explanation**
Choice "a" is correct. $2,500 accrued interest expense at 9-30-89.

Face $100,000 x 10% x 3/12 yr = $2,500 accrued interest.

**Note:** The 6 month accrued interest from Jan. 1 to June 30 was paid semiannually on June 30, thus only 3 months accrued interest remains until Sept. 30, 1989.

**CPA-00614 Type1 M/C A-D Corr Ans: B PM#34 F 5-99**

107. CPA-00614 Nov 89 I #31 (Adapted) Page 58

On February 1, 1986, Davis Corp. issued 12%, $1,000,000 face amount, 10-year bonds for $1,117,000. Davis reacquired all of these bonds at 102, plus accrued interest, on May 1, 1989 and retired them. This type of transaction is considered a normal part of risk management for Davis Corp. Unamortized bond premium on that date was $78,000. What was Davis' gain on the bond retirement?

a. $97,000
b. $58,000
c. $39,000
d. $19,000

**CPA-00614 Explanation**
Choice "b" is correct. $58,000 gain on bond retirement.

| | |
|---|---|
| Bonds at face value | $ 1,000,000 |
| Add: Unamortized bond premium | 78,000 |
| Carrying value of bonds to be retired | 1,078,000 |
| Less: Cash paid (1,000 bonds at 102) | (1,020,000) |


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Gain on bond retirement $ 58,000

| Journal entry: | DR | CR |
|---|---|---|
| Bonds payable | 1,000 | |
| Unamortized bond premium | 78 | |
| Cash | | 1,020 |
| Gain | | 58 |

*Note:* The gain is not automatically extraordinary under SFAS 145.

**CPA-00621 Type1 M/C A-D Corr Ans: C PM#35 F 5-99**

108. CPA-00621 Nov 89 T #17 Page 47

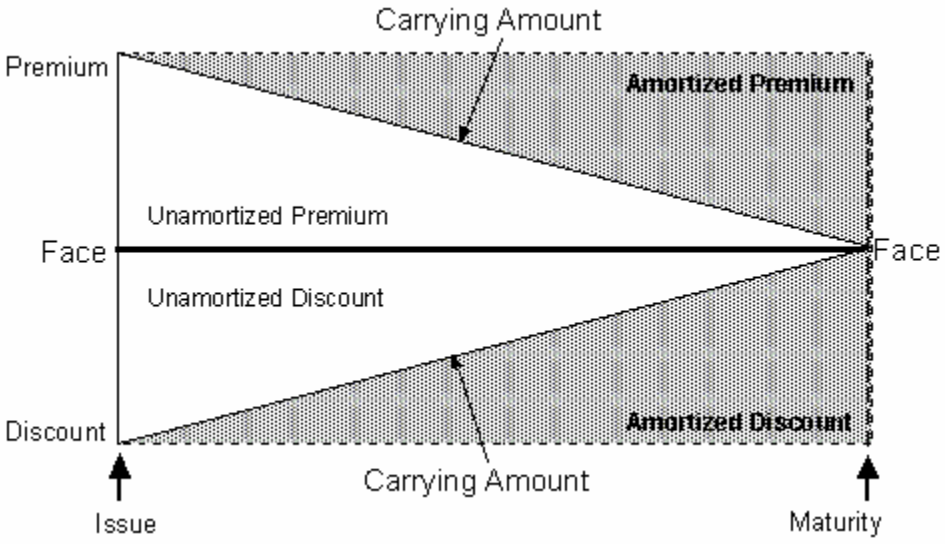
How would the carrying amount of a bond payable be affected by amortization of the following?

| | *Discount* | *Premium* |
|---|---|---|
| a. | Increase | Increase |
| b. | Decrease | Decrease |
| c. | Increase | Decrease |
| d. | Decrease | Increase |

**CPA-00621 Explanation**

Choice "c" is correct. Over time, the carrying amount of a bond sold at a discount will increase, wheras the carrying amount of a bond sold at a premium will decrease.

The carrying amount of a bond liability on the balance sheet is the face plus unamortized premium or less on amortized discount. Amortization causes the carrying value to approach the face value.




**CPA-00626 Type1 M/C A-D Corr Ans: C PM#36 F 5-99**

109. CPA-00626 Nov 89 T #18 Page 51

Bonds payable issued with scheduled maturities at various dates are called:

| | *Serial bonds* | *Term bonds* |
|---|---|---|
| a. | No | Yes |
| b. | No | No |
| c. | Yes | No |
| d. | Yes | Yes |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**CPA-00626 Explanation**
Choice "c" is correct. Yes - No.

Serial bonds are those issued with scheduled maturities at various dates.

Term bonds are issued with a single fixed maturity date.

**CPA-00628 Type1 M/C A-D Corr Ans: A PM#37 F 5-99**

110. CPA-00628 May 90 I #37 Page 41

During 1989, Eddy Corp. incurred the following costs in connection with the issuance of bonds:

| | |
|---|---|
| Printing and engraving | $ 30,000 |
| Legal fees | 160,000 |
| Fees paid to independent accountants for registration information | 20,000 |
| Commissions paid to underwriter | 300,000 |

What amount should be recorded as a deferred charge to be amortized over the term of the bonds?

a. $510,000
b. $480,000
c. $300,000
d. $210,000

**CPA-00628 Explanation**
Choice "a" is correct. $510,000.

**Rule:** All costs associated with the issuance of bonds should be capitalized and amortized over the "outstanding" term of the bonds since issue.

| | |
|---|---|
| Capitalized costs include: | |
| Printing and engraving | $ 30,000 |
| Legal fees | 160,000 |
| Fees to accountants | 20,000 |
| Commissions to underwriter | 300,000 |
| Total capitalized | $510,000 **A** |

**CPA-00629 Type1 M/C A-D Corr Ans: A PM#38 F 5-99**

111. CPA-00629 May 90 T #16 Page 56

Blue Co. issued preferred stock with detachable common stock warrants at a price which exceeded both the par value and the market value of the preferred stock. At the time the warrants are exercised, Blue's total stockholders' equity is increased by the:

| | *Cash received upon exercise of the warrants* | *Carrying amount of warrants* |
|---|---|---|
| a. | Yes | No |
| b. | Yes | Yes |
| c. | No | No |
| d. | No | Yes |

**CPA-00629 Explanation**
Choice "a" is correct. Yes, No. At the time the warrants are exercised total shareholders equity is increased by the cash received upon exercise of the warrants, but not by the carrying amount of warrants.

At the date of issuance, "paid in capital" (stockholders' equity) was increased (credited) by the amount allocated to warrants, which became the carrying amount of warrants.


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**CPA-00630 Type1 M/C A-D Corr Ans: D PM#39 F 5-99**

112. CPA-00630 Nov 90 I #4 Page 41

On October 1, 1988, Park Co. purchased 200 of the $1,000 face value, 10% bonds of Ott, Inc., for $220,000, including accrued interest of $5,000. The bonds, which mature on January 1, 1995, pay interest semiannually on January 1 and July 1. Park used the straight-line method of amortization and appropriately recorded the bonds as a long-term investment. On Park's December 31, 1989 balance sheet, the bonds should be reported at:

a. $215,000
b. $214,400
c. $214,200
d. $212,000

**CPA-00630 Explanation**
Choice "d" is correct. $212,000 carrying value on the balance sheet at 12-31-89.

| | |
|---|---|
| Purchase price, including interest | $220,000 |
| Less accrued interest | (5,000) |
| | 215,000 |
| S/L amortization of bond premium ($15,000 x 15/75) | (3,000) |
| Carrying value at 12-31-89 | $212,000 |

**CPA-00631 Type1 M/C A-D Corr Ans: D PM#40 F 5-99**

113. CPA-00631 Nov 90 I #23 Page 48

On March 1, 1990, Cain Corp. issued at 103 plus accrued interest, two hundred of its 9%, $1,000 bonds. The bonds are dated January 1, 1990 and mature on January 1, 2000. Interest is payable semiannually on January 1 and July 1. Cain paid bond issue costs of $10,000. Cain should realize net cash receipts from the bond issuance of:

a. $216,000
b. $209,000
c. $206,000
d. $199,000

**CPA-00631 Explanation**
Choice "d" is correct. $199,000 net cash receipts from the bond issuance.

| | | | DR | CR |
|---|---|---|---|---|
| Cash: | Sales Price [$1,030 × 200] | 206,000 | | |
| | Accrued Interest [200,000 × 9% × 2/12] | 3,000 | | |
| | Less: Deferred Bond Issue Cost | (10,000) | | |
| | | | 199,000 | |

The rest of the journal entry could be prepared as a proof:

| | | | |
|---|---|---|---|
| Deferred bond issue costs | | 10,000 | |
| Bonds payable | | | 200,000 |
| Unamortized bond premium | | | 6,000 |
| Bonds interest payable | | | 3,000 |
| | | 209,000 | 209,000 |

**CPA-00632 Type1 M/C A-D Corr Ans: B PM#41 F 5-99**

114. CPA-00632 Nov 90 I #24 Page 41


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On June 30, 1990, Huff Corp. issued at 99, one thousand of its 8%, $1,000 bonds. The bonds were issued through an underwriter to whom Huff paid bond issue costs of $35,000. On June 30, 1990, Huff should report the bond liability at:

a. $ 955,000
b. $ 990,000
c. $1,000,000
d. $1,025,000

**CPA-00632 Explanation**
Choice "b" is correct. $990,000 bond liability at 6/30/90.

**Rule:** Discount or premium on the sale of bonds is included in the carrying value of the bonds on the balance sheet, regardless of whether the bonds are assets or liabilities.

"Bond issue costs" are a deferred charge and are not netted or included in the carrying value of the bonds on the balance sheet.

Sales price of 1,000 bonds x $990 = $990,000 bond liability.

**CPA-00633 Type1 M/C A-D Corr Ans: B PM#42 F 5-99**

115. CPA-00633 Nov 90 I #26 Page 57

On April 1, 1989 Ward Corp. issued $750,000 of 10% nonconvertible bonds at 102 that are due on March 31, 1999. Each $1,000 bond was issued with 40 detachable stock warrants, each of which entitled the bondholder to purchase one share of Ward $10 par common stock for $25. On April 1, 1989, the market value of Ward's common stock was $20 per share, and the market value of each warrant was $4. What amount of the proceeds from the bond issue should Ward record as an increase in stockholders' equity?

a. $15,000
b. $120,000
c. $300,000
d. $750,000

**CPA-00633 Explanation**
Choice "b" is correct. $120,000 is credited to "paid-in capital", (thus increasing stockholders' equity).

Amount allocated is based upon FMV of "detachable" warrants at date of issuance as follows:

Total bond issue $750,000 / price per bond $1,000 = 750 bonds

× 40 Warrants per bond
30,000 Warrants

× $4 FMV per warrant
"B" $120,000 Credit to paid-in capital

**CPA-00634 Type1 M/C A-D Corr Ans: D PM#43 F 5-99**

116. CPA-00634 Nov 90 I #54 Page 61

Witt Corp. has outstanding at December 31, 1989 two long-term borrowings with annual sinking fund requirements and maturities as follows:

| | *Sinking fund Requirements* | *Maturities* |
|---|---|---|
| 1989 | $1,000,000 | $ - |
| 1990 | 1,500,000 | 2,000,000 |
| 1991 | 1,500,000 | 2,000,000 |
| 1992 | 2,000,000 | 2,500,000 |


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| | | |
|---|---|---|
| 1993 | 2,000,000 | 3,000,000 |
| | $8,000,000 | $9,500,000 |

In the notes to its December 31, 1989 balance sheet, how should Witt report the above data?

a. No disclosure is required.
b. Only sinking fund payments totaling $8,000,000 for the next five years detailed by year need be disclosed.
c. Only maturities totaling $9,500,000 for the next five years detailed by year need be disclosed.
d. The combined aggregate of $17,500,000 of maturities and sinking fund requirements detailed by year should be.

**CPA-00634 Explanation**
Choice "d" is correct. The combined aggregate of $17,500,000 of maturities and sinking fund requirements detailed by year should be disclosed in the notes to the balance sheet at 12-31-89.

**Rule:** For long-term borrowings and redeemable stock, disclosures should include maturities and sinking fund requirements (if any) for each of the next five years and redemption requirements for each of the next five years, respectively.

**CPA-00635 Type1 M/C A-D Corr Ans: D PM#44 F 5-99**

117. CPA-00635 Nov 90 II #11 (Adapted) Page 58

On its December 31, 1988 balance sheet, Nilo Corp. reported bonds payable of $8,000,000 and related unamortized bond issue costs of $430,000. The bonds had been issued at par. On January 2, 1989, Nilo retired $4,000,000 of the outstanding bonds at par plus a call premium of $100,000. This transaction is material to Nilo and is also considered to be an unusual and infrequent event. Ignoring income taxes, what amount should Nilo report in its 1989 income statement as loss on extinguishment of debt?

a. $0
b. $100,000
c. $215,000
d. $315,000

**CPA-00635 Explanation**
Choice "d" is correct. $315,000 extraordinary loss on early extinguishment of debt.

| | |
|---|---|
| Face value of bonds retired | $4,000,000 |
| Less pro rata unamortized bond issue costs (4,000,000/8,000,000 x 430,000) | (215,000) |
| Net carrying amount | 3,785,000 |
| Reacquisition price (4,000,000 + 100,000) | 4,100,000 |
| Extraordinary loss on early extinguishment of debt | $ (315,000) "D" |

**CPA-00636 Type1 M/C A-D Corr Ans: D PM#45 F 5-99**

118. CPA-00636 Nov 90 T #29 Page 53

On January 2, 1986, Chard Co. issued 10-year convertible bonds at 105. During 1989, these bonds were converted into common stock having an aggregate par value equal to the total face amount of the bonds. At conversion, the market price of Chard's common stock was 50 percent above its par value.

On January 2, 1986, cash proceeds from the issuance of the convertible bonds should be reported as:

a. Contributed capital for the entire proceeds.
b. Contributed capital for the portion of the proceeds attributable to the conversion feature and as a liability for the balance.
c. A liability for the face amount of the bonds and contributed capital for the premium over the face amount.
d. A liability for the entire proceeds.


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**CPA-00636 Explanation**
Choice "d" is correct. On 1-2-86, cash proceeds from the issuance of the convertible bonds should be reported a liability for the entire proceeds. (Note: No accrued interest.)

**Rule:** Discount or premium on the sale of bonds is included in the carrying value of the bonds on the balance sheet.

**CPA-00637 Type1 M/C A-D Corr Ans: C PM#46 F 5-99**

119. CPA-00637 Nov 90 T #30 Page 53

On January 2, 1986, Chard Co. issued 10-year convertible bonds at 105. During 1989, these bonds were converted into common stock having an aggregate par value equal to the total face amount of the bonds. At conversion, the market price of Chard's common stock was 50 percent above its par value. Depending on whether the book value method or the market value method was used, Chard would recognize gains or losses on conversion when using the:

| | *Book value method* | *Market value method* |
|---|---|---|
| a. | Either gain or loss | Gain |
| b. | Either gain or loss | Loss |
| c. | Neither gain nor loss | Loss |
| d. | Neither gain nor loss | Gain |

**CPA-00637 Explanation**
Choice "c" is correct. Book value method - neither gain nor loss. Market value method - loss.

**Rules:**

1. No gain or loss is recognized under the GAAP book value method at the time bonds are converted to common stock.
2. The use of the market value method recognizes gain or loss, but is not GAAP.

| Illustrative JE: | Debit | Credit |
|---|---|---|
| Bond payable | 105 | |
| Loss | 45 | |
| Common stock & APIC | | 150 |

**CPA-00638 Type1 M/C A-D Corr Ans: A PM#47 F 5-99**

120. CPA-00638 Nov 90 T #31 Page 57

Main Co. issued bonds with detachable common stock warrants. Only the warrants had a known market value. The sum of the fair value of the warrants and the face amount of the bonds exceeds the cash proceeds. This excess is reported as:

a. Discount on bonds payable.
b. Premium on bonds payable.
c. Common stock subscribed.
d. Contributed capital in excess of par-stock warrants.

**CPA-00638 Explanation**
Choice "a" is correct. Discount on bonds payable.

**Rule:** Allocate amounts separately to debt and detachable warrants according to their FMV at date of issuance. The amount allocated to warrants is "paid-in capital." Any difference between the amount paid (proceeds) and the combination of FMVs of debt and warrants should be debited or credited to "discount or premium on bonds payable."

In this case, however, only the warrants had a known market value. The bonds have an "implied" market value which is equal to the difference between the cash received and the FMV of the warrants.


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| Illustration | Amounts Assumed |
|---|---|
| Fair value of warrants | $ 5,000 |
| Face amount of bonds | 100,000 |
| Subtotal | 105,000 |
| Cash proceeds received | (102,000) |
| Discount on bonds payable | $ 3,000 |

**CPA-00639 Type1 M/C A-D Corr Ans: A PM#48 F 5-99**

121. CPA-00639 May 91 I #47 Page 34

Hancock Co.'s December 31, 1990, balance sheet contained the following items in the long-term liabilities section:

| | |
|---|---|
| Unsecured | |
| 9.375% registered bonds ($25,000 maturing annually beginning in 1994) | $275,000 |
| 11.5% convertible bonds, callable beginning in 1999, due 2010 | 125,000 |
| Secured | |
| 9.875 % guaranty security bonds, due 2010 | $50,000 |
| 10.0% commodity backed bonds ($50,000 maturing annually beginning in 1995) | 200,000 |

What are the total amounts of serial bonds and debenture bonds?

| | *Serial bonds* | *Debenture bonds* |
|---|---|---|
| a. | $475,000 | $400,000 |
| b. | $475,000 | $125,000 |
| c. | $450,000 | $400,000 |
| d. | $200,000 | $650,000 |

**CPA-00639 Explanation**

Choice "a" is correct. $475,000 serial bonds, $400,000 debenture bonds.

Serial bonds are redeemed pro-rata over the life of the issue and would include the following:

| | |
|---|---|
| 9.375% registered bonds maturing annually | $275,000 |
| 10% commodity backed bonds maturing annually | 200,000 |
| Total serial bonds | $475,000 |

Debenture bonds are unsecured bonds and would include both bonds under the "unsecured" caption as follows:

| | |
|---|---|
| 9.375% registered bonds | $275,000 |
| 11.5% convertible bonds | 125,000 |
| Total debenture bonds | $400,000 |

**CPA-00640 Type1 M/C A-D Corr Ans: B PM#49 F 5-99**

122. CPA-00640 May 91 II #5 Page 56

Ray Corp. issued bonds with a face amount of $200,000. Each $1,000 bond contained detachable stock warrants for 100 shares of Ray's common stock. Total proceeds from the issue amounted to $240,000. The market value of each warrant was $2, and the market value of the bonds without the warrants was $196,000. The bonds were issued at a discount of:

a. $0
b. $678
c. $4,000
d. $33,898


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**CPA-00640 Explanation**
Choice "b" is correct. $678 discount on bonds payable.

Approach: (1) Allocate amount received separately to bonds and detachable warrants according to their relative FMV's at date of issuance.

(2) Amount allocated to detachable warrants is paid-in capital.

(3) The difference between the amount allocated to the bonds and face value (par) should be debited or credited to "discount or premium on bonds payable."

| | Total | | Bonds | | Warrants |
|---|---|---|---|---|---|
| Number of $1000 bonds | | | | | 200 |
| Number of warrants per bond | | | | | × 100 |
| Total number of warrants | | | | | 20,000 |
| FMV of each warrant | | | | | × $2 |
| Total FMV | $ 236,000 | = | $196,000 | + | $ 40,000 |
| % to total | 100% | = | 83.1% | + | 16.9% |
| Allocation of total proceeds (via %) | 240,000 | = | 199,322 | + | 40,678 |
| Face amount of bonds | 200,000 | | | | |
| Discount on bonds | | | $ (678) | | Credit paid-in capital |

**CPA-00643 Type1 M/C A-D Corr Ans: B PM#50 F 5-99**

123. CPA-00643 May 91 T #5 Page 33

A 15-year bond was issued in 1980 at a discount. During 1990, a 10-year bond was issued at face amount with the proceeds used to retire the 15-year bond at its face amount. The net effect of the 1990 bond transactions was to increase long-term liabilities by the excess of the 10-year bond's face amount over the 15-year bond's:

a. Face amount.
b. Carrying amount.
c. Face amount less the deferred loss on bond retirement.
d. Carrying amount less the deferred loss on bond retirement.

**CPA-00643 Explanation**
Choice "b" is correct. The long-term liabilities will increase by the difference between the carrying amount of the old 15-year bond and the face amount (issuing price) of the new 10-year bond.

**Rule:** Bond liability is shown on the balance sheet net of unamortized discount.

Choice "a" is incorrect. The bond liability is shown net of discount.

Choices "c" and "d" are incorrect. The loss cannot be deferred.

**CPA-00646 Type1 M/C A-D Corr Ans: C PM#51 F 5-99**

124. CPA-00646 Nov 91 T #35 Page 37

The market price of a bond issued at a discount is the present value of its principal amount at the market (effective) rate of interest:

a. Less the present value of all future interest payments at the market (effective) rate of interest.
b. Less the present value of all future interest payments at the rate of interest stated on the bond.
c. Plus the present value of all future interest payments at the market (effective) rate of interest.


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d. Plus the present value of all future interest payments at the rate of interest stated on the bond.

**CPA-00646 Explanation**
Choice "c" is correct. The market value of a bond issued at a discount (or a premium) is the present value of two cash flows.

1. The present value of the principal amount, plus,
2. The present value of all future interest payments,
3. Both at the market (effective) rate of interest.

**CPA-00648 Type1 M/C A-D Corr Ans: A PM#52 F 5-99**

125. CPA-00648 Nov 91 T #36 Page 49

An issuer of bonds uses a sinking fund for the retirement of the bonds. Cash was transferred to the sinking fund and subsequently used to purchase investments. The sinking fund:

I. Increases by revenue earned on the investments.
II. Is not affected by revenue earned on the investments.
III. Decreases when the investments are purchased.

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

**CPA-00648 Explanation**
Choice "a" is correct. I only. The sinking fund increases by revenue earned on the investments.

The sinking fund is used to retire bonds at a future date and cash is transferred to the sinking fund on a discounted basis to consider future revenue earned on the investments made with sinking fund assets.

Choices "b", "c", and "d" are incorrect. Investment purchases simply transform the cash into another form of investment within the sinking fund itself.

**CPA-00649 Type1 M/C A-D Corr Ans: C PM#53 F 5-99**

126. CPA-00649 Nov 91 T #37 Page 56

Bonds with detachable stock warrants were issued by Flack Co. Immediately after issue the aggregate market value of the bonds and the warrants exceeds the proceeds. Is the portion of the proceeds allocated to the warrants less than their market value, and is that amount recorded as contributed capital?

| | *Less than warrants' market value* | *Contributed capital* |
|---|---|---|
| a. | No | Yes |
| b. | Yes | No |
| c. | Yes | Yes |
| d. | No | No |

**CPA-00649 Explanation**
Choice "c" is correct. Yes - Yes.

**Rule:** Allocate amounts separately to debt and detachable warrants according to their relative FMVs at the date of issuance. The amount allocated to detachable warrants is recorded as contributed (additional paid-in) capital.

The portion of the proceeds allocated to the warrants is recorded as contributed capital, and the amount will be less than their market value because the total proceeds were less than the combined market values of the bonds and warrants.


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**CPA-00651 Type1 M/C A-D Corr Ans: B PM#54 F 5-99**

127. CPA-00651 May 92 I #29 Page 41

Dixon Co. incurred costs of $3,300 when it issued, on August 31, 1991, 5-year debenture bonds dated April 1, 1991. What amount of bond issue expense should Dixon report in its income statement for the year ended December 31, 1991?

a. $220
b. $240
c. $495
d. $3,300

**CPA-00651 Explanation**
Choice "b" is correct. $240 bond issue expense for year ended Dec 31, 1991.

| | |
|---|---|
| Issue costs | $3,300 |
| Months to maturity [60-5 (Apr 1 to Aug 31)] = | ÷ 55 |
| Per month | 60 |
| Months outstanding (Sept 1 to Dec 31) | × 4 |
| 4 months' expense | $ 240 |

**CPA-00652 Type1 M/C A-D Corr Ans: C PM#55 F 5-99**

128. CPA-00652 May 92 I #30 Page 37

The following information pertains to Camp Corp.'s issuance of bonds on July 1, 1991:

| | |
|---|---|
| Face amount | $800,000 |
| Term | 10 years |
| Stated interest rate | 6% |
| Interest payment dates | Annually on July 1 |
| Yield | 9% |

| | At 6% | At 9% |
|---|---|---|
| Present value of 1 for 10 periods | 0.558 | 0.422 |
| Future value of 1 for 10 periods | 1.791 | 2.367 |
| Present value of ordinary annuity of 1 for 10 periods | 7.360 | 6.418 |

What should be the issue price for each $1,000 bond?

a. $1,000
b. $864
c. $807
d. $700

**CPA-00652 Explanation**
Choice "c" is correct. $807 issue price for each $1,000 bond.

**Rule:** Bond issue price is the sum of the present values of the maturity value and the interest payment annuity.

| Calculation components | | | 9% PV factor | PV at 9% |
|---|---|---|---|---|
| PV of princ. for 10 yrs. | $1,000 | × | 0.422 | $422 |
| PV of interest annuity for 10 yrs. ($1,000 × 6% = $60 per year) | $ 60 | × | 6.418 | $385 |
| Total issue price for each $1,000 bond to yield 9% | | | | $807 |


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**CPA-00655 Type1 M/C A-D Corr Ans: A PM#56 F 5-99**

129. CPA-00655 May 92 I #58 (Adapted) Page 58

On December 31, 1998, Wright Corp. placed cash of $875,000 in an irrevocable trust. The trust's assets are to be used solely for satisfying obligations on Wright's 6%, $1,100,000, 30-year bond payable. Wright has not been legally released from its obligations under the bond agreement, but any additional liability is considered remote. This material event is considered unusual and infrequent for Wright. On December 31, 1998, the bond's carrying amount was $1,050,000, and its market value was $800,000. Disregarding income taxes, what amount of extraordinary gain (loss) should Wright report in its 1998 income statement?

a. $0
b. $(75,000)
c. $175,000
d. $250,000

**CPA-00655 Explanation**
Choice "a" is correct. None

Under the provisions of FAS 125, a debtor is relieved of its obligation to the creditor only by:

1) Paying the creditor.
2) Being released of the debt judicially or by the creditor.

Considering debt as "extinguished" (defeasing debt) by placing cash in an irrevocable trust is not GAAP for "extinguishment of debt."

**CPA-00657 Type1 M/C A-D Corr Ans: D PM#57 F 5-99**

130. CPA-00657 Nov 92 I #5 Page 49

Able, Inc. had the following amounts of long-term debt outstanding at December 31, 1991:

| | |
|---|---|
| 14 1/2% term note, due 1992 | $ 3,000 |
| 11 1/8% term note, due 1995 | 107,000 |
| 8% note, due in 11 equal annual principal payments, plus interest beginning December 31, 1992 | 110,000 |
| 7% guaranteed debentures, due 1996 | 100,000 |
| Total | $320,000 |

Able's annual sinking-fund requirement on the guaranteed debentures is $4,000 per year. What amount should Able report as current maturities of long-term debt in its December 31, 1991, balance sheet?

a. $4,000
b. $7,000
c. $10,000
d. $13,000

**CPA-00657 Explanation**
**Rule:** Current maturities of long-term debt in the balance sheet should include amounts due and payable within 12 months of the balance sheet date.

The $4,000 sinking-fund requirement would be disclosed in a footnote but is not included as a current maturity of long-term debt. Deposits into a bond sinking fund are an asset held by a trustee to repay the entire liability at maturity.

Choice "d" is correct. $13,000 current maturities of long-term debt at Dec. 31, 1991.

**CPA-00660 Type1 M/C A-D Corr Ans: D PM#58 F 5-99**


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131. CPA-00660 Nov 92 I #36 Page 48

On April 1, 1992, Hill Corp. issued 200 of its $ 1,000 face value bonds at 101 plus accrued interest. The bonds were dated November 1,1991, and bear interest at an annual rate of 9% payable semiannually on November 1 and May 1. What amount did Hill receive from the bond issuance?

a. $194,500
b. $200,000
c. $202,000
d. $209,500

**CPA-00660 Explanation**

| | | |
|---|---|---|
| Sales price (200 bonds x $1,000 x 101%) | 202,000 | |
| Cash -Accrued interest ($200,000 x 9% x 5/12) | 7,500 | |
| Less: deferred bond issue costs | (0) | |
| Cash received | 209,500 | |

The rest of journal entry could be prepared as proof:

| | | |
|---|---|---|
| Deferred bond issue costs | 0 | |
| Bonds payable | | 200,000 |
| Unamortized bond premium, | | 2,000 |
| Bond interest payable | | 7,500 |
| | 209,500 | 209,500 |

Choice "d" is correct. $209,500 cash received from the bond issuance.

**CPA-00662 Type1 M/C A-D Corr Ans: D PM#59 F 5-99**

132. CPA-00662 Nov 92 I #37 Page 41

During 1992, Lake Co. issued 3,000 of its 9%, $1,000 face value bonds at 101 l/2. In connection with the sale of these bonds, Lake paid the following expenses:

| | |
|---|---|
| Promotion costs | $ 20,000 |
| Engraving and printing | 25,000 |
| Underwriters' commissions | 200,000 |

What amount should Lake record as bond issue costs to be amortized over the term of the bonds?

a. $0
b. $220,000
c. $225,000
d. $245,000

**CPA-00662 Explanation**

**Rule:** All costs associated with the issuance of bonds should be capitalized and amortized over the "outstanding" term of the bonds.

Capitalized costs include:

| | |
|---|---|
| Promotion costs | $ 20,000 |
| Engraving and printing | 25,000 |
| Underwriters' commissions | 200,000 |
| Total capitalized | $245,000 **D** |

Choice "d" is correct. $245,000 deferred bond issue costs to be amortized over the term of the bonds.

**CPA-00666 Type1 M/C A-D Corr Ans: B PM#60 F 5-99**


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133. CPA-00666 May 93 II #18 (Adapted)Page 63

On December 30, 1992, Hale Corp. paid $400,000 cash and issued 80,000 shares of its $1 par value common stock to its unsecured creditors on a pro rata basis pursuant to a reorganization plan under Chapter 11 of the bankruptcy statutes. Hale owed these unsecured creditors a total of $1,200,000. This transaction is considered an extraordinary event for Hale. Hale's common stock was trading at $1.25 per share on December 30, 1992. Ignoring income taxes, as a result of this transaction, Hale's total stockholder's equity had a net increase of:

a. $1,200,000
b. $800,000
c. $100,000
d. $80,000

**CPA-00666 Explanation**
**Rule:** A troubled debt restructuring exists when a creditor grants a concession to a debtor that it would not otherwise consider for economic or legal reasons (bankruptcy chapter 11 reorganization).

Gain is recognized by debtor if the face amount of the payable exceeds the FMV of assets and/or equity transferred. In this case, the gain would be classified as extraordinary.

| | | |
|---|---|---|
| Face amount of payables | | $1,200,000 |
| Less: Assets/equity transferred: | | |
| Cash paid | $400,000 | |
| Stock issued: 80,000 shares @ $1.25 FMV | 100,000 | |
| | | (500,000) |
| Gain on troubled debt restructuring | | 700,000 |
| Add: 80,000 shares of stock issued @ $1.25 PV | | 100,000 |
| Increase in stockholders' equity | | $ 800,000 |

Note that both the "gain" (assuming no income tax effects) and the issuance of new stock increase stockholders' equity

Choice "b" is correct. $800,000 net increase in total stockholders' equity.

**CPA-00673 Type1 M/C A-D Corr Ans: D PM#61 F 5-99**

134. CPA-00673 Nov 93 I #41 Page 73

On November 1, 1992, Davis Co. discounted with recourse at 10% a one-year, noninterest bearing, $20,500 note receivable maturing on January 31, 1993. What amount of contingent liability for this note must Davis disclose in its financial statements for the year ended December 31, 1992?

a. $0
b. $20,000
c. $20,333
d. $20,500

**CPA-00673 Explanation**
Choice "d" is correct. $20,500 contingent liability must be disclosed in its financial statements at 12-31-92. The note is not discounted for footnote liability purposes because Davis is contingently liable for the full amount because it was sold with recourse.

**CPA-00675 Type1 M/C A-D Corr Ans: D PM#62 F 5-99**

135. CPA-00675 Nov 93 T #43 Page 49

On March 1, 1988, a company established a sinking fund in connection with an issue of bonds due in 2000. At December 31, 1992, the independent trustee held cash in the sinking fund account representing


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the annual deposits to the fund and the interest earned on those deposits. How should the sinking fund be reported in the company's balance sheet at December 31, 1992?

a. The cash in the sinking fund should appear as a current asset.
b. Only the accumulated deposits should appear as a noncurrent asset.
c. The entire balance in the sinking fund account should appear as a current asset.
d. The entire balance in the sinking fund account should appear as a noncurrent asset.

**CPA-00675 Explanation**
**Rule:** Only sinking fund accounts (or the portion thereof) that are considered to offset current bond liabilities can be included within current assets.

Choice "d" is correct. The entire balance in the sinking fund account (deposits plus interest earned) in this example is shown as a noncurrent asset since all of the bonds mature in the year 2000 (8 years later). The bond liability is not current, and the interest earned is also included in the sinking fund, a noncurrent asset.

Choices "a" and "c" are incorrect. The asset is not current since the related liability and offsetting interest earned is not current.

Choice "b" is incorrect. The interest earned is also part of the sinking fund available to retire the bonds, and is noncurrent.

**CPA-00676 Type1 M/C A-D Corr Ans: C PM#63 F 5-99**

136. CPA-00676 May 95 #5 Page 34

Cali, Inc., had a $4,000,000 note payable due on March 15, 1995. On January 28, 1995, before the issuance of its 1994 financial statements, Cali issued long-term bonds in the amount of $4,500,000. Proceeds from the bonds were used to repay the note when it came due. How should Cali classify the note in its December 31, 1994, financial statements?

a. As a current liability, with separate disclosure of the note refinancing.
b. As a current liability, with no separate disclosure required.
c. As a noncurrent liability, with separate disclosure of the note refinancing.
d. As a noncurrent liability, with no separate disclosure required.

**CPA-00676 Explanation**
**Rule:** Bonds or notes due within one year are shown as "noncurrent" if the issuer has the intent and ability to refinance with a new issuance of long-term debt. This intent and ability must usually be demonstrated through refinancing of the debt after the balance sheet date, but before the issuance of the financial statements. Separate disclosure of the refinancing is required.

Choice "c" is correct. As a noncurrent liability, with separate disclosure of the note refinancing.

Choices "a", "b", and "d" are incorrect, per the above rule.

**CPA-00677 Type1 M/C A-D Corr Ans: D PM#64 F 5-99**

137. CPA-00677 Nov 95 #41 (Adapted) Page 58

In open market transactions, Gold Corp. simultaneously sold its long-term investment in Iron Corp. bonds and purchased its own outstanding bonds. The purchase of its own bonds is a material unusual and infrequent event for Gold Corp. The broker remitted the net cash from the two transactions. Gold's gain on the purchase of its own bonds exceeded its loss on the sale of the Iron bonds. Gold should report the:

a. Net effect of the two transactions as an extraordinary gain.
b. Net effect of the two transactions in income before extraordinary items.
c. Effect of its own bond transaction gain in income before extraordinary items, and report the Iron bond transaction as an extraordinary loss.


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d. Effect of its own bond transaction as an extraordinary gain, and report the Iron bond transaction loss in income before extraordinary items.

**CPA-00677 Explanation**
Choice "d" is correct. These are two separate transactions because Gold Corp.

(1) Sold Iron Corp. Bonds (an investment) for a loss, and

(2) Bought back its own (Gold) Corp. Bonds (a debt) for a gain.

This is **not** a "refinancing" (where one would sell new bond debt to buy back old bond debt outstanding). The gain from the purchase of its own bonds is an "extraordinary gain" because it meets the criteria of APBO No. 30 (per SFAS No. 145). The Iron Corp. transaction is a loss in "income before extraordinary items."

Choices "a" and "b" are incorrect. The two transactions are separate and **cannot** be netted because one is a sale of an investment, while the other an extinguishment of debt that meets the criteria to be classified as an extraordinary item.

Choice "c" is incorrect. Just the opposite. The sale of the investment is a loss in "income before extraordinary items," while the purchase of its bond debt is an "extraordinary gain."

**CPA-00678 Type1 M/C A-D Corr Ans: C PM#65 F 5-99**

138. CPA-00678 Nov 96 #7 Page 65

When a loan receivable is impaired but foreclosure is **not** probable, which of the following may the creditor use to measure the impairment?

I. The loan's observable market price.
II. The fair value of the collateral if the loan is collateral dependent.

a. I only.
b. II only.
c. Either I or II.
d. Neither I nor II.

**CPA-00678 Explanation**
Choice "c" is correct. FAS 114 states that a loan is impaired when it is probable that a creditor will be unable to collect all amounts due (including both principal and interest) according to the contractual terms of the loan agreement. When a loan is impaired and foreclosure is not probable, the creditor should measure impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate. However, as a practical expedient, the creditor may measure impairment based on (1) a loan's observable market price, or (2) the fair value of the collateral if the loan is collateral dependent. If foreclosure of a loan is probable, impairment must be measured based on the fair value of the collateral.

Choices "a", "b", and "d" are incorrect. Both the loan's observable market price and the fair value of collateral can be used to measure impairment.

**CPA-04340 Type1 M/C A-X Corr Ans: Q PM#66 F 5-99**

139. CPA-04340 FARE Nov 95 #3a 1 Page 3

On January 2, 1994, North Co. issued bonds payable with a face value of $480,000 at a discount. The bonds are due in 10 years and interest is payable semiannually every June 30 and December 31. On June 30, 1994, and on December 31, 1994, North made the semiannual interest payments due, and recorded interest expense and amortization of bond discount.


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This question, indicated by **[X]**, is contained in the partially completed amortization table below and represents information needed to complete the table. Select from the following list the correct numerical response for the **[X]** value.

| | Cash | Interest Expense | Amortization | Discount | Carrying Amount |
|---|---|---|---|---|---|
| 1/2/94 | | | | | |
| 6/30/94 | | 18,000 | 3,600 | **[X]** | 363,600 |
| 12/31/94 | $14,400 | | | | |

Annual Interest Rates: Stated
Effective

A. 3.0%
B. 4.5%
C. 5.0%
D. 6.0%
E. 9.0%
F. 10.0%
G. $3,420
H. $3,600
I. $3,780
J. $3,960
K. $14,400
L. $17,820
M. $18,000
N. $18,180
O. $18,360
P. $21,600
Q. $116,400
R. $120,000
S. $123,600
T. $360,000
U. $363,600
V. $367,200
W. $467,400
X. $480,000

**CPA-04340 Explanation**
OBSERVATIONS: Bonds are issued at a discount: carrying value (CV) is less than face value; carrying value increases over the life of the bonds; effective rate is greater than stated rate; interest expense is greater than interest paid.

**Choice "Q" is correct.**

Discount = Face - CV
Discount = $480,000 - 363,600
= $116,400

**CPA-04341 Type1 M/C A-X Corr Ans: K PM#67 F 5-99**

140. CPA-04341 FARE Nov 95 #3a 2 Page 3

On January 2, 1994, North Co. issued bonds payable with a face value of $480,000 at a discount. The bonds are due in 10 years and interest is payable semiannually every June 30 and December 31. On June 30, 1994, and on December 31, 1994, North made the semiannual interest payments due, and recorded interest expense and amortization of bond discount.


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This question, indicated by **[X]**, is contained in the partially completed amortization table below and represents information needed to complete the table. Select from the following list the correct numerical response for the **[X]** value.

| | Cash | Interest Expense | Amortization | Discount | Carrying Amount |
|---|---|---|---|---|---|
| 1/2/94 | | | | | |
| 6/30/94 | **[X]** | 18,000 | 3,600 | | 363,600 |
| 12/31/94 | $14,400 | | | | |

Annual Interest Rates: Stated
Effective

A. 3.0%
B. 4.5%
C. 5.0%
D. 6.0%
E. 9.0%
F. 10.0%
G. $3,420
H. $3,600
I. $3,780
J. $3,960
K. $14,400
L. $17,820
M. $18,000
N. $18,180
O. $18,360
P. $21,600
Q. $116,400
R. $120,000
S. $123,600
T. $360,000
U. $363,600
V. $367,200
W. $467,400
X. $480,000

**CPA-04341 Explanation**
OBSERVATIONS: Bonds are issued at a discount: carrying value (CV) is less than face value; carrying value increases over the life of the bonds; effective rate is greater than stated rate; interest expense is greater than interest paid.

**Choice "K" is correct.**

Interest expense - Cash expense = Amortization
$18,000 - Cash interest = $3,600
Cash interest = $14,400 or Cash interest is a constant amount at each payment date and must equal the $14,400 listed on 12/31/94

**CPA-04343 Type1 M/C A-X Corr Ans: T PM#68 F 5-99**

141. CPA-04343 FARE Nov 95 #3a 3 Page 3

On January 2, 1994, North Co. issued bonds payable with a face value of $480,000 at a discount. The bonds are due in 10 years and interest is payable semiannually every June 30 and December 31. On June 30, 1994, and on December 31, 1994, North made the semiannual interest payments due, and recorded interest expense and amortization of bond discount.


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This question, indicated by **[X]**, is contained in the partially completed amortization table below and represents information needed to complete the table. Select from the following list the correct numerical response for the **[X]** value.

| | Cash | Interest Expense | Amortization | Discount | Carrying Amount |
|---|---|---|---|---|---|
| 1/2/94 | | | | | **[X]** |
| 6/30/94 | | 18,000 | 3,600 | | 363,600 |
| 12/31/94 | $14,400 | | | | |

Annual Interest Rates: Stated
Effective

A. 3.0%
B. 4.5%
C. 5.0%
D. 6.0%
E. 9.0%
F. 10.0%
G. $3,420
H. $3,600
I. $3,780
J. $3,960
K. $14,400
L. $17,820
M. $18,000
N. $18,180
O. $18,360
P. $21,600
Q. $116,400
R. $120,000
S. $123,600
T. $360,000
U. $363,600
V. $367,200
W. $467,400
X. $480,000

**CPA-04343 Explanation**
OBSERVATIONS: Bonds are issued at a discount: carrying value (CV) is less than face value; carrying value increases over the life of the bonds; effective rate is greater than stated rate; interest expense is greater than interest paid.

**Choice "T" is correct.**

| | | |
|---|---|---|
| 1/2/94 | | 6/30/94 |
| CV + Amortization | = | CV |
| 1/2/94 CV + $3,600 | = | $363,600 |
| 1/2/94 Carrying amount | = | $360,000 |

**CPA-04345 Type1 M/C A-X Corr Ans: D PM#69 F 5-99**

142. CPA-04345 FARE Nov 95 #3a 4 Page 3

On January 2, 1994, North Co. issued bonds payable with a face value of $480,000 at a discount. The bonds are due in 10 years and interest is payable semiannually every June 30 and December 31. On June 30, 1994, and on December 31, 1994, North made the semiannual interest payments due, and recorded interest expense and amortization of bond discount.


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This question, indicated by **[X]**, is contained in the partially completed amortization table below and represents information needed to complete the table. Select from the following list the correct numerical response for the **[X]** value.

| | Cash | Interest Expense | Amortization | Discount | Carrying Amount |
|---|---|---|---|---|---|
| 1/2/94 | | | | | |
| 6/30/94 | | 18,000 | 3,600 | | 363,600 |
| 12/31/94 | $14,400 | | | | |

Annual Interest Rates: Stated / Effective **[X]**

A. 3.0%
B. 4.5%
C. 5.0%
D. 6.0%
E. 9.0%
F. 10.0%
G. $3,420
H. $3,600
I. $3,780
J. $3,960
K. $14,400
L. $17,820
M. $18,000
N. $18,180
O. $18,360
P. $21,600
Q. $116,400
R. $120,000
S. $123,600
T. $360,000
U. $363,600
V. $367,200
W. $467,400
X. $480,000

**CPA-04345 Explanation**
OBSERVATIONS: Bonds are issued at a discount: carrying value (CV) is less than face value; carrying value increases over the life of the bonds; effective rate is greater than stated rate; interest expense is greater than interest paid.

**Choice "D" is correct.**

Use standard interest formula: Cash interest is the face value times stated rate times time. Annual stated interest rate: Cash interest = face x rate x time $14,400 = $480,000 x R x 6/12 R = 2 x $14,400/480,000 = 6%

**CPA-04349 Type1 M/C A-X Corr Ans: F PM#70 F 5-99**

143. CPA-04349 FARE Nov 95 #3a 5 Page 3

On January 2, 1994, North Co. issued bonds payable with a face value of $480,000 at a discount. The bonds are due in 10 years and interest is payable semiannually every June 30 and December 31. On June 30, 1994, and on December 31, 1994, North made the semiannual interest payments due, and recorded interest expense and amortization of bond discount.


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This question, indicated by **[X]**, is contained in the partially completed amortization table below and represents information needed to complete the table. Select from the following list the correct numerical response for the **[X]** value.

| | Cash | Interest Expense | Amortization | Discount | Carrying Amount |
|---|---|---|---|---|---|
| 1/2/94 | | | | | |
| 6/30/94 | | 18,000 | 3,600 | | 363,600 |
| 12/31/94 | $14,400 | | | | |

| Annual Interest Rates: | Stated Effective | **[X]** |
|---|---|---|

A. 3.0%
B. 4.5%
C. 5.0%
D. 6.0%
E. 9.0%
F. 10.0%
G. $3,420
H. $3,600
I. $3,780
J. $3,960
K. $14,400
L. $17,820
M. $18,000
N. $18,180
O. $18,360
P. $21,600
Q. $116,400
R. $120,000
S. $123,600
T. $360,000
U. $363,600
V. $367,200
W. $467,400
X. $480,000

**CPA-04349 Explanation**
OBSERVATIONS: Bonds are issued at a discount: carrying value (CV) is less than face value; carrying value increases over the life of the bonds; effective rate is greater than stated rate; interest expense is greater than interest paid.

**Choice "F" is correct.**

At annual effective interest rate, interest expense is the initial carrying value times the effective rate times time.

Int. expense = CV x rate x time
= 2 x Int. expense/initial CV
Eff. rate = 2 x $18,000/$360,000 = 10%

**CPA-04352 Type1 M/C A-X Corr Ans: N PM#71 F 5-99**

144. CPA-04352 FARE Nov 95 #3a 6 Page 3

On January 2, 1994, North Co. issued bonds payable with a face value of $480,000 at a discount. The bonds are due in 10 years and interest is payable semiannually every June 30 and December 31. On


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June 30, 1994, and on December 31, 1994, North made the semiannual interest payments due, and recorded interest expense and amortization of bond discount.

This question, indicated by **[X]**, is contained in the partially completed amortization table below and represents information needed to complete the table. Select from the following list the correct numerical response for the **[X]** value.

| | Cash | Interest Expense | Amortization | Discount | Carrying Amount |
|---|---|---|---|---|---|
| 1/2/94 | | | | | |
| 6/30/94 | | 18,000 | 3,600 | | 363,600 |
| 12/31/94 | $14,400 | **[X]** | | | |

Annual Interest Rates: Stated
Effective

A. 3.0%
B. 4.5%
C. 5.0%
D. 6.0%
E. 9.0%
F. 10.0%
G. $3,420
H. $3,600
I. $3,780
J. $3,960
K. $14,400
L. $17,820
M. $18,000
N. $18,180
O. $18,360
P. $21,600
Q. $116,400
R. $120,000
S. $123,600
T. $360,000
U. $363,600
V. $367,200
W. $467,400
X. $480,000

**CPA-04352 Explanation**
OBSERVATIONS: Bonds are issued at a discount: carrying value (CV) is less than face value; carrying value increases over the life of the bonds; effective rate is greater than stated rate; interest expense is greater than interest paid.

**Choice "N" is correct.**

Interest expense = semiannual effective interest rate x carrying value
Interest expense = 10%/2 x $363,600 = $18,180

**CPA-04354 Type1 M/C A-X Corr Ans: I PM#72 F 5-99**

145. CPA-04354 FARE Nov 95 #3a 7 Page 3

On January 2, 1994, North Co. issued bonds payable with a face value of $480,000 at a discount. The bonds are due in 10 years and interest is payable semiannually every June 30 and December 31. On June 30, 1994, and on December 31, 1994, North made the semiannual interest payments due, and recorded interest expense and amortization of bond discount.


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This question, indicated by **[X]**, is contained in the partially completed amortization table below and represents information needed to complete the table. Select from the following list the correct numerical response for the **[X]** value.

| | Cash | Interest Expense | Amortization | Discount | Carrying Amount |
|---|---|---|---|---|---|
| 1/2/94 | | | | | |
| 6/30/94 | | 18,000 | 3,600 | | 363,600 |
| 12/31/94 | $14,400 | | **[X]** | | |

Annual Interest Rates: Stated
Effective

A. 3.0%
B. 4.5%
C. 5.0%
D. 6.0%
E. 9.0%
F. 10.0%
G. $3,420
H. $3,600
I. $3,780
J. $3,960
K. $14,400
L. $17,820
M. $18,000
N. $18,180
O. $18,360
P. $21,600
Q. $116,400
R. $120,000
S. $123,600
T. $360,000
U. $363,600
V. $367,200
W. $467,400
X. $480,000

**CPA-04354 Explanation**
OBSERVATIONS: Bonds are issued at a discount: carrying value (CV) is less than face value; carrying value increases over the life of the bonds; effective rate is greater than stated rate; interest expense is greater than interest paid.

**Choice "I" is correct.**

Amortization = Interest expense - Cash interest
Amortization = $18,180 - $14,400 = $3,780


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# CPA PassMaster Questions–Financial 6
# Export Date: 10/30/08


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**Pension Plans**

**CPA-00679 Type1 M/C A-D Corr Ans: D PM#1 F 6-01**

1. CPA-00679 FARE R02 #8 Page 19

Which of the following disclosures is **not** required of companies with a defined-benefit pension plan?

a. A description of the plan.
b. The amount of pension expense by component.
c. The weighted average discount rate.
d. The estimates of future contributions.

**CPA-00679 Explanation**
Choice "d" is correct. Although pension accounting has extensive disclosures, projections of future contributions into a pension plan are not required. "a", "b", and "c" are required disclosures.

**CPA-00681 Type1 M/C A-D Corr Ans: C PM#2 F 6-01**

2. CPA-00681 FARE R99 #13 Page 9

Jan Corp. amended its defined benefit pension plan, granting a total credit of $100,000 to four employees for services rendered prior to the plan's adoption. The employees, A, B, C, and D, are expected to retire from the company as follows:

"A" will retire after three years.
"B" and "C" will retire after five years.
"D" will retire after seven years.

What is the amount of prior service cost amortization in the first year?

a. $0
b. $5,000
c. $20,000
d. $25,000

**CPA-00681 Explanation**
Choice "c" is correct. Amortization of unrecognized prior service cost is calculated by assigning an equal amount of the cost to the future periods of service of each employee at the date of amendment to the plan. The average service life of the four employees is five years.

$100,000 ÷ 5 years = $20,000

**CPA-00699 Type1 M/C A-D Corr Ans: C PM#4 F 6-01**

3. CPA-00699 Th Nov 93 #30 Page 8

Visor Co. maintains a defined benefit pension plan for its employees. The service cost component of Visor's net periodic pension cost is measured using the:

a. Unfunded accumulated benefit obligation.
b. Unfunded vested benefit obligation.
c. Projected benefit obligation.
d. Expected return on plan assets.

**CPA-00699 Explanation**
Choice "c" is correct. Service cost represents the increase in the projected benefit obligation resulting from employees' services rendered during the year. SFAS 87 para. 264

Choice "a" is incorrect. The unfunded accumulated benefit obligation is not related to service cost calculations.


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Choice "b" is incorrect. The unfunded vested benefit obligation is not related to service cost calculations.

Choice "d" is incorrect. The expected return on plan assets is not related to service cost calculations.

**CPA-04698 Type1 M/C A-D Corr Ans: C PM#5 F 6-01**

4. CPA-04698 Released 2005 Page 17

Footnote disclosures in the financial statements for pensions do **not** require inclusion of which of the following?

a. The components of period pension costs.
b. The amount of unrecognized prior service cost.
c. The differences in executive and non-executive plans.
d. A detailed description of the plan including employee groups covered.

**CPA-04698 Explanation**
Choice "c" is correct. Per SFAS 132 the difference in executive and non executive plans is not a required disclosure.

Choice "a" is incorrect. The components of period pension cost "SIRAGE" is a required disclosure.

Choice "b" is incorrect. The amount of unrecognized prior service cost must be disclosed.

Choice "d" is incorrect. Disclosure showing a detailed description of the plan including employee groups covered is required.

**CPA-05236 Type1 M/C A-D Corr Ans: D PM#13 F 6-01**

5. CPA-05236 Released 2006 Page 5

What is the present value of all future retirement payments attributed by the pension benefit formula to employee services rendered prior to that date and based on past and current compensation levels only?

a. Service cost.
b. Interest cost.
c. Projected benefit obligation.
d. Accumulated benefit obligation.

**CPA-05236 Explanation**
Choice "d" is correct. The accumulated benefit obligation is the present value of future retirement payments attributed to the pension benefit formula to employee services rendered prior to a date, based on current and past compensation levels.

Choice "a" is incorrect. Service cost is the present value of all pension benefits earned by company employees in the current year.

Choice "b" is incorrect. Interest cost is the interest on the projected benefit obligation.

Choice "c" is incorrect. The projected benefit obligation is the present value of future retirement payments attributed to the pension benefit formula to employee services rendered prior to a date, based on current and past and (an assumption about) future compensation levels. The only difference between the accumulated benefit obligation and the projected benefit obligation is the assumption of future compensation levels. The projected benefit obligation is used for most pension calculations.

**CPA-05400 Type1 M/C A-D Corr Ans: C PM#16 F 6-01**

6. CPA-05400 Page 7

Big Books, Inc. has the following information related to its defined benefit pension plan:

| | |
|---|---|
| <u>December 31, 20X6:</u> | |
| Projected benefit obligation | $1,500,000 |


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| | |
|---|---|
| Fair value of plan assets | 1,400,000 |
| Unrecognized prior service cost | 200,000 |
| Unrecognized net transition asset | 60,000 |
| | |
| December 31, 20X7: | |
| Projected benefit obligation | $1,740,000 |
| Fair value of plan assets | 1,800,000 |
| Service cost | 220,000 |
| | |
| Assumptions: | |
| Discount rate | 6% |
| Expected return on plan assets | 8% |

Big Books makes an annual pension plan contribution of $200,000. The company's employees had an average remaining service life of 20 years on 12/31/X6 and the company expects to pay benefits totaling $170,000 to retired employees in 20X8. Big Books has an effective tax rate of 30%. What would Big Books report as net periodic pension cost on its December 31, 20X7, income statement?

a. $187,400
b. $193,400
c. $205,000
d. $211,000

**CPA-05400 Explanation**

Choice "c" is correct. The 20X7 net periodic pension cost should be calculated as follows:

| | | | |
|---|---|---|---|
| **S** | Service cost | $220,000 | |
| **I** | Interest cost | 90,000 | = $1,500,000 x 6% = Beg PBO x discount rate |
| **R** | Expected return on plan assets | (112,000) | = $1,400,000 x 8% = Beg FV x expected rate |
| **A** | Amortization of prior service cost | 10,000 | = $200,000 / 20 years |
| **G** | Amortization of (gains)/losses | 0 | |
| **E** | Amortization of transition asset | (3,000) | = $60,000 / 20 years |
| | Net periodic pension cost | $205,000 | |

Choice "a" is incorrect. This amount includes interest cost incorrectly calculated using the 20X7 PBO instead of the beginning PBO and return on plan assets incorrectly calculated using the 20X7 fair value of plan assets instead of the beginning fair value.

Choice "b" is incorrect. This amount includes interest cost incorrectly calculated using the 20X7 PBO instead of the beginning PBO and return on plan assets incorrectly calculated using the 20X7 fair value of plan assets instead of the beginning fair value. This amount also incorrectly adds the amortization of the net transition asset.

Choice "d" is incorrect. This amount incorrectly adds the amortization of the net transition asset. It is important to note that the amortization of a net transition obligation increases net periodic pension cost, while the amortization of a net transition asset decreases net periodic pension cost.

**CPA-05401 Type1 M/C A-D Corr Ans: B PM#17 F 6-01**

7. CPA-05401 Page 9

At December 31, 20X8, High Horse Company has the following pension plan information:

| | |
|---|---|
| Fair value of plan assets, beginning of year | $1,100,000 |
| Fair value of plan assets, ending of year | 1,135,000 |
| Contributions | 275,000 |
| Benefits paid | 340,000 |
| Expected rate of return on plan assets | 7% |


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The expected return on plan assets was used to calculate net periodic pension cost. No actuarial gains or losses were incurred during 20X8. High Horse's effective tax rate is 30%. What is the net gain to be reported in 20X8 other comprehensive income?

a. $0
b. $16,100
c. $23,000
d. $77,000

**CPA-05401 Explanation**
Choice "b" is correct. Absent any actuarial gains or losses, the net pension gain or loss incurred during an accounting period is the difference between the expected return on plan assets recorded in net periodic pension cost and the actual return on plan assets earned during the accounting period. This amount is reported in other comprehensive, after-tax, in the period incurred.

The expected return on plan assets is calculated as:

Beginning fair value of plan assets x Expected rate of return = $1,100,000 x 7% = $77,000

The actual return on plan assets is calculated as:

| | | | |
|---|---|---|---|
| | Beginning fair value of plan assets | $1,100,000 | |
| + | Contributions | 275,000 | |
| - | Benefits paid | (340,000) | |
| + | Actual return on plan assets | 100,000 | Squeeze |
| | Ending fair value of plan assets | $1,135,000 | |

Therefore, the difference between the actual return on plan assets and expected return on plan assets is $23,000 ($100,000 actual - $77,000 expected), which on an after-tax basis is $16,100 [$23,000 x (1-30%)].

This gain is recorded with the following journal entry:

| | | | |
|---|---|---|---|
| Dr. | Pension benefit asset/liability | 23,000 | |
| Dr. | Deferred tax expense - OCI | 6,900 | |
| Cr. | Deferred tax liability | | 6,900 |
| Cr. | Other comprehensive income | | 23,000 |

Choice "a" is incorrect. As explained above, there is a net pension gain equal to the after-tax difference between actual and expected return on plan assets.

Choice "c" is incorrect. This is the net gain before tax. SFAS No. 158 requires that the difference between actual and expected return on plan assets be reported in other comprehensive income net of tax.

Choice "d" is incorrect. This is the expected return on plan assets, not the net pension gain to be reported in 20X8 other comprehensive income.

**CPA-05402 Type1 M/C A-D Corr Ans: C PM#18 F 6-01**

8. CPA-05402 Page 9

In 20X9, Rhino Robots Inc. has the following information related to its defined benefit pension plan:

| | |
|---|---|
| Fair value of plan assets, 1/1/X9 | $2,130,000 |
| Fair value of plan assets, 12/31/X9 | 2,525,000 |
| Projected benefit obligation, 1/1/X9 | 3,500,000 |
| Projected benefit obligation, 12/31/X9 | 3,850,000 |
| Unrecognized net losses | 420,000 |

The average remaining service period of Rhino's employees is 20 years. What is the net loss amortization that Rhino will include in its 20X9 net periodic pension cost?

a. $0


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b. $1,750
c. $3,500
d. $21,000

**CPA-05402 Explanation**
Choice "c" is correct. Unrecognized pension gains or losses are amortized over the average remaining service period if, at the beginning of the year, the gain or loss exceeds 10% of the greater of the beginning of the year PBO or the beginning of the year market related value of plan assets (we will use the fair value of the plan assets in this example as the market related value is not given and these amounts are approximately equal).

At 1/1/X9, Rhino's PBO exceeds the fair value of the plan assets, so the 20X9 net loss amortization is calculated as:

| | |
|---|---|
| Unrecognized net loss | $420,000 |
| Less: 10% of Greater of Beg. PBO/Plan Assets | - 350,000 = $3,500,000 PBO x 10% |
| Excess | $ 70,000 |

Excess / Average Remaining Service Life = $70,000 / 20 = $3,500

Choice "a" is incorrect. Because the unrecognized net loss exceeds 10% of the greater of the beginning PBO/Plan assets, the excess must be amortized over the average remaining service period.

Choice "b" is incorrect. This amortization is calculated using the 12/31/X9 PBO. The greater of the *beginning* PBO/Plan assets must be used to determine the amount to amortize.

Choice "d" is incorrect. This is the total unrecognized net loss amortized over 20 years. GAAP allows companies to amortize only the portion of net gain or loss in excess of 10% of the greater of PBO/Plan assets.

**CPA-05403 Type1 M/C A-D Corr Ans: D PM#19 F 6-01**

9. CPA-05403 Page 12

Big Sports Inc. and its subsidiaries, Batter Up, Slam Dunk and Touchdown, had the following defined benefit pension plans at December 31, 20X8:

| | Big Sports | Batter Up | Slam Dunk | Touchdown |
|---|---|---|---|---|
| Fair Value - Plan Assets | $1,000,000 | $1,275,000 | $900,000 | $200,000 |
| PBO | $1,600,000 | $ 850,000 | $700,000 | $800,000 |
| Benefits Payable - 20X9 | $ 425,000 | $ 360,000 | $150,000 | $245,000 |

How would these pension plans be reported on Big Sports' December 31, 20X8 consolidated balance sheet?

| | *Noncurrent asset* | *Current liability* | *Noncurrent liability* |
|---|---|---|---|
| a. | $0 | $0 | $575,000 |
| b. | $0 | $45,000 | $530,000 |
| c. | $625,000 | $0 | $1,200,000 |
| d. | $625,000 | $45,000 | $1,155,000 |

**CPA-05403 Explanation**
Choice "d" is correct. SFAS No. 158 requires that all overfunded (FV plan assets > PBO) pension plans be aggregated and reported as a noncurrent asset, and that all underfunded (FV plan assets < PBO) pension plans be aggregated and reported as a current liability (to the extent that the benefits payable in the next year exceed the fair value of the pension plan assets), a noncurrent liability, or both. Big Sports and subsidiaries would report their pension plans as follows:

| | Big Sports | Batter Up | Slam Dunk | Touchdown | Total |
|---|---|---|---|---|---|
| FV Plan Assets | $ 1,000,000 | $ 1,275,000 | $ 900,000 | $ 200,000 | |
| Less: PBO | 1,600,000 | 850,000 | 700,000 | 800,000 | |
| Funded Status | $ (600,000) | $ 425,000 | $ 200,000 | $ (600,000) | |


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| | | | | | |
|---|---|---|---|---|---|
| Noncurrent Asset | - | $ 425,000 | $ 200,000 | - | $ 625,000 |
| Current liability | - | - | - | $ 45,000 | $ 45,000 |
| Noncurrent liability | $ 600,000 | - | - | $ 555,000 | $1,155,000 |

Note that Touchdown's pension plan must be reported as a current and noncurrent liability because it is underfunded and the benefits payable in 20X9 exceed the fair value of the plan assets by $45,000 ($245,000 benefits payable - $200,000 plan assets).

Choice "a" is incorrect. SFAS No. 158 does not permit the netting of all pension plans. Overfunded pension plans must be aggregated separately from underfunded pension plans.

Choice "b" is incorrect. This presentation is not supported by SFAS No. 158.

Choice "c" is incorrect. SFAS No. 158 requires that Touchdown's underfunded pension plan be reported as a current liability of $45,000 and noncurrent liability of $555,000 because it is underfunded and the benefits payable in 20X9 exceed the fair value of the plan assets by $45,000 ($245,000 benefits payable - $200,000 plan assets).

**CPA-05404 Type1 M/C A-D Corr Ans: A PM#20 F 6-01**

10. CPA-05404 Page 13

Zen Transportation Inc.'s pension trustee provided the company with the following information for its defined benefit pension plan at December 31, 20X7:

| | |
|---|---|
| Projected benefit obligation | $2,500,000 |
| Fair value of pension plan assets | 1,950,000 |
| Unrecognized prior service cost | 375,000 |
| Unrecognized net gain | 50,000 |
| Unrecognized transition obligation | 135,000 |
| Net periodic pension cost | 440,000 |

Zen has an effective tax rate of 40%. What amount would Zen report in accumulated other comprehensive income related to its pensions plan on its December 31, 20X7 balance sheet?

a. $276,000
b. $336,000
c. $460,000
d. $560,000

**CPA-05404 Explanation**

Choice "a" is correct. Unrecognized prior service cost, unrecognized transition obligations and unrecognized net gains or losses must be reported in accumulated other comprehensive income, net of tax, until recognized as a component of net periodic pension cost through amortization. Unrecognized prior service cost, transition obligations and net losses all increase pension expense when recognized and are therefore recorded as a debit to accumulated OCI. Unrecognized transition assets and net gains decrease pension expense when recognized and are therefore recorded as a credit to accumulated OCI. For Zen, the total pension related amount to be reported in accumulated OCI (before tax) is:

| | |
|---|---|
| Unrecognized prior service cost | $375,000 |
| Unrecognized transition obligation | 135,000 |
| Unrecognized net gain | (50,000) |
| | $460,000 |

SFAS No. 158 requires that this amount be reported on an after-tax basis: $460,000 x (1 - 40%) = $276,000. Note that this would be a $276,000 offset (debit) to accumulated OCI.

Choice "b" is incorrect. This amount is calculated by adding the unrecognized net gain to the unrecognized prior service cost and transition obligation. The unrecognized net gain should be subtracted.


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Choice "c" is incorrect. This is the total of the unrecognized amounts that must be reported in accumulated other comprehensive income on a pre-tax basis. SFAS No. 158 requires that these amounts be reported in accumulated OCI after-tax.

Choice "d" is incorrect. This amount is calculated by adding the unrecognized net gain to the unrecognized prior service cost and transition obligation. The unrecognized net gain should be subtracted. Additionally, this is a pre-tax amount. SFAS No. 158 requires that these amounts be reported in accumulated OCI after-tax.

**CPA-05405 Type1 M/C A-D Corr Ans: C PM#21 F 6-01**

11. CPA-05405 Page 13

AmeriGene Inc. reported net periodic pension cost of $400,000 in 20X9, calculated as follows:

| | |
|---|---|
| Service cost | $300,000 |
| Interest cost | 175,000 |
| Expected return on plan assets | (100,000) |
| Amortization of prior service cost | 40,000 |
| Amortization of net gain | (15,000) |
| Net periodic pension cost | $400,000 |

AmeriGene has an overfunded pension plan. The company's effective tax rate is 30%. How will the service cost component of the 20X9 net periodic pension cost affect the 20X9 balance sheet?

a. $300,000 increase in noncurrent pension benefit asset.
b. $300,000 decrease in retained earnings.
c. $90,000 increase in deferred tax asset.
d. $90,000 increase in accumulated other comprehensive income.

**CPA-05405 Explanation**

Choice "c" is correct. SFAS No. 158 requires that SFAS No. 109 - Accounting for Income Taxes be considered when recording net periodic pension cost and changes in pension plan funded status due to prior service cost, net gains and losses, and net transition assets and obligations. Therefore, the service cost component of AmeriGene's net periodic pension cost would be recorded with the following JE:

| | | | |
|---|---|---|---|
| Dr. | Net periodic pension cost | 300,000 | |
| Dr. | Deferred tax asset | 90,000 | |
| Cr. | Deferred tax benefit - income statement | | 90,000 |
| Cr. | Pension benefit asset | | 300,000 |

Choice "a" is incorrect. As demonstrated in the journal entry above, service cost decreases the pension benefit asset.

Choice "b" is incorrect. Net periodic pension cost affects retained earnings on an after-tax basis. Therefore, the service component will decrease retained earnings by $210,000 [$300,000 x (1-30%)].

Choice "d" is incorrect. Service cost does not affect accumulated other comprehensive income. The pension component of accumulated other comprehensive income reflects changes in the funded status of a pension plan due to prior service cost, net gains and losses, and net transition assets or obligations.

**CPA-05406 Type1 M/C A-D Corr Ans: B PM#22 F 6-01**

12. CPA-05406 Page 13

AmeriGene Inc. reported net periodic pension cost of $400,000 in 20X9, calculated as follows:

| | |
|---|---|
| Service cost | $300,000 |
| Interest cost | 175,000 |
| Expected return on plan assets | (100,000) |
| Amortization of prior service cost | 40,000 |
| Amortization of net gain | (15,000) |


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| | |
|---|---|
| Net periodic pension cost | $400,000 |

AmeriGene has an overfunded pension plan. The company's effective tax rate is 30%. How will the amortization of the net gain affect the 20X9 balance sheet?

a. No effect.
b. $10,500 increase in retained earnings.
c. $15,000 increase in net pension asset.
d. $15,000 decrease in accumulated other comprehensive income.

**CPA-05406 Explanation**
Choice "b" is correct. SFAS No. 158 requires that net gains and losses be reported as a component of accumulated other comprehensive income until recognized in net periodic pension cost through amortization. The 20X9 amortization of the net gain would be recorded as a reclassification adjustment from accumulated other comprehensive income with the following journal entry:

| | | | |
|---|---|---|---|
| Dr. | Other comprehensive income | 15,000 | |
| Dr. | Deferred tax expense - net income | 4,500 | |
| Cr. | Deferred tax expense - OCI | | 4,500 |
| Cr. | Net periodic pension cost | | 15,000 |

The reclassification adjustment affects net income and retained earnings on an after-tax basis.

Choice "a" is incorrect. As demonstrated by the journal entry above, the amortization of the net gain increases retained earnings and decreases accumulated other comprehensive income by $10,500.

Choice "c" is incorrect. The amortization of the net gain does not change the net pension asset. The net pension asset was increased when the net gain was incurred.

Choice "d" is incorrect. SFAS No. 158 requires that pensions be accounted for on an after-tax basis. As a result, the amortization of the net gain decreases accumulated other comprehensive income by $10,500 ($15,000 debit to other comprehensive income - $4,500 credit to deferred tax expense - OCI).

**CPA-05424 Type1 M/C A-D Corr Ans: C PM#23 F 6-01**

13. CPA-05424 Released 2007 Page 9

Parker Co. amended its pension plan on January 2 of the current year. It also granted $600,000 of unrecognized prior service costs to its employees. The employees are all active and expect to provide 2,000 service years in the future, with 350 service years this year. What is Parker's unrecognized prior service cost amortization for the year?

a. $0
b. $2,000
c. $105,000
d. $600,000

**CPA-05424 Explanation**
Choice "c" is correct. Unrecognized prior service cost is amortized by assigning an equal amount to each future period of service of each employee who is active at the date of the amendment. In this problem, prior service cost will be assigned equally to each service year provided by the company's employees as follows:

$$\$600,000 \times (350/2000) = \$105,000$$

Choice "a" is incorrect. Unrecognized prior service cost must be amortized by assigning an equal amount to each future period of service of each employee who is active at the date of the amendment.

Choice "b" is incorrect. The current period amortization of Parker's prior service cost is not equal to the expected future service hours. Unrecognized prior service cost must be amortized by assigning an equal amount to each future period of service of each employee who is active at the date of the amendment, as described above.


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Choice "d" is incorrect. The company would not recognized the entire prior service cost in the current period, but would instead amortize the prior service cost by assigning an equal amount to each future period of service of each employee who is active at the date of the amendment.

**Estimated Liability (vs. Accrued Liability)**

**CPA-00706 Type1 M/C A-D Corr Ans: A PM#1 F 6-04**

14. CPA-00706 FARE R01 #6 Page 28

For the week ended June 30, 1995, Free Co. paid gross wages of $20,000, from which federal income taxes of $2,500 and FICA were withheld. All wages paid were subject to FICA tax rates of 7% each for employer and employee. Free makes all payroll-related disbursements from a special payroll checking account. What amount should Free have deposited in the payroll checking account to cover net payroll and related payroll taxes for the week ended June 30, 1995?

a. $21,400
b. $22,800
c. $23,900
d. $25,300

**CPA-00706 Explanation**
Choice "a" is correct. $21,400 is the net payroll and related employer FICA payroll taxes. The amount is calculated as follows:

| | | |
|---|---|---|
| Gross wages | | $20,000 |
| Employer FICA tax | | |
| Wages | $20,000 | |
| FICA rate | x 7% | |
| Employer | | 1,400 |
| Net payroll & employer FICA | | $21,400 |

**CPA-00709 Type1 M/C A-D Corr Ans: D PM#2 F 6-04**

15. CPA-00709 FARE Nov 95 #13 Page 28

Lime Co.'s payroll for the month ended January 31, 1995, is summarized as follows:

| | |
|---|---|
| Total wages | $10,000 |
| Federal income tax withheld | 1,200 |

All wages paid were subject to FICA. FICA tax rates were 7% each for employee and employer. Lime remits payroll taxes on the 15th of the following month. In its financial statements for the month ended January 31, 1995, what amounts should Lime report as total payroll tax liability and as payroll tax expense?

| | *Liability* | *Expense* |
|---|---|---|
| a. | $1,200 | $1,400 |
| b. | $1,900 | $1,400 |
| c. | $1,900 | $700 |
| d. | $2,600 | $700 |

**CPA-00709 Explanation**
Choice "d" is correct. Amounts withheld from employees are payable to the government and thus are liabilities.

| | |
|---|---|
| Federal income tax withheld | $1,200 |
| Employee FICA, 7% × $10,000 | 700 |
| Employer matching FICA | 700 |
| Total payroll liability | $2,600 |


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Of this total payroll liability, only the employer matching FICA is a payroll tax expense for the employer.

Choice "a" is incorrect. A $1,200 liability includes only the federal income tax withheld; it does not include the employee's FICA liability or the employer's matching FICA liability. Only the employer's matching FICA represents an expense to the employer.

Choice "b" is incorrect. A $1,900 liability does not include the employer's matching FICA liability. Only the employer's matching FICA represents an expense to the employer.

Choice "c" is incorrect. A $1,900 liability does not include the employer's matching FICA liability.

**CPA-00713 Type1 M/C A-D Corr Ans: B PM#3 F 6-04**

16. CPA-00713 FARE May 95 #14 Page 28

Roro, Inc. paid $7,200 to renew its only insurance policy for three years on March 1, 1995, the effective date of the policy. At March 31, 1995, Roro's unadjusted trial balance showed a balance of $300 for prepaid insurance and $7,200 for insurance expense. What amounts should be reported for prepaid insurance and insurance expense in Roro's financial statements for the three months ended March 31, 1995?

| | *Prepaid insurance* | *Insurance expense* |
|---|---|---|
| a. | $7,000 | $300 |
| b. | $7,000 | $500 |
| c. | $7,200 | $300 |
| d. | $7,300 | $200 |

**CPA-00713 Explanation**

Choice "b" is correct. The prepaid insurance reflected in the unadjusted trial balance would be fully expensed and one month (March 1 through March 31) of the renewed policy cost would be expensed. Insurance expense equals $500 ($300 plus $7,200/36 months). Prepaid insurance equals $7,000 ($7,200 x 35/36).

Choice "a" is incorrect. Insurance expense should include a portion of the renewed policy cost.

Choice "c" is incorrect. Prepaid insurance should be adjusted for the month which has expired on the renewed policy.

Choice "d" is incorrect. The previous balance in prepaid insurance should be expensed.

**CPA-00727 Type1 M/C A-D Corr Ans: B PM#4 F 6-04**

17. CPA-00727 FARE May 95 #15 Page 28

Ivy Co. operates a retail store. All items are sold subject to a 6% state sales tax, which Ivy collects and records as sales revenue. Ivy files quarterly sales tax returns when due, by the 20th day following the end of the sales quarter. However, in accordance with state requirements, Ivy remits sales tax collected by the 20th day of the month following any month such collections exceed $500. Ivy takes these payments as credits on the quarterly sales tax return. The sales taxes paid by Ivy are charged against sales revenue.

Following is a monthly summary appearing in Ivy's first quarter 1995 sales revenue account:

| | *Debit* | *Credit* |
|---|---|---|
| January | $ -- | $10,600 |
| February | 600 | 7,420 |
| March | -- | 8,480 |
| | $600 | $26,500 |

In its March 31, 1995, balance sheet, what amount should Ivy report as sales taxes payable?

a. $600


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b. $900
c. $1,500
d. $1,590

**CPA-00727 Explanation**
Choice "b" is correct. Actual sales revenue equals $25,000 ($26,500/1.06) and total sales tax collected equals $1,500 (6% x $25,000). Sales taxes payable equals $900 ($1,500 taxes collected less $600 taxes remitted).

Choice "a" is incorrect. $600 is the amount of sales taxes previously remitted, not the amount owed.

Choice "c" is incorrect. $1,500 is the total amount collected rather than the amount owed.

Choice "d" is incorrect. The total amount collected ($26,500) includes sales tax. Thus, the amount of sales tax plus the sales amount equals the total amount collected ($26,500).

**CPA-00728 Type1 M/C A-D Corr Ans: B PM#5 F 6-04**

18. CPA-00728 FARE Nov 94 #19 Page 28

On July 1, 1993, Ran County issued realty tax assessments for its fiscal year ended June 30, 1994. On September 1, 1993, Day Co. purchased a warehouse in Ran County. The purchase price was reduced by a credit for accrued realty taxes. Day did not record the entire year's real estate tax obligation, but instead records tax expenses at the end of each month by adjusting prepaid real estate taxes or real estate taxes payable, as appropriate. On November 1, 1993, Day paid the first of two equal installments of $12,000 for realty taxes. What amount of this payment should Day record as a debit to real estate taxes payable?

a. $4,000
b. $8,000
c. $10,000
d. $12,000

**CPA-00728 Explanation**
Choice "b" is correct. The total real estate tax assessment is $24,000 (2 payments times $12,000 each). The monthly accrual equals $2,000. At the purchase date, September 1, $4,000 real estate taxes payable would be accrued (2 months since July 1) since the buyer is assuming the real estate tax liability. As of November 1, an additional $4,000 is accrued (2 months since September 1). When the payment is made, real estate taxes payable will be debited for $8,000 (4 months of accrual) and real estate tax expense (or prepaid real estate taxes) will be debited for $4,000.

Choice "a" is incorrect. $4,000 is the amount of real estate tax expense (or prepaid real estate taxes) recognized.

Choice "c" is incorrect. Four months of accrual have occurred.

Choice "d" is incorrect. Four months of accrual have occurred.

**CPA-00729 Type1 M/C A-D Corr Ans: B PM#6 F 6-04**

19. CPA-00729 FARE May 94 #21 Page 28

Hudson Hotel collects 15% in city sales taxes on room rentals, in addition to a $2 per room, per night, occupancy tax. Sales taxes for each month are due at the end of the following month, and occupancy taxes are due 15 days after the end of each calendar quarter. On January 3, 1994, Hudson paid its November 1993 sales taxes and its fourth quarter 1993 occupancy taxes. Additional information pertaining to Hudson's operations is:

| 1993 | *Room rentals* | *Room nights* |
|---|---|---|
| October | $100,000 | 1,100 |


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| | | |
|---|---|---|
| November | 110,000 | 1,200 |
| December | 150,000 | 1,800 |

What amounts should Hudson report as sales taxes payable and occupancy taxes payable in its December 31, 1993, balance sheet?

| | *Sales taxes* | *Occupancy taxes* |
|---|---|---|
| a. | $39,000 | $6,000 |
| b. | $39,000 | $8,200 |
| c. | $54,000 | $6,000 |
| d. | $54,000 | $8,200 |

**CPA-00729 Explanation**
Choice "b" is correct.

| | 15% City Sales Tax | Date Paid | Occupancy Tax | Date Paid |
|---|---|---|---|---|
| Oct | $ - | 11/30 | $2,200 | 1/3 |
| Nov | 16,500 | 1/3 | 2,400 | 1/3 |
| Dec | 22,500 | - | 3,600 | 1/3 |
| | $39,000 | | $8,200 | |

The sales tax accrual is $39,000. The occupancy tax accrual is $8,200.

Choice "a" is incorrect. The occupancy tax accrual should include the $2,200 from October which was not paid until January 3.

Choice "c" is incorrect. The sales tax accrual should not include the $15,000 from October which was due November 30 and is presumed to be paid. The occupancy tax accrual should include the $2,200 from October which was not paid until January 3.

Choice "d" is incorrect. The sales tax accrual should not include the $15,000 from October which was due November 30 and is presumed to be paid.

**CPA-00730 Type1 M/C A-D Corr Ans: A PM#7 F 6-04**

20. CPA-00730 FARE May 94 #22 Page 28

Under state law, Acme may pay 3% of eligible gross wages or it may reimburse the state directly for actual unemployment claims. Acme believes that actual unemployment claims will be 2% of eligible gross wages and has chosen to reimburse the state. Eligible gross wages are defined as the first $10,000 of gross wages paid to each employee. Acme had five employees each of whom earned $20,000 during 1993. In its December 31, 1993, balance sheet, what amount should Acme report as accrued liability for unemployment claims?

a. $1,000
b. $1,500
c. $2,000
d. $3,000

**CPA-00730 Explanation**
Choice "a" is correct. Acme elects to reimburse for actual unemployment claims which can be estimated. The estimate is 2% of the eligible wages of 5 persons x $10,000 eligible wages per person. Thus, the accrued liability for unemployment claims = $2\% \times \$50{,}000 = \$1{,}000$.

Choice "b" is incorrect. The calculation should be based on the 2% estimate of actual unemployment claims.

Choice "c" is incorrect. The calculation should be based on the eligible wages only, the first $10,000 of gross wages per employee.

Choice "d" is incorrect. The calculation should be based on the 2% estimate of actual unemployment claims.


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**CPA-00731 Type1 M/C A-D Corr Ans: C PM#8 F 6-04**

21. CPA-00731 PI Nov 93 #32 Page 28

Kent Co., a division of National Realty, Inc., maintains escrow accounts and pays real estate taxes for National's mortgage customers. Escrow funds are kept in interest-bearing accounts. Interest, less a 10% service fee, is credited to the mortgagee's account and used to reduce future escrow payments. Additional information follows:

| | |
|---|---|
| Escrow accounts liability, 1/1/92 | $ 700,000 |
| Escrow payments received during 1992 | 1,580,000 |
| Real estate taxes paid during | 1,720,000 |
| Interest on escrow funds during 1992 | 50,000 |

What amount should Kent report as escrow accounts liability in its December 31, 1992, balance sheet?

a. $510,000
b. $515,000
c. $605,000
d. $610,000

**CPA-00731 Explanation**

Choice "c" is correct. Escrow account liability is increased by amounts received from mortgages and is decreased by payments for taxes. Interest earned, less 10%, is credited (increase) to the escrow account.

| | |
|---|---|
| Escrow liability, 1/1/92 | $ 700,000 |
| Escrow receipts | 1,580,000 |
| Interest earned ($50,000 less 10%) | 45,000 |
| | 2,325,000 |
| Less: Payments for taxes | 1,720,000 |
| Escrow liability, 12/31/92 | $ 605,000 |

Choice "a" is incorrect. Interest earned, less 10%, should be added to the liability. It is credited to the mortgagee's account.

Choice "b" is incorrect. Interest earned, less 10%, should be added to the liability. It is credited to the mortgagee's account.

Choice "d" is incorrect. Interest earned, less 10%, should be added to the liability.

**CPA-00732 Type1 M/C A-D Corr Ans: B PM#9 F 6-04**

22. CPA-00732 PI May 93 #27 Page 28

An analysis of Thrift Corp.'s unadjusted prepaid expense account at December 31, 1992, revealed the following:

- An opening balance of $1,500 for Thrift's comprehensive insurance policy. Thrift had paid an annual premium of $3,000 on July 1, 1991.
- A $3,200 annual insurance premium payment made July 1, 1992.
- A $2,000 advance rental payment for a warehouse Thrift leased for one year beginning January 1, 1993.

In its December 31, 1992, balance sheet, what amount should Thrift report as prepaid expenses?

a. $5,200
b. $3,600
c. $2,000
d. $1,600


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**CPA-00732 Explanation**
Choice "b" is correct. Prepayments as of December 31, 1992 include:

| | |
|---|---|
| Insurance, $3,200 × ½ | $1,600 |
| Rental prepayment | 2,000 |
| | $3,600 |

Choice "a" is incorrect. Only 1/2 of the $3,200 annual payment is prepaid as of December 31, 1992.

Choice "c" is incorrect. The insurance premium has an unexpired component. 1/2 of the $3,200 annual payment is prepaid as of December 31, 1992.

Choice "d" is incorrect. The $2,000 advance rental payment is prepaid as of December 31, 1992.

**Contingencies (SFAS 5)**

**CPA-00734 Type1 M/C A-D Corr Ans: A PM#2 F 6-05**

23. CPA-00734 FARE Nov 95 #17 Page 30

Eagle Co. has cosigned the mortgage note on the home of its president, guaranteeing the indebtedness in the event that the president should default. Eagle considers the likelihood of default to be remote. How should the guarantee be treated in Eagle's financial statements?

a. Disclosed only.
b. Accrued only.
c. Accrued and disclosed.
d. Neither accrued nor disclosed.

**CPA-00734 Explanation**
Choice "a" is correct. Contingent liabilities which are remotely possible are neither accrued nor disclosed. However, related party transactions such as the one described must be disclosed. SFAS 5 para. 3 and SFAS 57 para. 2

Choice "b" is incorrect. Remotely possible contingent liabilities and related party transactions are not accrued.

Choice "c" is incorrect. Remotely possible contingent liabilities are neither accrued nor disclosed. Related party transactions are disclosed but not accrued.

Choice "d" is incorrect. Related party transactions must be disclosed.

**CPA-00735 Type1 M/C A-D Corr Ans: A PM#3 F 6-05**

24. CPA-00735 FARE Nov 95 #44 Page 52

Oak Co. offers a three-year warranty on its products. Oak previously estimated warranty costs to be 2% of sales. Due to a technological advance in production at the beginning of 1994, Oak now believes 1% of sales to be a better estimate of warranty costs. Warranty costs of $80,000 and $96,000 were reported in 1992 and 1993, respectively. Sales for 1994 were $5,000,000. What amount should be disclosed in Oak's 1994 financial statements as warranty expense?

a. $50,000
b. $88,000
c. $100,000
d. $138,000

**CPA-00735 Explanation**
Choice "a" is correct. Warranty expense is calculated as a percentage of sales. Any change in the estimate of the percentage is recorded prospectively, from the current year forward. Thus, 1994 warranty expense equals $50,000 [1% x $5,000,000].


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Choice "b" is incorrect. The change in warranty percentage is not accounted for as the average of the warranty costs reported in the two prior periods.

Choice "c" is incorrect. The new 1% estimate should be used in 1994 rather than the old 2% estimate.

Choice "d" is incorrect. This is the average of the warranty costs reported in 1992 and 1993 plus the $50,000 warranty cost for 1994.

**CPA-00737 Type1 M/C A-D Corr Ans: D PM#5 F 6-05**

25. CPA-00737 FARE Nov 94 #21 Page 50

For $50 a month, Rawl Co. visits its customers' premises and performs insect control services. If customers experience problems between regularly scheduled visits, Rawl makes service calls at no additional charge. Instead of paying monthly, customers may pay an annual fee of $540 in advance. For a customer who pays the annual fee in advance, Rawl should recognize the related revenue:

a. When the cash is collected.
b. At the end of the fiscal year.
c. At the end of the contract year after all of the services have been performed.
d. Evenly over the contract year as the services are performed.

**CPA-00737 Explanation**

Choice "d" is correct. Revenue is recognized as it is earned (when services are performed) and realized (cash collected) or realizable (accounts receivable).

Choice "a" is incorrect. The accrual basis, rather than the cash basis, is required for revenue recognition.

Choice "b" is incorrect. Revenue is recognized as it is earned (when services are performed).

Choice "c" is incorrect. Revenue is recognized as it is earned (when services are performed).

**CPA-00738 Type1 M/C A-D Corr Ans: C PM#6 F 6-05**

26. CPA-00738 FARE Nov 94 #23 Page 52

House Publishers offered a contest in which the winner would receive $1,000,000, payable over 20 years. On December 31, 1993, House announced the winner of the contest and signed a note payable to the winner for $1,000,000, payable in $50,000 installments every January 2. Also on December 31, 1993, House purchased an annuity for $418,250 to provide the $950,000 prize monies remaining after the first $50,000 installment, which was paid on January 2, 1994. In its 1993 income statement, what should House report as contest prize expense?

a. $0
b. $418,250
c. $468,250
d. $1,000,000

**CPA-00738 Explanation**

Choice "c" is correct. The contest prize expense is reported as the present value of the future cash flows. The present value of the $50,000 due January 2, 1994 equals $50,000. The present value of the $950,000 due in 19 future payments of $50,000 annually equals $418,250. The expense equals $468,250, the total of the present values. The correct journal entry follows:

| | | |
|---|---|---|
| Contest Prize Expense | 468,250 | |
| Discount on Notes Payable | 531,750 | |
| Notes Payable, current portion | | 50,000 |
| Notes Payable, net of current portion | | 950,000 |

Choice "a" is incorrect. Expense is recognized when incurred on the date the contest winner is announced.


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Choice "b" is incorrect. The expense must include the present value of the currently due $50,000 as well as the present value of the noncurrent future payments.

Choice "d" is incorrect. The present value of future cash flows, rather than the face value of the note payable, is the measure of the contest prize expense.

**CPA-00739 Type1 M/C A-D Corr Ans: A PM#7 F 6-05**

27. CPA-00739 FARE Nov 94 #26 Page 30

Management can estimate the amount of loss that will occur if a foreign government expropriates some company assets. If expropriation is reasonably possible, a loss contingency should be:

a. Disclosed but not accrued as a liability.
b. Disclosed and accrued as a liability.
c. Accrued as a liability but not disclosed.
d. Neither accrued as a liability nor disclosed.

**CPA-00739 Explanation**
Choice "a" is correct. Only a loss that is probable and estimable will be accrued. Reasonably possible losses are disclosed in the notes only.

Choice "b" is incorrect. Only a loss that is probable and estimable will be accrued.

Choice "c" is incorrect. A reasonably possible loss is not accrued.

Choice "d" is incorrect. Only a loss with a remote possibility of occurring can be ignored in the financial statements.

**CPA-00740 Type1 M/C A-D Corr Ans: D PM#8 F 6-05**

28. CPA-00740 FARE Nov 94 #27 Page 52

Vadis Co. sells appliances that include a three-year warranty. Service calls under the warranty are performed by an independent mechanic under a contract with Vadis. Based on experience, warranty costs are estimated at $30 for each machine sold. When should Vadis recognize these warranty costs?

a. Evenly over the life of the warranty.
b. When the service calls are performed.
c. When payments are made to the mechanic.
d. When the machines are sold.

**CPA-00740 Explanation**
Choice "d" is correct. At the date of sale, the warranty costs are probable and estimable and must be recognized.

Choice "a" is incorrect. The warranty expense is incurred because of the sale and must be matched with the associated revenues rather than allocated over a period of time.

Choice "b" is incorrect. The warranty expense is incurred because of the sale and must be matched with the associated revenues. The warranty liability is reduced as warranty services are performed.

Choice "c" is incorrect. Warranty expense must be recognized on the accrual basis rather than on a cash basis.

**CPA-00741 Type1 M/C A-D Corr Ans: A PM#9 F 6-05**

29. CPA-00741 FARE Nov 94 #40 Page 53

Wren Corp.'s trademark was licensed to Mont Co. for royalties of 15% of sales of the trademarked items. Royalties are payable semiannually on March 15 for sales in July through December of the prior year,


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and on September 15 for sales in January through June of the same year. Wren received the following royalties from Mont:

| | *March 15* | *September 15* |
|---|---|---|
| 1992 | $10,000 | $15,000 |
| 1993 | 12,000 | 17,000 |

Mont estimated that sales of the trademarked items would total $60,000 for July through December 1993.

In Wren's 1993 income statement, the royalty revenue should be:

a. $26,000
b. $29,000
c. $38,000
d. $41,000

**CPA-00741 Explanation**
Choice "a" is correct. Royalties to be received on March 15 reflect earnings from the latter half of the prior year. Royalties to be received on September 15 reflect earnings from the first half of the current year. Earnings for the latter half of 1993 equal $9,000 (15% x $60,000). 1993 earnings equal first half earnings of $17,000 plus second half earnings of $9,000 for a total of $26,000. Note: 1992 earnings equal $27,000 ($12,000 plus $15,000); 1991 earnings equal $10,000.

**CPA-00743 Type1 M/C A-D Corr Ans: B PM#10 F 6-05**

30. CPA-00743 FARE Nov 94 #48 Page 53

Able Co. provides an incentive compensation plan under which its president receives a bonus equal to 10% of the corporation's income before income tax but after deduction of the bonus. If the tax rate is 40% and net income after bonus and income tax was $360,000, what was the amount of the bonus?

a. $36,000
b. $60,000
c. $66,000
d. $90,000

**CPA-00743 Explanation**
Choice "b" is correct. If net income after bonus and tax is $360,000 and the tax rate is 40%, net income after bonus can be calculated as follows:

$360,000/.6 = $600,000 (.6 = 100% - 40% tax rate)

If net income after bonus (but before tax) is $600,000; the bonus is 10% of the $600,000 or $60,000.

Choice "a" is incorrect. The bonus is not defined to equal 10% of the $360,000 net income.

Choice "c" is incorrect. The bonus is not defined to equal 10% of the profit before deductions for bonus and tax.

Choice "d" is incorrect.

**CPA-00745 Type1 M/C A-D Corr Ans: D PM#11 F 6-05**

31. CPA-00745 FARE May 94 #57 Page 31

During 1993, Smith Co. filed suit against West, Inc. seeking damages for patent infringement. At December 31, 1993, Smith's legal counsel believed that it was probable that Smith would be successful against West for an estimated amount in the range of $75,000 to $150,000, with all amounts in the range considered equally likely. In March 1994, Smith was awarded $100,000 and received full payment thereof. In its 1993 financial statements, issued in February 1994, how should this award be reported?

a. As a receivable and revenue of $100,000.
b. As a receivable and deferred revenue of $100,000.


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c. As a disclosure of a contingent gain of $100,000.
d. As a disclosure of a contingent gain of an undetermined amount in the range of $75,000 to $150,000.

**CPA-00745 Explanation**
Choice "d" is correct. Gain contingencies should be disclosed in the notes unless the likelihood of the gain being realized is remote. The full range of possible settlements should be disclosed. The actual settlement (subsequent event) did not occur until after the financial statements were issued. SFAS 5 para. 17

Choice "a" is incorrect. The actual settlement was not determined until after the financial statements were issued. Gain contingencies are not recognized until realized.

Choice "b" is incorrect. The actual settlement was not determined until after the financial statements were issued. Deferred revenue is an improper account.

Choice "c" is incorrect. The full range of possible settlements must be disclosed. The actual settlement amount of $100,000 was not known until after the financial statements were issued.

**CPA-00748 Type1 M/C A-D Corr Ans: A PM#12 F 6-05**

32. CPA-00748 Th Nov 93 #21 Page 31

At December 31, 1992, Date Co. awaits judgment on a lawsuit for a competitor's infringement of Date's patent. Legal counsel believes it is probable that Date will win the suit and indicated the most likely award together with a range of possible awards. How should the lawsuit be reported in Date's 1992 financial statements?

a. In note disclosure only.
b. By accrual for the most likely award.
c. By accrual for the lowest amount of the range of possible awards.
d. Neither in note disclosure nor by accrual.

**CPA-00748 Explanation**
Choice "a" is correct. Gain contingencies should be disclosed with care taken not to mislead users of the financial statements as to the likelihood of realization.

Choice "b" is incorrect. Gain contingencies are not accrued until the transaction generating the gain is completed.

Choice "c" is incorrect. Gain contingencies are not accrued until the transaction generating the gain is completed.

Choice "d" is incorrect. Gain contingencies should be disclosed according to SFAS #5, unless the likelihood of realization is remote.

**CPA-00750 Type1 M/C A-D Corr Ans: B PM#13 F 6-05**

33. CPA-00750 PI Nov 93 #38 Page 53

Dunne Co. sells equipment service contracts that cover a two-year period. The sales price of each contract is $600. Dunne's past experience is that, of the total dollars spent for repairs on service contracts, 40% is incurred evenly during the first contract year and 60% evenly during the second contract year. Dunne sold 1,000 contracts evenly throughout 1992. In its December 31, 1992, balance sheet, what amount should Dunne report as deferred service contract revenue?

a. $540,000
b. $480,000
c. $360,000
d. $300,000

**CPA-00750 Explanation**


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Choice "b" is correct. When service contracts are sold, the entire proceeds are reported as deferred revenue. Revenue is recognized, and deferral reduced as the service is performed. Since repairs are made evenly (July 1 is average date), only ½ of the 40% of repairs will be in 1992.

| | |
|---|---|
| 1992 deferral ($600 x 1,000) | $ 600,000 |
| Earned in 1992 (600,000 x 40% x 1/2) | (120,000) |
| Deferral 12-31-92 | $ 480,000 |

Choice "a" is incorrect. When service contracts are sold, the entire proceeds are reported as deferred revenue. Revenue is recognized, and deferral reduced as the service is performed. Since repairs are made evenly, (July 1 is average date) only ½ of the 40% of repairs will be in 1992.

Choice "c" is incorrect. Since repairs are incurred evenly during the first year (July 1 is average date) only ½ of 40% will be earned in 1992.

Choice "d" is incorrect. Revenue is recognized, and deferral reduced, as the service is performed.

**CPA-00751 Type1 M/C A-D Corr Ans: D PM#14 F 6-05**

34. CPA-00751 PI Nov 93 #41 Page 29

On November 1, 1992, Davis Co. discounted with recourse at 10% a one-year, noninterest bearing, $20,500 note receivable maturing on January 31, 1993. What amount of contingent liability for this note must Davis disclose in its financial statements for the year ended December 31, 1992?

a. $0
b. $20,000
c. $20,333
d. $20,500

**CPA-00751 Explanation**
Choice "d" is correct. The contingent liability for a discounted note receivable is the maturity value or $20,500. This should be disclosed. SFAS #5 para 12

Choice "a" is incorrect. A note endorsed "with recourse" means the endorser is liable if the maker of the note does not pay. This contingent liability should be disclosed.

Choice "b" is incorrect. The contingent liability for a discounted note receivable is the maturity value.

Choice "c" is incorrect. The contingent liability for a discounted note receivable is the maturity value.

**CPA-00752 Type1 M/C A-D Corr Ans: A PM#15 F 6-05**

35. CPA-00752 PII May 93 #7 Page 52

In May 1989, Caso Co. filed suit against Wayne, Inc. seeking $1,900,000 damages for patent infringement. A court verdict in November 1992 awarded Caso $1,500,000 in damages, but Wayne's appeal is not expected to be decided before 1994. Caso's counsel believes it is probable that Caso will be successful against Wayne for an estimated amount in the range between $800,000 and $1,100,000, with $1,000,000 considered the most likely amount. What amount should Caso record as income from the lawsuit in the year ended December 31, 1992?

a. $0
b. $800,000
c. $1,000,000
d. $1,500,000

**CPA-00752 Explanation**
Choice "a" is correct. Gain contingencies are not recorded in the accounts since revenue is not recognized before realization. In this case, that would be when the appeals process is complete and the award is collected, which is expected to be sometime in 1994 or thereafter. Therefore, no income would be reported for the year ended 12-31-92.


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**CPA-00753 Type1 M/C A-D Corr Ans: C PM#16 F 6-05**

36. CPA-00753 PII May 93 #11 Page 31

During 1992, Leader Corp. sued Cape Co. for patent infringement. On December 31, 1992, Leader was awarded a $500,000 favorable judgment in the suit. On that date, Cape offered to settle out of court for $300,000 and not appeal the judgment. In February 1993, after the issuance of its 1992 financial statements, Leader agreed to the out-of-court settlement and received a certified check for $300,000. In its 1992 financial statements, how should Leader have reported these events?

a. As a gain of $300,000.
b. As a receivable and deferred credit of $300,000.
c. As a disclosure in the notes to the financial statements only.
d. It should not be reported in the financial statements.

**CPA-00753 Explanation**
Choice "c" is correct. Gain contingencies are not reported as revenue until realized. Since Leader had not accepted the $300,000 out-of-court settlement by the date of the issuance of the 1992 financial statements, the gain should not be reported in 1992. However, there should be adequate disclosure in the notes to the financial statements.

**CPA-00755 Type1 M/C A-D Corr Ans: C PM#17 F 6-05**

37. CPA-00755 PII May 93 #20 Page 55

On January 1, 1992, Card Corp. signed a three-year, noncancelable purchase contract, which allows Card to purchase up to 500,000 units of a computer part annually from Hart Supply Co. at $.10 per unit and guarantees a minimum annual purchase of 100,000 units. During 1992, the part unexpectedly became obsolete. Card had 250,000 units of this inventory at December 31, 1992, and believes these parts can be sold as scrap for $.02 per unit. What amount of probable loss from the purchase commitment should Card report in its 1992 income statement?

a. $24,000
b. $20,000
c. $16,000
d. $8,000

**CPA-00755 Explanation**
Choice "c" is correct. The probable loss from the purchase commitment is the minimum annual purchase of 100,000 units times the 2 years left (1993 and 1994) on the noncancelable purchase contract at $0.08 per unit ($0.10 purchase price – $0.02 scrap value), or $16,000. The journal entry would be:

| | | |
|---|---|---|
| Estimated loss on purchase commitments | 16,000 | |
| Estimated liability on purchase commitments | | 16,000 |

**CPA-00756 Type1 M/C A-D Corr Ans: C PM#18 F 6-05**

38. CPA-00756 Th May 93 #29 Page 29

In 1991, a contract dispute between Dollis Co. and Brooks Co. was submitted to binding arbitration. In 1991, each party's attorney indicated privately that the probable award in Dollis' favor could be reasonably estimated. In 1992, the arbitrator decided in favor of Dollis. When should Dollis and Brooks recognize their respective gain and loss?

| | *Dollis' gain* | *Brooks' loss* |
|---|---|---|
| a. | 1991 | 1991 |
| b. | 1991 | 1992 |
| c. | 1992 | 1991 |
| d. | 1992 | 1992 |


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**CPA-00756 Explanation**
Choice "c" is correct. Dollis' gain contingency cannot be recognized until it is settled and realized in 1992. In 1991, Brooks's loss contingency is probable and estimable and must be recognized.

**CPA-00757 Type1 M/C A-D Corr Ans: D PM#19 F 6-05**

39. CPA-00757 PI May 93 #33 Page 29

On February 5, 1993, an employee filed a $2,000,000 lawsuit against Steel Co. for damages suffered when one of Steel's plants exploded on December 29, 1992. Steel's legal counsel expects the company will lose the lawsuit and estimates the loss to be between $500,000 and $1,000,000. The employee has offered to settle the lawsuit out of court for $900,000, but Steel will not agree to the settlement. In its December 31, 1992, balance sheet, what amount should Steel report as liability from lawsuit?

a. $2,000,000
b. $1,000,000
c. $900,000
d. $500,000

**CPA-00757 Explanation**
Choice "d" is correct. When a contingent loss is accrued and only a range of possible loss can be estimated, and no amount is a better estimate than the others, the minimum amount in the range is used. Therefore, $500,000 is reported.

**CPA-00764 Type1 M/C A-D Corr Ans: D PM#20 F 6-05**

40. CPA-00764 PI May 93 #34 Page 29

In 1991, a personal injury lawsuit was brought against Halsey Co. Based on counsel's estimate, Halsey reported a $50,000 liability in its December 31, 1991, balance sheet. In November 1992, Halsey received a favorable judgment, requiring the plaintiff to reimburse Halsey for expenses of $30,000. The plaintiff has appealed the decision, and Halsey's counsel is unable to predict the outcome of the appeal. In its December 31, 1992, balance sheet, Halsey should report what amounts of asset and liability related to these legal actions?

| | *Asset* | *Liability* |
|---|---|---|
| a. | $30,000 | $50,000 |
| b. | $30,000 | $0 |
| c. | $0 | $20,000 |
| d. | $0 | $0 |

**CPA-00764 Explanation**
Choice "d" is correct. The $30,000 judgment is on appeal and is a contingent gain (or reduction of expense) and should not be reported. The favorable judgment means the $50,000 may not have to be paid. Since this loss is then not probable, it should not be accrued on the balance sheet.

Choice "a" is incorrect. The $30,000 judgment is on appeal and is a contingent gain (or reduction of expense). It should not be recognized until realized. In addition, the original amount of the liability is no longer probable.

Choice "b" is incorrect. The $30,000 judgment is on appeal and is a contingent gain (or reduction of expense). It should not recognized until realized.

Choice "c" is incorrect. The favorable judgment means the $50,000 may not have to be paid. Since this loss is then not probable, it should not be accrued on the balance sheet.

**CPA-00766 Type1 M/C A-D Corr Ans: B PM#21 F 6-05**

41. CPA-00766 Th May 93 #40 Page 53


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Delect Co. provides repair services for the AZ195 TV set. Customers prepay the fee on the standard one-year service contract. The 1991 and 1992 contracts were identical, and the number of contracts outstanding was substantially the same at the end of each year. However, Delect's December 31, 1992, deferred revenues' balance on unperformed service contracts was significantly less than the balance at December 31, 1991. Which of the following situations might account for this reduction in the deferred revenue balance?

a. Most 1992 contracts were signed later in the calendar year than were the 1991 contracts.
b. Most 1992 contracts were signed earlier in the calendar year than were the 1991 contracts.
c. The 1992 contract contribution margin was greater than the 1991 contract contribution margin.
d. The 1992 contract contribution margin was less than the 1991 contract contribution margin.

**CPA-00766 Explanation**
Choice "b" is correct. If 1992 contracts were signed earlier in the year than before, more warranty work would have been performed by year-end, thus reducing the deferred revenue balance more than in prior years.

Choice "a" is incorrect. Contracts signed later in the year than before would create fewer opportunities for warranty work to be done. Thus, the balance in the deferred revenue account would be greater than before.

Choice "c" is incorrect. None of the facts indicate that contribution margin would be any different between the contracts written in two separate years.

Choice "d" is incorrect. None of the facts indicate that contribution margin would be any different between the contracts written in two separate years.

**CPA-00769 Type1 M/C A-D Corr Ans: B PM#22 F 6-05**

42. CPA-00769 PI May 93 #49 Page 28

Zach Corp. pays commissions to its sales staff at the rate of 3% of net sales. Sales staff are not paid salaries but are given monthly advances of $15,000. Advances are charged to commission expense, and reconciliations against commissions are prepared quarterly. Net sales for the year ended March 31, 1992, were $15,000,000. The unadjusted balance in the commissions expense account on March 31, 1992, was $400,000. March advances were paid on April 3, 1992. In its income statement for the year ended March 31, 1992, what amount should Zach report as commission expense?

a. $465,000
b. $450,000
c. $415,000
d. $400,000

**CPA-00769 Explanation**
Choice "b" is correct. The commission expense is 3% of net sales of $15,000,000, or $450,000. An adjustment would be required on March 31, 1992 to bring the expense to this amount.

Choice "a" is incorrect. Advances should not be considered as expenses at year-end. Charging an expense subject to adjustment is permitted, but Zach should adjust the expense to 3% of net sales of $15,000,000.

Choice "c" is incorrect. Advances should not be considered as expenses at year-end. Charging an expense subject to adjustment is permitted, but Zach should adjust the expense to 3% of net sales of $15,000,000.

Choice "d" is incorrect. The unadjusted balance in the commissions expense account is not the amount reported as commission expense. Net sales for the period must be considered.

**CPA-00773 Type1 M/C A-D Corr Ans: C PM#23 F 6-05**

43. CPA-00773 PI May 93 #50 Page 28


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On February 12, 1992, VIP Publishing, Inc. purchased the copyright to a book for $15,000 and agreed to pay royalties equal to 10% of book sales, with a guaranteed minimum royalty of $60,000. VIP had book sales of $800,000 in 1992. In its 1992 income statement, what amount should VIP report as royalty expense?

a. $60,000
b. $75,000
c. $80,000
d. $95,000

**CPA-00773 Explanation**
Choice "c" is correct. Royalty expense is the larger of minimum royalties of $60,000, or 10% of $800,000 sales, $80,000.

Choice "a" is incorrect. The minimum royalty would be the expense if actual royalties were less than $60,000.

Choice "b" is incorrect. The minimum royalty would be the expense if actual royalties were less than $60,000. The copyright should be recorded as an intangible asset, not royalty expense.

Choice "d" is incorrect. The copyright should be recorded as an intangible asset, not as royalty expense.

**CPA-00774 Type1 M/C A-D Corr Ans: A PM#24 F 6-05**

44. CPA-00774 PI May 93 #52 Page 28

Dana Co.'s officers' compensation expense account had a balance of $224,000 at December 31, 1992, before any appropriate year-end adjustment relating to the following:

- No salary accrual was made for December 30-31, 1992. Salaries for the two-day period totaled $3,500.
- 1992 officers' bonuses of $62,500 were paid on January 31, 1993.

In its 1992 income statement, what amount should Dana report as officers' compensation expense?

a. $290,000
b. $286,500
c. $227,500
d. $224,000

**CPA-00774 Explanation**
Choice "a" is correct. Salaries should be accrued at year-end. Officers' bonuses should also be accrued at year-end, applying the matching principle. $224,000 + $62,500 + $3,500 = $290,000.

Choice "b" is incorrect. Salaries at year-end should be accrued.

Choice "c" is incorrect. Officer's bonuses should be expensed (matching principle) at year-end.

Choice "d" is incorrect. Salaries at year-end should be accrued.

**CPA-04686 Type1 M/C A-D Corr Ans: B PM#25 F 6-05**

45. CPA-04686 Released 2005 Page 29

Bell Co. is a defendant in a lawsuit that could result in a large payment to the plaintiff. Bell's attorney believes that there is a 90% chance that Bell will lose the suit, and estimates that the loss will be anywhere from $5,000,000 to $20,000,000 and possibly as much as $30,000,000. None of the estimates are better than the others. What amount of liability should Bell report on its balance sheet related to the lawsuit?

a. $0
b. $5,000,000


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c. $20,000,000
d. $30,000,000

**CPA-04686 Explanation**
Choice "b" is correct. Provision for a loss contingency should be accrued by a charge to income, providing it is probable that a liability will be incurred and the amount of loss can be reasonably estimated. When a range of probable losses is given,GAAP requires that the best estimate of the loss be accrued. If no amount in the range is a better estimate than any other amount within the range, the minimum amount in the range should be accrued (in this case $5,000,000).

Choices "a", "c", and "d" are incorrect, per the above.

**Accounting for Income Taxes**

**CPA-00776 Type1 M/C A-D Corr Ans: A PM#1 F 6-06**

46. CPA-00776R99 #17 Page 34

Under current generally accepted accounting principles, which approach is used to determine income tax expense?

a. Asset and liability approach.
b. "With and without" approach.
c. Net of tax approach.
d. Periodic expense approach.

**CPA-00776 Explanation**
Choice "a" is correct. The approach used in GAAP to determine income tax expense is the asset and liability approach (sometimes referred to as the balance sheet approach). The asset and liability approach is used to squeeze out the amount of income tax expense after the amount of deferred tax assets and liabilities have been determined.

Choice "b" is incorrect, which is a distracter.

Choice "c" is incorrect, as the net of tax approach is used for presentation on the income statement.

Choice "d" is incorrect, which relates to an income statement based approach of expense.

**CPA-00779 Type1 M/C A-D Corr Ans: D PM#2 F 6-06**

47. CPA-00779R97 #11 Page 44

Hut Co. has temporary taxable differences that will reverse during the next year and add to taxable income. These differences relate to noncurrent assets. Deferred income taxes based on these temporary differences should be classified in Hut's balance sheet as a:

a. Current asset.
b. Noncurrent asset.
c. Current liability.
d. Noncurrent liability.

**CPA-00779 Explanation**
Choice "d" is correct. Hut's temporary taxable differences add to taxable income, making them deferred tax liabilities. Deferred tax liabilities are classified in the balance sheet based on the classification of the related assets. In this case, the related asset is a noncurrent asset, so the deferred tax liability is classified as a noncurrent liability.

Choice "a" is incorrect. Hut's temporary taxable differences add to taxable income, making them deferred tax liabilities, not deferred tax assets.

Choice "b" is incorrect. Hut's temporary taxable differences add to taxable income, making them deferred tax liabilities, not deferred tax assets.


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Choice "c" is incorrect. Deferred tax liabilities are classified in the balance sheet based on the classification of the related assets. In this case, the related asset is a noncurrent asset.

**CPA-00784 Type1 M/C A-D Corr Ans: A PM#6 F 6-06**

48. CPA-00784 Nov 95 #56 Page 35

In financial statements prepared on the income-tax basis, how should the nondeductible portion of expenses such as meals and entertainment be reported?

a. Included in the expense category in the determination of income.
b. Included in a separate category in the determination of income.
c. Excluded from the determination of income but included in the determination of retained earnings.
d. Excluded from the financial statements.

**CPA-00784 Explanation**
Choice "a" is correct. In financial statements prepared on the income-tax basis, the nondeductible portion of expenses (such as meals and entertainment) should be included in the expense category in the determination of income.

Choices "b", "c", and "d" are incorrect, per the answer above.

**CPA-00786 Type1 M/C A-D Corr Ans: B PM#8 F 6-06**

49. CPA-00786 May 95 #17 Page 44

At December 31, 1994, Bren Co. had the following deferred income tax items:

- A deferred income tax liability of $15,000 related to a noncurrent asset.
- A deferred income tax asset of $3,000 related to a noncurrent liability.
- A deferred income tax asset of $8,000 related to a current liability.

Which of the following should Bren report in the noncurrent section of its December 31, 1994, balance sheet?

a. A noncurrent asset of $3,000 and a noncurrent liability of $15,000.
b. A noncurrent liability of $12,000.
c. A noncurrent asset of $11,000 and a noncurrent liability of $15,000.
d. A noncurrent liability of $4,000.

**CPA-00786 Explanation**
Choice "b" is correct. Noncurrent liability of $12,000 should be reported in the noncurrent section of the balance sheet (and a current deferred income tax asset of $8,000 should be reported in the current section of the balance sheet). Rule 1 - All current deferred tax liabilities and assets must be offset and presented as one amount. Rule 2 - All noncurrent deferred tax liabilities and assets of a particular tax jurisdiction must be offset and presented as one amount.

**CPA-00787 Type1 M/C A-D Corr Ans: C PM#9 F 6-06**

50. CPA-00787 May 95 #41 Page 38

For the year ended December 31, 1994, Tyre Co. reported pretax financial statement income of $750,000. Its taxable income was $650,000. The difference is due to accelerated depreciation for income tax purposes. Tyre's effective income tax rate is 30%, and Tyre made estimated tax payments during 1994 of $90,000. What amount should Tyre report as current income tax expense for 1994?

a. $105,000
b. $135,000
c. $195,000
d. $225,000


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**CPA-00787 Explanation**

| | |
|---|---|
| Taxable income for 1994 | $650,000 |
| Tax rate | 30% |
| Current income tax expense | $195,000 |

Choice "c" is correct, $195,000 current income tax expense.

Choice "a" is incorrect. $105,000 is the current income tax liability, which takes the $90,000 tax payment improperly into effect.

Choice "b" is incorrect. $135,000 is the total tax expense improperly reduced by the $90,000 tax payment.

Choice "d" is incorrect. $225,000 is the total income tax expense.

**Comprehensive solution follows:**

| | *Book* | *Tax* | *Diff* |
|---|---|---|---|
| Income before tax | $750 | 650 | 100 |
| Provision for income tax: | | x 30% | x 30% |
| Current income tax exp | (195) | 195 | |
| Deferred income tax exp | (30) | | 30 |
| Total income tax exp | (225) | | |
| Net income | $525 | | |

**CPA-00788 Type1 M/C A-D Corr Ans: C PM#10 F 6-06**

51. CPA-00788 May 95 #42 Page 38

Quinn Co. reported a net deferred tax asset of $9,000 in its December 31, 1993, balance sheet. For 1994, Quinn reported pretax financial statement income of $300,000. Temporary differences of $100,000 resulted in taxable income of $200,000 for 1994. At December 31, 1994, Quinn had cumulative taxable differences of $70,000. Quinn's effective income tax rate is 30%. In its December 31, 1994, income statement, what should Quinn report as deferred income tax expense?

a. $12,000
b. $21,000
c. $30,000
d. $60,000

**CPA-00788 Explanation**

Choice "c" is correct, $30,000.

Analysis of deferred tax account:

| | *12/31/93* | *Change* | *12/31/94* |
|---|---|---|---|
| Temporary differences | 30 | (100) | (70) |
| Tax rate | x30% | | x30% |
| Deferred tax asset | 9 | (9) | 0 |
| Deferred tax liability | 0 | (21) | (21) |
| Net deferred tax | 9 | (30) | (21) |

**CPA-00792 Type1 M/C A-D Corr Ans: D PM#13 F 6-06**

52. CPA-00792 Nov 94 #49 Page 42

Kent, Inc.'s reconciliation between financial statement and taxable income for 1993 follows:

| | |
|---|---|
| Pretax financial income | $150,000 |
| Permanent difference | (12,000) |
| | 138,000 |
| Temporary difference-depreciation | (9,000) |


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| | |
|---|---|
| Taxable income | $129,000 |

Additional information:

| | At 12/31/92 | 12/31/93 |
|---|---|---|
| Cumulative temporary differences (future taxable amounts) | $11,000 | $20,000 |

The enacted tax rate was 34% for 1992, and 40% for 1993 and years thereafter.

In its December 31, 1993, balance sheet, what amount should Kent report as deferred income tax liability?

a. $3,600
b. $6,800
c. $7,340
d. $8,000

**CPA-00792 Explanation**
Choice "d" is correct. The deferred income tax liability balance equals the future enacted tax rate (40%) times the future taxable amounts ($20,000). SFAS 109 para. 18

Choice "a" is incorrect. The deferred income tax liability balance depends on the total future taxable amounts ($20,000), rather than the change in future taxable amounts ($9,000), times the future enacted tax rate (40%).

Choice "b" is incorrect. The current enacted tax rate (40%), not the past rate (34%), should be applied to the future taxable amounts ($20,000).

Choice "c" is incorrect. The balance in the account should equal the future enacted tax rate times the future taxable amounts. Any adjustment results from a comparison of the previous balance with the correct balance necessary at year end.

**CPA-00793 Type1 M/C A-D Corr Ans: A PM#14 F 6-06**

53. CPA-00793 Nov 94 #50 Page 42

Kent, Inc.'s reconciliation between financial statement and taxable income for 1993 follows:

| | |
|---|---|
| Pretax financial income | $150,000 |
| Permanent difference | (12,000) |
| | 138,000 |
| Temporary difference-depreciation | (9,000) |
| Taxable income | $129,000 |

Additional information:

| | At 12/31/92 | 12/31/93 |
|---|---|---|
| Cumulative temporary differences (future taxable amounts) | $11,000 | $20,000 |

The enacted tax rate was 34% for 1992, and 40% for 1993 and years thereafter.

In its 1993 income statement, what amount should Kent report as current portion of income tax expense?

a. $51,600
b. $55,200
c. $55,860
d. $60,000

**CPA-00793 Explanation**
Choice "a" is correct. The current portion of income tax expense equals the 1993 tax liability of $51,600 (40% x $129,000 taxable income). SFAS 109


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Choice "b" is incorrect. Taxable income should be used rather than financial income, adjusted for permanent differences only.

Choice "c" is incorrect. The current portion of income tax expense equals the 1993 tax liability.

Choice "d" is incorrect. Taxable income should be used rather than pretax financial income.

**CPA-00795 Type1 M/C A-D Corr Ans: C PM#15 F 6-06**

54. CPA-00795 Nov 94 #51 Page 38

In its 1993 income statement, Cere Co. reported income before income taxes of $300,000. Cere estimated that, because of permanent differences, taxable income for 1993 would be $280,000. During 1993 Cere made estimated tax payments of $50,000, which were debited to income tax expense. Cere is subject to a 30% tax rate. What amount should Cere report as income tax expense?

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

**CPA-00795 Explanation**
Choice "c" is correct. $84,000 income tax expense.

| | |
|---|---|
| Financial income | $300,000 |
| Less permanent differences | (20,000) |
| Taxable income | 280,000 |
| Tax rate | 30% |
| Income tax expense - current | 84,000 |
| Less estimated tax payments | 50,000 |
| Estimated tax liability - current | $ 34,000 |

**CPA-00801 Type1 M/C A-D Corr Ans: D PM#16 F 6-06**

55. CPA-00801 May 94 #24 Page 44

Because Jab Co. uses different methods to depreciate equipment for financial statement and income tax purposes, Jab has temporary differences that will reverse during the next year and add to taxable income. Deferred income taxes that are based on these temporary differences should be classified in Jab's balance sheet as a:

a. Contra account to current assets.
b. Contra account to noncurrent assets.
c. Current liability.
d. Noncurrent liability.

**CPA-00801 Explanation**
Choice "d" is correct, noncurrent deferred tax liability since the items causing the temporary differences (equipment depreciation) are noncurrent fixed assets.

Choices "a", "b", and "c" are incorrect, per above.

**CPA-00803 Type1 M/C A-D Corr Ans: D PM#18 F 6-06**

56. CPA-00803 Nov 93 T #32 Page 44

In its first four years of operations ending December 31, 1992, Alder, Inc.'s depreciation for income tax purposes exceeded its depreciation for financial statement purposes. This temporary difference was expected to reverse in 1993, 1994, and 1995. Alder had no other temporary difference and elected early adoption of FASB 109. Alder's 1992 balance sheet should include:


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

**CPA-00803 Explanation**
Choice "d" is correct. Future taxable income will be greater than future accounting income since future taxable expenses will be less than future accounting expenses. The related deferred tax liability is classified according to the related asset which is a noncurrent asset. SFAS 109

Choice "a" is incorrect. Future taxable income will be greater than future accounting income since future taxable expenses will be less than future accounting expenses. Thus, deferred tax liabilities would be recognized on the balance sheet.

Choice "b" is incorrect. Future taxable income will be greater than future accounting income since future taxable expenses will be less than future accounting expenses. Thus, deferred tax liabilities would be recognized on the balance sheet.

Choice "c" is incorrect. The related deferred tax liability is classified according to the related asset which is a long-term asset.

**CPA-00804 Type1 M/C A-D Corr Ans: B PM#19 F 6-06**

57. CPA-00804 May 93 I #26 Page 38

West Corp. leased a building and received the $36,000 annual rental payment on June 15, 1992. The beginning of the lease was July 1, 1992. Rental income is taxable when received. West's tax rates are 30% for 1992 and 40% thereafter. West has elected early adoption of FASB statement No. 109, Accounting for Income Taxes. West had no other permanent or temporary differences. West determined that no valuation allowance was needed. What amount of deferred tax asset should West report in its December 31, 1992, balance sheet?

a. $5,400
b. $7,200
c. $10,800
d. $14,400

**CPA-00804 Explanation**
Choice "b" is correct. Taxable income includes $36,000 and book income should be 1/2 of $36,000 for 1992. The $18,000 difference results in a deferred tax asset at the tax rate in the year of reversal. $18,000 x 40% = $7,200. SFAS 109 para. 17

Choice "a" is incorrect. The $18,000 temporary difference results in a deferred tax asset at the tax rate in the year of reversal.

Choice "c" is incorrect. The $18,000 temporary difference results in a deferred tax asset. The amount of the deferred tax asset is the difference times the tax rate in the year of reversal.

Choice "d" is incorrect. The $18,000 temporary difference results in a deferred tax asset. The amount of the deferred tax asset is the difference times the tax rate in the year of reversal.

**CPA-00805 Type1 M/C A-D Corr Ans: A PM#20 F 6-06**

58. CPA-00805 May 93 I #35 Page 48

Taft Corp. uses the equity method to account for its 25% investment in Flame, Inc. During 1992, Taft received dividends of $30,000 from Flame and recorded $180,000 as its equity in the earnings of Flame. Additional information follows:

- All the undistributed earnings of Flame will be distributed as dividends in future periods.


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- The dividends received from Flame are eligible for the 80% dividends received deduction.
- There are no other temporary differences.
- Enacted income tax rates are 30% for 1992 and thereafter.

Taft elected early application of FASB Statement No. 109, Accounting for Income Taxes. In its December 31, 1992, balance sheet, what amount should Taft report for deferred income tax liability?

a. $9,000
b. $10,800
c. $45,000
d. $54,000

**CPA-00805 Explanation**
Choice "a" is correct, $9,000 deferred tax liability reported in Dec. 31, 1992 balance sheet.

| | *Book* | | *Tax* | | *Temporary Difference Taxable in Future* |
|---|---|---|---|---|---|
| Equity in earnings of investee | 180,000 | | 0 | | |
| Dividends received from investee | 0 | | 30,000 | | |
| Less 80% dividends received deduction | (144,000) | | (24,000) | | |
| Total | 36,000 | - | 6,000 | = | 30,000 |
| Future tax rate | | | | | x 30% |
| Deferred tax liability | | | | | 9,000 |

Note: The question is asking for the temporary difference amount. We must subtract the permanent differences to arrive at the temporary difference.

**CPA-00806 Type1 M/C A-D Corr Ans: A PM#21 F 6-06**

59. CPA-00806 May 93 I #36 Page 42

Stone Co. began operations in 1992 and reported $225,000 in income before income taxes for the year. Stone's 1992 tax depreciation exceeded its book depreciation by $25,000. Stone also had nondeductible book expenses of $10,000 related to permanent differences. Stone's tax rate for 1992 was 40%, and the enacted rate for years after 1992 is 35%. Stone elected early adoption of FASB statement No. 109, Accounting for Income Taxes. In its December 31, 1992, balance sheet, what amount of deferred income tax liability should Stone report?

a. $8,750
b. $10,000
c. $12,250
d. $14,000

**CPA-00806 Explanation**
Choice "a" is correct, $8,750 deferred tax liability at 12/31/92.

| | *Book* | *Tax* | *Temporary difference* |
|---|---|---|---|
| Tax depreciation in Excess of book | 0 | 25,000 | 25,000 |
| Tax rate for Years after 1992 - When the diff reverses | | | x 35% |
| Deferred tax liability at 12/31/92 | | | 8,750 |

**CPA-00808 Type1 M/C A-D Corr Ans: C PM#22 F 6-06**

60. CPA-00808 May 93 I #55 (Adapted) Page 43

Venus Corp.'s worksheet for calculating current and deferred income taxes for 1992 follows:

| 1992 | 1993 | 1994 |
|---|---|---|


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| | | | |
|---|---|---|---|
| Pretax income | $1,400 | | |
| Temporary differences: | | | |
| Depreciation | (800) | (1,200) | $2,000 |
| Warranty costs | 400 | (100) | (300) |
| Taxable income | $1,000 | (1,300) | 1,700 |
| Loss carryback | (1,000) | 1,000 | |
| Loss carryforward | | 300 | (300) |
| | $ 0 | $ 0 | $1,400 |
| Enacted rate | 30% | 30% | 25% |

Venus elected early adoption of FASB Statement No. 109, Accounting for Income Taxes. Venus had no prior deferred tax balances. In its 1992 income statement, what amount should Venus report as:

Current income tax expense?

a. $420
b. $350
c. $300
d. $0

**CPA-00808 Explanation**
Choice "c" is correct, $300 current income tax expense (taxable income of $1,000 x 30%).

**CPA-00809 Type1 M/C A-D Corr Ans: D PM#23 F 6-06**

61. CPA-00809 May 93 I #56 (Adapted) Page 43

Venus Corp.'s worksheet for calculating current and deferred income taxes for 1992 follows:

| | 1992 | 1993 | 1994 |
|---|---|---|---|
| Pretax income | $1,400 | | |
| Temporary differences: | | | |
| Depreciation | (800) | (1,200) | $2,000 |
| Warranty costs | 400 | (100) | (300) |
| Taxable income | $1,000 | (1,300) | 1,700 |
| Loss carryback | (1,000) | 1,000 | |
| Loss carryforward | | 300 | (300) |
| | $ 0 | $ 0 | $1,400 |
| Enacted rate | 30% | 30% | 25% |

Venus elected early adoption of FASB Statement No. 109, Accounting for Income Taxes. Venus had no prior deferred tax balances. In its 1992 income statement, what amount should Venus report as:

Deferred income tax expense?

a. $350
b. $300
c. $120
d. $95

**CPA-00809 Explanation**
Choice "d" is correct, $95 deferred income tax expense (see calculations below). The tax rate used to compute the DTA, or DTA should be the enacted tax rate for the year the temporary difference is expected to reverse.

1992

| | | | |
|---|---|---|---|
| Deferred tax liability | = | | |
| 800 x .25 | = | 200 | (25% used because this is the enacted tax rate for 1994) |
| Deferred tax asset | = | | |
| 100 x .30 | = | 30 | (30% used because this is the enacted |


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| | | | |
|---|---|---|---|
| | | | tax rate for 1993) |
| 300 x .25 | = | 75 | (25% used because this is the enacted tax rate for 1994) |
| | | 105 | |
| Deferred tax expense = | | 95 | |

1992 Journal Entry

| | | |
|---|---|---|
| Tax expense - current | 300 | |
| Tax expense - deferred | 95 | |
| Deferred tax asset | 105* | |
| Deferred tax liability | | 200* |
| Tax payable | | 300 |

* Can't net since warranty costs relate to current operations and depreciation to a noncurrent asset.

**CPA-00813 Type1 M/C A-D Corr Ans: A PM#24 F 6-06**

62. CPA-00813 Nov 92 I #27 Page 42

For the year ended Dec. 31, 1992, Mont Co.'s books showed income of $600,000 before provision for income tax expense. To compute taxable income for federal income tax purposes, the following items should be noted:

| | |
|---|---|
| Income from exempt municipal bonds | $60,000 |
| Depreciation deducted for tax purposes in excess of depreciation recorded on the books | 120,000 |
| Proceeds received from TERM life insurance on death of officer | 100,000 |
| Estimated tax payments | 0 |
| Enacted corporate tax rate | 30% |

Ignoring the alternative minimum tax provisions, what amount should Mont report at December 31, 1992, as its current federal income tax liability?

a. $96,000
b. $114,000
c. $150,000
d. $162,000

**CPA-00813 Explanation**

Choice "a" is correct, $96,000 current tax liability.

| | | *Tax* |
|---|---|---|
| IIncome before taxes | | $600,000 |
| Less: | | |
| Permanent differences: | | |
| Tax-free muni bonds | | (60,000) |
| Insurance proceeds on death of officer | | (100,000) |
| Income before taxes and temporary differences | | 440,000 |
| Less: | | |
| Temporary differences: | | |
| Excess tax depreciation | | (120,000) |
| Taxable income | | 320,000 |
| Enacted tax rate | | x 30% |
| Tax liability | | $96,000 |

Deferred tax liability calculation:

| | |
|---|---|
| Excess tax depreciation | $120,000 |
| Enacted tax rate | x 30% |
| | $ 36,000 |

Journal entry


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| | | |
|---|---|---|
| Tax expense - current | 96,000 | |
| Tax expense - deferred | 36,000 | |
| Tax liability - current - at 12/31/92 | | 96,000 |
| Deferred tax liability | | 36,000 |

**CPA-00814 Type1 M/C A-D Corr Ans: B PM#25 F 6-06**

63. CPA-00814 Nov 92 I #32 Page 38

Tower Corp. began operations on January 1, 1990. For financial reporting, Tower recognizes revenues from all sales under the accrual method. However, in its income tax returns, Tower reports qualifying sales under the installment method. On December 31, 1991, Tower's gross profit on these installment sales under each method was as follows:

| *Year* | *Accrual method* | *Installment method* |
|---|---|---|
| 1990 | $1,600,000 | $ 600,000 |
| 1991 | 2,600,000 | 1,400,000 |

The income tax rate is 30% for 1990 and future years. There are no other temporary or permanent differences. In its December 31, 1991, balance sheet, what amount should Tower report as a liability for deferred income taxes?

a. $840,000
b. $660,000
c. $600,000
d. $360,000

**CPA-00814 Explanation**
Choice "b" is correct, $660,000 deferred tax liability in December 31, 1991.

| | *Financial Income* | *Taxable Income* | *Temporary Difference* |
|---|---|---|---|
| 1990 | $1,600,000 | $ 600,000 | $1,000,000 |
| 1991 | 2,600,000 | 1,400,000 | 1,200,000 |
| Total | $4,200,000 | $2,000,000 | 2,200,000 |

| | |
|---|---|
| Income tax rate | x 30% |
| Liability for deferred taxes | $ 660,000 |

**CPA-00816 Type1 M/C A-D Corr Ans: D PM#26 F 6-06**

64. CPA-00816 Nov 92 #41 Page 34

Rein Inc. reported deferred tax assets and deferred tax liabilities at the end of 1990 and at the end of 1991. According to FASB Statement No. 109, Accounting for Income Taxes, for the year ended 1991 Rein should report deferred income tax expense or benefit equal to the:

a. Decrease in the deferred tax assets.
b. Increase in the deferred tax liabilities.
c. Amount of the current tax liability plus the sum of the net changes in deferred tax assets and deferred tax liabilities.
d. Sum of the net changes in deferred tax assets and deferred tax liabilities.

**CPA-00816 Explanation**
Choice "d" is correct. The deferred tax expense reported in the income statement is the sum of the net changes in deferred tax assets and deferred tax liabilities.

Choice "a" is incorrect. Decreases in deferred tax assets (if any) is only part of the computation.

Choice "b" is incorrect. Increase in deferred tax liabilities is only part of the computation.


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Choice "c" is incorrect. The amount of the "current tax liability" is reported separately.

**CPA-00818 Type1 M/C A-D Corr Ans: B PM#27 F 6-06**

65. CPA-00818 May 92 #9 Page 37

Orleans Co., a cash basis taxpayer, prepares accrual basis financial statements. Since 1988, Orleans has applied FASB Statement No. 109, Accounting for Income Taxes. In its 1991 balance sheet, Orleans' deferred income tax liabilities increased compared to 1990. Which of the following changes would cause this increase in deferred income tax liabilities?

I. An increase in prepaid insurance.
II. An increase in rent receivable.
III. An increase in warranty obligations.

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

**CPA-00818 Explanation**
Choice "b" is correct.

I - Prepaid insurance would be deducted for tax purposes in the year in which it was paid, but for book purposes in the subsequent year for the period covered by the policy.

II - Rent receivable represents income earned but not yet received in cash. Taxes will be paid in the following year when the receivable is collected.

Not III - Increased warranty obligations represent expenses incurred but not yet paid. They will be deductible for tax purposes in subsequent years when actually paid.

**CPA-00821 Type1 M/C A-D Corr Ans: C PM#28 F 6-06**

66. CPA-00821 May 92 #10 Page 34

According to FASB Statement No. 109, Accounting for Income Taxes, which of the following items should affect current income tax expense for 1991?

a. Interest on a 1989 tax deficiency paid in 1991.
b. Penalties on a 1989 tax deficiency paid in 1991.
c. Change in income tax rate for 1991.
d. Change in income tax rate for 1992.

**CPA-00821 Explanation**
Choice "c" is correct, change in income tax rate for 1991 will affect current income tax expense for 1991.

Choice "a" is incorrect. Interest on a 1989 tax deficiency paid in 1991 would be recorded in interest expense.

Choice "b" is incorrect. Penalties on the 1989 tax deficiency paid in 1991 would be recorded in general and administrative expenses.

Choice "d" is incorrect. Change in income tax rate for 1992 will affect deferred tax expense for 1991.

**CPA-00823 Type1 M/C A-D Corr Ans: B PM#29 F 6-06**

67. CPA-00823 May 92 I #24 (Adapted) Page 38

Rom Corp. began business in 1999 and reported taxable income of $50,000 on its 1999 tax return. Rom's enacted tax rate is 30% for 1999 and future years. All differences except for equipment relate to current balance sheet accounts. The following is a schedule of Rom's December 31, 1999, temporary differences in thousands of dollars:


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| | *12/31/99 Book basis over (under) tax basis* | *Future taxable (deductible) amounts* | | | |
|---|---|---|---|---|---|
| | | 2000 | 2001 | 2002 | 2003 |
| Equipment | 10 | (5) | 5 | 5 | 5 |
| Warranty liability | (20) | (20) | | | |
| Deferred compensation liability | (15) | | (5) | | (10) |
| Installment receivables | 30 | 10 | | 20 | |
| Totals | 5 | (15) | (0) | 25 | (5) |

What amount should Rom report as current deferred tax asset in its December 31, 1999, balance sheet?

a. $0
b. $1,500
c. $4,500
d. $6,000

**CPA-00823 Explanation**

Choice "b" is correct. The December 31, 1999 deferred tax asset =

| | |
|---|---|
| Net differences related to current balance sheet accounts | |
| [(20) + (15) + 30] | $(5,000) |
| x Future enacted tax rate | .30 |
| Current deferred tax asset | $ 1,500 |

The timing of the temporary difference reversals is not used, unless the temporary difference has no underlying balance sheet account.

**CPA-00826 Type1 M/C A-D Corr Ans: C PM#30 F 6-06**

68. CPA-00826 May 92 I #26 Page 38

On January 2, 1990, Ross Co. purchased a machine for $70,000. This machine has a 5-year useful life, a residual value of $10,000, and is depreciated using the straight-line method for financial statement purposes. For tax purposes, depreciation expense was $25,000 for 1990 and $20,000 for 1991. Ross elected early application of FASB Statement No. 109, Accounting for Income Taxes. Ross' 1991 income, before income taxes and depreciation expense, was $100,000 and its tax rate was 30%. If Ross had made no estimated tax payments during 1991, what amount of current income tax liability would Ross report in its December 31, 1991, balance sheet?

a. $26,400
b. $25,800
c. $24,000
d. $22,500

**CPA-00826 Explanation**

Choice "c" is correct, $24,000. Current income tax liability is based upon taxable income and current tax rates.

| | *1991* |
|---|---|
| Income before depreciation and taxes | $100,000 |
| Tax depreciation | (20,000) |
| Taxable income | 80,000 |
| Tax rate | x 30% |
| Current income tax liability at 12/31/91 | $ 24,000 |

Note: The question involves the second year (1991). This is a common trick used by the examiners. Had you used the first year (1990), you would have arrived at an incorrect answer ($100,000 - 25,000 = 75,000 x 30% = $22,500).


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**CPA-00827 Type1 M/C A-D Corr Ans: A PM#31 F 6-06**

69. CPA-00827 May 92 I #56 Page 38

Busy Corp. prepared the following reconciliation between pretax accounting income and taxable income for the year ended December 31, 1991:

| | |
|---|---|
| Pretax accounting income | $250,000 |
| Taxable income | 150,000 |
| Difference | $100,000 |
| Analysis of difference: | |
| Interest on municipal bonds | $ 25,000 |
| Excess of tax over book depreciation | 75,000 |
| | $100,000 |

Busy uses FASB Statement No. 109, Accounting for Income Taxes. Busy's effective income tax rate for 1991 is 30%. The depreciation difference will reverse in equal amounts over the next three years at an enacted tax rate of 40%.

In Busy's 1991 income statement, what amount should be reported as the current portion of its provision for income taxes?

a. $45,000
b. $67,500
c. $75,000
d. $82,500

**CPA-00827 Explanation**
Choice "a" is correct. This question asks for the current portion of income taxes payable, which is simply 30% of taxable income, $150,000 x 30%, or $45,000.

**CPA-00828 Type1 M/C A-D Corr Ans: C PM#32 F 6-06**

70. CPA-00828 Nov 91 #3 Page 34

According to FASB Statement No. 109, Accounting for Income Taxes, justification for the method of determining periodic deferred tax expense is based on the concept of:

a. Matching of periodic expense to periodic revenue.
b. Objectivity in the calculation of periodic expense.
c. Recognition of assets and liabilities.
d. Consistency of tax expense measurements with actual tax planning strategies.

**CPA-00828 Explanation**
Choice "c" is correct. Under SFAS #109, the justification for the method of determining periodic deferred tax expense is based on recognition of assets and liabilities.

**CPA-00829 Type1 M/C A-D Corr Ans: B PM#33 F 6-06**

71. CPA-00829 Nov 91 #4 Page 37

At the end of year 1, Cody Co. reported a profit on a partially completed construction contract by applying the percentage-of-completion method. By the end of year 2, the total estimated profit on the contract at completion in year 3 had been drastically reduced from the amount estimated at the end of year 1. Consequently, in year 2, a loss equal to one-half of the year 1 profit was recognized. Cody used the completed-contract method for income tax purposes and had no other contracts. According to FASB Statement No. 109, Accounting for Income Taxes, the year 2 balance sheet should include a deferred tax:

| | *Asset* | *Liability* |
|---|---|---|
| a. | Yes | Yes |


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b. No Yes
c. Yes No
d. No No

**CPA-00829 Explanation**
Choice "b" is correct, No - Yes.

**Rule:** Whenever income is recognized in the financial statement before it is reported as taxable income, a deferred tax liability should be reported. Even though a loss was recognized in year 2, on a cumulative basis the financial statement have recognized income which has not yet been recognized for tax purposes. Accordingly, a deferred liability will still exist at the end of year 2 (however, it will be less than the deferred liability reported at the end of year 1).

**CPA-00830 Type1 M/C A-D Corr Ans: B PM#34 F 6-06**

72. CPA-00830 Nov 91 I #25 Page 42

Dunn Co.'s 1990 income statement reported $90,000 income before provision for income taxes. To compute the provision for federal income taxes, the following 1990 data are provided:

| | |
|---|---|
| Rent received in advance | $16,000 |
| Income from exempt municipal bonds | 20,000 |
| Depreciation deducted for income tax purposes in excess of depreciation reported for financial statement purposes | 10,000 |
| Enacted corporate income tax rate | 30% |

If the alternative minimum tax provisions are ignored, what amount of current federal income tax liability should be reported in Dunn's December 31, 1990, balance sheet?

a. $18,000
b. $22,800
c. $25,800
d. $28,800

**CPA-00830 Explanation**
Choice "b" is correct. The current tax liability is computed by multiplying the tax rate of 30% times taxable income.

| | |
|---|---|
| Pretax financial income | $90,000 |
| Permanent difference: | |
| Tax exempt bonds income | (20,000) |
| Pretax financial income subject to tax | 70,000 |
| Temporary differences: | |
| Rent (taxable when received) | 16,000 |
| Depreciation (tax deduction) | (10,000) |
| Taxable income | 76,000 |
| Tax rate | x 30% |
| Tax liability | $22,800 |

**CPA-00837 Type1 M/C A-D Corr Ans: D PM#35 F 6-06**

73. CPA-00837 Nov 91 I #32 Page 35

Lake Corp., a newly organized company, reported pretax financial income of $100,000 for 1990. Among the items reported in Lake's 1990 income statement are the following:

- Premium on officer's life insurance with Lake as owner and beneficiary $15,000
- Interest received on municipal bonds 20,000


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Lake elected early application of FASB Statement No. 109, Accounting for Income Taxes. The enacted tax rate for 1990 is 30% and 25% thereafter. In its December 31, 1990, balance sheet, Lake should report a deferred income tax liability of:

a. $28,500
b. $4,500
c. $3,750
d. $0

**CPA-00837 Explanation**
Choice "d" is correct, $0 deferred income tax liability at 12/31/90. As both the premium on an officer's life insurance (when the co. is the beneficiary) as well as interest on municipal bonds are permanent differences. Deferred taxes are not affected by either, accordingly the correct answer is $0.

**CPA-00838 Type1 M/C A-D Corr Ans: C PM#36 F 6-06**

74. CPA-00838 Nov 91 I #38 Page 43

Mill, which began operations on January 1, 1988, recognizes income from long-term construction contracts under the percentage-of-completion method in its financial statements and under the completed contract method for income tax reporting. Income under each method follows:

| *Year* | *Completed contract* | *Percentage of-completion* |
|---|---|---|
| 1988 | $ - | $300,000 |
| 1989 | 400,000 | 600,000 |
| 1990 | 700,000 | 850,000 |

The income tax rate was 30% for 1988 through 1990. For years after 1990, the enacted tax rate is 25%. There are no other temporary differences. Mill elected early application of FASB Statement No. 109, Accounting for Income Taxes. Mill should report in its December 31, 1990, balance sheet, a deferred income tax liability of:

a. $87,500
b. $105,000
c. $162,500
d. $195,000

**CPA-00838 Explanation**
Choice "c" is correct, $162,500 deferred income tax liability.

| *Year* | *(tax) Completed contract* | *(book) % of completion* | *Difference* |
|---|---|---|---|
| 1988 | - | 300,000 | |
| 1989 | 400,000 | 600,000 | |
| 1990 | 700,000 | 850,000 | |
| Cumulative | 1,100,000 | 1,750,000 | 650,000 |
| Enacted tax rate - after 1990 | | | x 25% |
| Deferred income tax liability | | | $162,500 |

Note: Use "enacted tax rates" of (future) year taxes are to be paid.

**CPA-00839 Type1 M/C A-D Corr Ans: A PM#37 F 6-06**

75. CPA-00839 Nov 91 I #59 Page 42

Shear, Inc. began operations in 1990. Included in Shear's 1990 financial statements were bad debt expenses of $1,400 and profit from an installment sale of $2,600. For tax purposes, the bad debts will be deducted and the profit from the installment sale will be recognized in 1992. The enacted tax rates are


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30% in 1990 and 25% in 1992. Shear elected early application of FASB Statement No. 109, Accounting for Income Taxes. In its 1990 income statement, what amount should Shear report as deferred income tax expense?

a. $300
b. $360
c. $650
d. $780

**CPA-00839 Explanation**
Choice "a" is correct, $300 deferred income tax expense Dec. 31, 1990.

| *Schedule of reversals* | *1991* | *1992* |
|---|---|---|
| Bad debts | - | (1,400) |
| Install. Sale | - | 2,600 |
| | - | 1,200 |
| 1992 tax rate | | 25% |
| | | $ 300 |

Note that future enacted tax rate of 25% is used to calculate the deferred tax amounts.

**CPA-00840 Type1 M/C A-D Corr Ans: D PM#38 F 6-06**

76. CPA-00840 May 91 #7 Page 36

A temporary difference arises when which of the following extraordinary items is included for tax purposes this year after having been recognized in financial income last year?

| | *Extraordinary gain* | *Extraordinary loss* |
|---|---|---|
| a. | No | No |
| b. | Yes | No |
| c. | No | Yes |
| d. | Yes | Yes |

**CPA-00840 Explanation**
Choice "d" is correct, Yes - Yes. Both extraordinary gains and extraordinary losses would be considered temporary differences if they enter into the determination of taxable income and GAAP basis income in different periods.

Choices "a", "b", and "c" are incorrect. Both extraordinary gains and losses could give rise to timing differences.

**CPA-00841 Type1 M/C A-D Corr Ans: C PM#39 F 6-06**

77. CPA-00841 May 91 #11 Page 38

At the end of its first year of operations (December 31, 1990), Gold Co. reported a current deferred tax asset in accordance with FASB Statement No. 109, Accounting for Income Taxes. Will reversal of current temporary differences result in taxable or deductible amounts, and did Gold have a 1990 profit or loss for tax purposes?

| | *Taxable or deductible amounts* | *Taxable status of 1990 operations* |
|---|---|---|
| a. | Taxable | Profit |
| b. | Taxable | Loss |
| c. | Deductible | Profit |
| d. | Deductible | Loss |

**CPA-00841 Explanation**


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Choice "c" is correct. The reversal of the current temporary differences will result in future deductible amounts because a deferred tax asset represents future tax savings. These tax savings will be realized in the form of future tax deductions that will reduce the amount of future taxes owed.

Gold Co. must have had a taxable profit in 1990 because it is reporting a deferred tax asset on the balance sheet. If Gold Co. had reported a taxable loss (NOL) in 1990, it would have been required to record a full valuation allowance against its deferred tax asset. This is because, absent significant evidence to the contrary (and none is provided in this question), a current NOL implies that there is a >50% chance that the company will have NOLs in future periods and will not have income to offset with the future tax deductions. If it is probable that a company will not be able to utilize the benefits of a DTA, then a full valuation allowance is recorded and the net DTA is $0.

**CPA-00842 Type1 M/C A-D Corr Ans: D PM#40 F 6-06**

78. CPA-00842 May 91 I #41 Page 42

On June 30, 1990, Ank Corp. prepaid a $19,000 premium on an annual insurance policy. The premium payment was a tax deductible expense in Ank's 1990 cash basis tax return. The accrual basis income statement will report a $9,500 insurance expense in 1990 and 1991.

Ank elected early application of FASB Statement No. 109, Accounting for Income Taxes. Ank's income tax rate as 30% in 1990 and 25% thereafter. In Ank's December 31, 1990, balance sheet, what amount related to the insurance should be reported as a deferred income tax liability?

a. $5,700
b. $4,750
c. $2,850
d. $2,375

**CPA-00842 Explanation**
Choice "d" is correct, $2,375.

**Rule:** Deferred taxes should be computed based upon the enacted tax rates when the difference will reverse:

| | |
|---|---|
| Insurance premium reversal 1991 | $9,500 |
| Tax rate 1991 | x 25% |
| Deferred tax liability | $2,375 |

**CPA-00844 Type1 M/C A-D Corr Ans: A PM#42 F 6-06**

79. CPA-00844 Nov 90 #27 Page 42

Senlo Co., which uses a one-year operating cycle, recognized profits for both financial statement and tax purposes during its two years of operation. Depreciation for tax purposes exceeded depreciation for financial statement purposes in each year. These temporary differences are expected to reverse in years 3, 4, and 5. According to FASB 109, at the end of year 2 the deferred tax liability shown as a noncurrent liability is based on the:

a. Enacted tax rates for years 3, 4, and 5.
b. Enacted tax rate for year 3.
c. Tax rates for years 1 and 2.
d. Tax rate for year 2.

**CPA-00844 Explanation**
Choice "a" is correct, at the end of year 2, the deferred tax liability shown as a noncurrent deferred liability is based on the enacted tax rate expected to apply to annual income for years 3, 4, and 5 (the years when the liability is expected to be settled).


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**CPA-00845 Type1 M/C A-D Corr Ans: A PM#43 F 6-06**

80. CPA-00845 Nov 90 #28 Page 34

Nala Inc. reported deferred tax assets and deferred tax liabilities at the end of 1988 and at the end of 1989. According to FASB 109, for the year ended 1989 Nala should report deferred income tax expense or benefit equal to the:

a. Sum of the net changes in deferred tax assets and deferred tax liabilities.
b. Decrease in the deferred tax assets.
c. Increase in the deferred tax liabilities.
d. Amount of the income tax liability plus the sum of the net changes in deferred tax assets and deferred tax liabilities.

**CPA-00845 Explanation**
Choice "a" is correct, sum of net changes in deferred tax assets and deferred tax liabilities. Rule: SFAS 109 defines "deferred tax expense or benefit" as: "the net change during the year in the deferred tax liability or asset."

Choices "b", "c", and "d" are incorrect, per the above rule.

**CPA-00846 Type1 M/C A-D Corr Ans: C PM#44 F 6-06**

81. CPA-00846 Nov 90 I #48 Page 42

For calendar year 1989, Clark Corp. reported depreciation of $300,000 in its income statement. On its 1989 income tax return, Clark reported depreciation of $500,000. Clark's income statement also included $50,000 accrued warranty expense that will be deducted for tax purposes when paid. Clark elected early application of FASB Statement No. 109, Accounting for Income Taxes, in its financial statements for the year ended December 31, 1989. Clark's enacted tax rates are 30% for 1989 and 1990, and 25% for 1991 and 1992. The depreciation difference and warranty expense will reverse over the next three years as follows:

| | *Depreciation difference* | *Warranty expense* |
|---|---|---|
| 1990 | $ 80,000 | $10,000 |
| 1991 | 70,000 | 15,000 |
| 1992 | 50,000 | 25,000 |
| | $200,000 | $50,000 |

These were Clark's only temporary differences. In Clark's 1989 income statement, the deferred portion of its provision for income taxes should be:
a. $67,000
b. $45,000
c. $41,000
d. $37,500

**CPA-00846 Explanation**
Choice "c" is correct, $41,000.

| | *1989 Temporary Difference* | *Key: taxable (deductible)* *1990* | *1991* | *1992* |
|---|---|---|---|---|
| Depreciation | $200,000 | $80,000 | $70,000 | $50,000 |
| Warranty accrual | $ 50,000 | (10,000) | (15,000) | (25,000) |
| | | 70,000 | 55,000 | 25,000 |
| Enacted tax rates | | .30 | .25 | .25 |
| Deferred taxes payable | | $21,000 | $13,750 | $6,250 |
| | | | $41,000 | |


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**CPA-00847 Type1 M/C A-D Corr Ans: D PM#45 F 6-06**

82. CPA-00847 May 90 #10 (Adapted) Page 44

Cahn Co. applies straight-line amortization to its organization costs for income tax purposes, but expenses all costs as incurred for financial statement reporting. For tax purposes a 15-year period is used. Cahn has no other temporary differences, has an operating cycle of less than 1 year, and has taxable income in all years. Cahn should report both current and noncurrent deferred income tax assets at the end of:

| | *Year 1* | *Year 14* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | Yes |
| d. | Yes | No |

**CPA-00847 Explanation**
Choice "d" is correct, Yes - Year 1; No - Year 14. Since there is no related balance sheet account the deferred income tax asset is classified based upon its expected reversal date. In Year 1 a portion of the deferred income tax asset will reverse during the year, therefore it must be classified, as current while the balance will reverse in subsequent years. In Year 14 the remaining deferred income tax asset is classified as current since no deferred income tax asset will reverse in more than one year.

**CPA-00848 Type1 M/C A-D Corr Ans: A PM#46 F 6-06**

83. CPA-00848 May 90 #25 Page 46

No deferred tax asset was recognized in the 1988 financial statements by the Chaise Company when a loss from discontinued segments was carried forward for tax purposes. Chaise had no temporary differences. The tax benefit of the loss carried forward reduced current taxes payable on 1989 continuing operations. In accordance with FASB Statement No. 109, the 1989 income statement would include the tax benefit from the loss brought forward in:

a. Income from continuing operations.
b. Gain or loss from discontinued segments.
c. Extraordinary gains.
d. Cumulative effect of accounting changes.

**CPA-00848 Explanation**
Choice "a" is correct. Since the tax benefit of the loss carried forward reduced current taxes payable on 1989 continuing operations, the 1989 income statement would include the benefit of the loss in income from continuing operations. SFAS 109 para. 16

Choice "b" is incorrect. The tax benefit of the loss carried forward did not affect the gain or loss from discontinued segments.

Choice "c" is incorrect. The tax benefit of the loss carried forward is not an extraordinary item.

Choice "d" is incorrect. There is no cumulative effect of an accounting change in this situation. Additionally, the cumulative effect of accounting changes is no longer reported on the income statement.

**CPA-00849 Type1 M/C A-D Corr Ans: A PM#47 F 6-06**

84. CPA-00849 May 90 I #26 Page 42

Graf Corp.'s 1989 income statement showed pretax accounting income of $200,000. To compute the federal income tax liability, the following 1989 data are provided:

| | |
|---|---|
| Income from exempt municipal bonds | $10,000 |
| Depreciation deducted for tax purposes in excess of depreciation deduced for financial statement purposes | $20,000 |
| Estimated federal income tax payments made | 40,000 |


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Enacted corporate income tax rate 30%

If the alternative minimum tax provisions are ignored, what amount of current federal income tax liability should be included in Graf's December 31, 1989, balance sheet?

a. $11,000
b. $20,000
c. $39,000
d. $51,000

**CPA-00849 Explanation**
Choice "a" is correct, $11,000 current federal income tax liability.

| | |
|---|---|
| Pretax accounting (book) income | $200,000 |
| Less: | |
| Tax exempt municipal income | (10,000) |
| Tax depreciation in excess of book | (20,000) |
| Taxable income | $170,000 |
| Tax rate | .30 |
| Tax provision | $ 51,000 |
| Less estimated payments made | (40,000) |
| Current federal income tax liability | $ 11,000 |

**CPA-00854 Type1 M/C A-D Corr Ans: C PM#48 F 6-06**

85. CPA-00854 May 90 I #34 Page 37

Huff Corp. began operations on January 1, 1988. Huff recognizes revenues from all sales under the accrual method for financial reporting purposes and appropriately uses the installment method for income tax purposes. Huff's gross margin on installment sales under each method was as follows:

| *Year* | *Accrual method* | *Installment method* |
|---|---|---|
| 1988 | $800,000 | $300,000 |
| 1989 | 1,300,000 | 700,000 |

Huff elected early application of FASB Statement No. 109, Accounting for Income Taxes. Enacted income tax rates are 30% for 1989 and 25% thereafter. There are no other temporary differences. In Huff's December 31, 1989 balance sheet, the deferred income tax liability should be:

a. $150,000
b. $180,000
c. $275,000
d. $330,000

**CPA-00854 Explanation**
Choice "c" is correct, $275,000 deferred income tax liability.

| | **[000 omitted]** | | | | |
|---|---|---|---|---|---|
| | *FS Accrual* | | *Tax Installment* | | *Temporary* |
| *Year* | *revenue* | | *revenue* | | *differences* |
| 1988 | $ 800 | - | $ 300 | = | $ 500 |
| 1989 | 1,300 | | 700 | = | 600 |
| | $2,100 | - | $1,000 | = | $1,100 |
| Enacted tax rate | | | | | .25 |
| Deferred income tax liability | | | | | $ 275 |

**CPA-00856 Type1 M/C A-D Corr Ans: C PM#49 F 6-06**

86. CPA-00856 May 90 I #39 Page 34


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For the year ended March 31, 1990, Dunn Corp.'s pretax financial statement income was $700,000, and its taxable income was $600,000. The difference is due to the following:

| | |
|---|---|
| Interest on municipal bonds | $ 30,000 |
| Lower depreciation for financial statement | 70,000 |
| Total | $100,000 |

Dunn elected early application of FASB Statement No. 109, Accounting for Income Taxes. Dunn's enacted income tax rate is 30%. What is Dunn's current portion of income tax expense for the year ended March 31, 1990?

a. $210,000
b. $189,000
c. $180,000
d. $159,000

**CPA-00856 Explanation**
Choice "c" is correct, $180,000 current portion of income tax expense. Rule: the current portion of income tax expense is the amount payable to IRS.

| | | |
|---|---|---|
| Pretax financial statement income | | $700,000 |
| Less: | | |
| Permanent difference on municipal bond interest | 30,000 | |
| Temporary difference on depreciation | 70,000 | |
| | | 100,000 |
| Taxable income | | 600,000 |
| Tax rate | | .30 |
| Current portion of income tax expense | | $180,000 |

**CPA-00857 Type1 M/C A-D Corr Ans: A PM#50 F 6-06**

87. CPA-00857 May 90 II #60 Page 46

Dodd Corp. is preparing its December 31, 1989 financial statements and must determine the proper accounting treatment for the following situations:

- For the year ended December 31, 1989, Dodd has a loss carry forward of $180,000 available to offset future taxable income. However, there are no temporary differences.
- On December 30, 1989, Dodd received a $200,000 offer for its patent. Dodd's management is considering whether to sell the patent. The offer expires on February 28, 1990. The patent has a carrying amount of $100,000 at December 31, 1989.

Assume a current and future income tax rate of 30%. In its 1989 income statement, Dodd should recognize an increase in net income of:

a. $0
b. $54,000
c. $70,000
d. $124,000

**CPA-00857 Explanation**
Choice "a" is correct, $0 increase in net income. SFAS 109 does permit recognition of "net operating loss carry forward" in year of loss, but the deferred asset should be reduced by a "valuation allowance" based on the "more likely or not" test of expected realization. In this case, there does not appear to be enough evidence to support realization. Unless evidence is provided to the contrary, it is generally assumed that an NOL in the current period means that there is a greater than 50% chance that there will be NOLs in future periods. Therefore, a "valuation allowance" should reduce the deferred asset to zero, and result in no increase in net income. Accounting recognition is not given to offers to sell assets because a completed transaction has not occurred.


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**CPA-00858 Type1 M/C A-D Corr Ans: D PM#51 F 6-06**

88. CPA-00858 Nov 89 #15 Page 34

As a result of differences between depreciation for financial reporting purposes and tax purposes, the financial reporting basis of a company's plant assets exceeded the tax basis. Assuming the company had no other temporary differences, the company should report a:

a. Current tax asset.
b. Current tax payable.
c. Deferred tax asset.
d. Deferred tax liability.

**CPA-00858 Explanation**
Choice "d" is correct, deferred tax liability. If book basis of asset is greater than tax basis (resulting from different depreciation methods), a deferred tax liability should be established for the tax effect of the difference. In future years the taxable income will be higher than book income when the temporary difference reverses.

*Year of originating temporary difference*

| | | |
|---|---|---|
| Tax expense | xxx | |
| Taxes payable | | xxx |
| Deferred tax liability | | xxx |

*Year of reversal of temporary difference*

| | | |
|---|---|---|
| Tax expense | xxx | |
| Deferred tax liability | xxx | |
| Taxes payable | | xxx |

**CPA-00859 Type1 M/C A-D Corr Ans: B PM#52 F 6-06**

89. CPA-00859 Nov 89 I #26 Page 42

On December 2, 1988, Huff Corp. received a condemnation award of $450,000 as compensation for the forced sale of land purchased five years earlier for $300,000. The gain was not reported as taxable income on its income tax return for the year ended December 31, 1988, because Huff elected to replace the land within the allowed replacement period for at least $450,000. Huff has an income tax rate of 25% for 1988, and there is an enacted rate of 30% for years ending after 1988. There were no other temporary differences. Huff elected early application of FASB Statement No. 109, Accounting for Income Taxes. In its December 31,1988 balance sheet, Huff should report a deferred income tax liability of:

a. $135,000
b. $45,000
c. $37,500
d. $0

**CPA-00859 Explanation**
Choice "b" is correct, $45,000. Rule: Establish deferred tax using enacted annual tax rate (current tax rate for the related years) when temporary differences (will) reverse.

Deferred tax liability on temporary difference:

| | |
|---|---|
| Sales price of asset | $450,000 |
| Cost | 300,000 |
| Gain on sale | 150,000 |
| Enacted tax rate - 1988 divided by | x 30% |
| Deferred tax liability | $ 45,000 |

In this case, gain on sale is taxable in a future year when the enacted tax rate is 30%.


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**CPA-00861 Type1 M/C A-D Corr Ans: C PM#53 F 6-06**

90. CPA-00861 Nov 89 I #47 Page 38

Bee Corp. prepared the following reconciliation between book income and taxable income for the year ended December 31, 1992:

| | |
|---|---|
| Pretax accounting income | $500,000 |
| Taxable income | 300,000 |
| Difference | $200,000 |
| Differences: | |
| Interest on municipal bonds | $ 50,000 |
| Lower depreciation per financial statements | 150,000 |
| Total differences | $200,000 |

Bee elected early application of FASB Statement No. 109, Accounting for Income Taxes, in its financial statements for the year ended December 31, 1992. Bee's effective income tax rate for 1992 is 30%. The depreciation difference will reverse equally over the next three years at enacted tax rates as follows:

| *Years* | *Tax rates* |
|---|---|
| 1993 | 30% |
| 1994 | 25% |
| 1995 | 25% |

In Bee's 1992 income statement, the current portion of its provision for income taxes should be:

a. $150,000
b. $125,000
c. $90,000
d. $75,000

**CPA-00861 Explanation**

Choice "c" is correct, $90,000 current portion of provision for income taxes. Current portion of tax expense is the amount of taxes payable.

| | |
|---|---|
| Taxable income | $300,000 |
| Tax rate | x 30% |
| Current tax expense | $ 90,000 |

**CPA-00863 Type1 M/C A-D Corr Ans: D PM#54 F 6-06**

91. CPA-00863 Nov 89 I #48 Page 43

Bee Corp. prepared the following reconciliation between book income and taxable income for the year ended December 31, 1992:

| | |
|---|---|
| Pretax accounting income | $500,000 |
| Taxable income | 300,000 |
| Difference | $200,000 |
| Differences: | |
| Interest on municipal bonds | $ 50,000 |
| Lower depreciation per financial statements | 150,000 |
| Total differences | $200,000 |

Bee elected early application of FASB Statement No. 109, Accounting for Income Taxes, in its financial statements for the year ended December 31, 1992. Bee's effective income tax rate for 1992 is 30%. The depreciation difference will reverse equally over the next three years at enacted tax rates as follows:

| *Years* | *Tax rates* |
|---|---|


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| | |
|---|---|
| 1993 | 30% |
| 1994 | 25% |
| 1995 | 25% |

In Bee's 1992 income statement, the deferred portion of its provision for income taxes should be:

a. $60,000
b. $50,000
c. $45,000
d. $40,000

**CPA-00863 Explanation**
Choice "d" is correct, $40,000 deferred portion of provision for income taxes.

| *12/31/92* | | *Reversal periods* | | |
|---|---|---|---|---|
| *Taxable difference* | *1993* | *1994* | *1995* | *Total* |
| | $50,000 | $50,000 | $50,000 | $150,000 |
| Enacted tax rate | x 30% | x 25% | x 25% | |
| Deferred tax expense | $15,000 | $12,500 | $12,500 | $ 40,000 |

**CPA-04661 Type1 M/C A-D Corr Ans: B PM#55 F 6-06**

92. CPA-04661 Released 2005 Page 36

For its first year of operations, Cable Corp. recorded a $100,000 expense in its tax return that will not be recorded in its accounting records until next year. There were no other differences between its taxable and financial statement income. Cable's effective tax rate for the current year is 45%, but a 40% rate has already been passed into law for next year. In its year-end balance sheet, what amount should Cable report as a deferred tax asset (liability)?

a. $40,000 asset.
b. $40,000 liability.
c. $45,000 asset.
d. $45,000 liability.

**CPA-04661 Explanation**
Choice "b" is correct. Pre-tax GAAP income was $100,000 more than taxable income for the current period, resulting from the timing difference which is to be settled next year. Next year's enacted tax rate will be 40%. Cable must recognize a $40,000 ($100,000 x 40%) tax liability in the current period which will be paid (settled) next year.

Choice "a" is incorrect. Taxes were not paid in advance.

Choice "c" is incorrect. Taxes were not paid in advance.

Choice "d" is incorrect. Liability will be settled when tax rate is 40% not current 45%.

**CPA-04683 Type1 M/C A-D Corr Ans: B PM#57 F 6-06**

93. CPA-04683 Released 2005 Page 36

Miro Co. began business on January 2, 20X0. Miro used the double-declining balance method of depreciation for financial statement purposes for its building, and the straight-line method for income taxes. This was the only difference between tax and financial statement accounting. On January 16, 20X2, Miro elected to switch to the straight-line method for both financial statement and tax purposes. The building, which cost $240,000 in 20X0, had a useful life of 15 years and no salvage value. Data related to the building is as follows:

| | *Double-declining balance* | *Straight-line* |
|---|---|---|
| *Year* | *Depreciation* | *Depreciation* |
| 20X0 | $30,000 | $16,000 |


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| | | |
|---|---|---|
| 20X1 | $20,000 | $16,000 |

Miro's tax rate is 40%.

Which of the following statements is correct?

a. There should be no reduction in Miro's deferred tax liability.
b. There should be no increase in Miro's deferred tax asset.
c. Miro's deferred tax asset should be reduced by $7,200 in 20X2.
d. Miro's deferred tax asset should be increased by $7,200 in 20X2.

**CPA-04683 Explanation**
Choice "b" is correct. Miro's deferred tax asset will not increase. Miro will continue to have a deferred tax asset that will decrease on a straight-line basis over the life of the asset. The change in depreciation method represents a change in accounting estimate inseparable from a change in accounting principle. The change from the double-declining balance method of depreciation for financial statement purposes to the straight-line method consistent with it tax treatment will be treated prospectively. At the beginning of 20X2, Miro will have a financial statement net book value of $190,000 and a tax basis of $208,000. Book depreciation of $14,615 will be consistently less than tax depreciation of $16,000, which will result in an annual decrease of the deferred tax asset.

Choice "a" is incorrect. Miro does not have a deferred tax liability. The question indicates that accelerated depreciation is used for financial statement purposes and straight-line depreciation is used for tax purposes. Therefore, the tax expense reported on the tax returns has been less than the depreciation expense reported on the books, and this resulted in a deferred tax asset (note: the tax returns will eventually report higher expense than book and reduce the deferred tax asset).

Choice "c" is incorrect. The reduction of the deferred tax asset by the balance that would have accumulated by the end of 20X1 ({(30,000 + 20,000) - (16,000 + 16,000)} x 40%= $7,200) assumes that the cumulative affect of a change in depreciation method is recorded in the year of the change and results in reversal of the deferred tax asset. Changes in depreciation method are handled prospectively. No immediate reversal of the asset account would be recorded.

Choice "d" is incorrect. The deferred tax asset would not increase by any amount.

**Supplemental Questions**

**CPA-00873 Type1 M/C A-D Corr Ans: B PM#1 F 6-99**

94. CPA-00873 May 90 #23 Page 8

Interest cost included in the net pension cost recognized for a period by an employer sponsoring a defined benefit pension plan represents the:

a. Shortage between the expected and actual returns on plan assets.
b. Increase in the projected benefit obligation due to the passage of time.
c. Increase in the fair value of plan assets due to the passage of time.
d. Amortization of the discount on unrecognized prior service costs.

**CPA-00873 Explanation**
Choice "b" is correct. Interest cost included in the net pension cost recognized for a period by an employer sponsoring a defined benefit pension plan represents the increase in the projected benefit obligation due to the passage of time.

Choice "a" is incorrect. The shortage between the expected and actual returns on plan assets represents a net loss from actual experience different from that assumed.

Choice "c" is incorrect. An increase in the fair value of the plan assets due to the passage of time represents the actual return on plan assets. (It excludes the contributions received and benefit payments made during the period.)

Choice "d" is incorrect. Amortization of the discount on unrecognized prior service costs represents the current period's expense relating to prior service costs (which were not recognized until this period).


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**CPA-00878 Type1 M/C A-D Corr Ans: D PM#2 F 6-99**

95. CPA-00878 Nov 90 II #16 Page 7

The following information pertains to Seda Co.'s pension plan:

| | |
|---|---|
| Actuarial estimate of projected benefit obligation at 1/1/89 | $72,000 |
| Assumed discount rate | 10% |
| Service costs for 1989 | 18,000 |
| Pension benefits paid during 1989 | 15,000 |

If no change in actuarial estimates occurred during 1989, Seda's projected benefit obligation at December 31, 1989 was:

a. $64,200
b. $75,000
c. $79,200
d. $82,200

**CPA-00878 Explanation**
Choice "d" is correct. $82,200 projected benefit obligation at December 31, 1989.

| Hint: Use account analysis format | | Projected benefit obligation |
|---|---|---|
| Balance 1/1/89 | | $72,000 |
| Add: | 10% interest cost (10% x $72,000) | 7,200 |
| | Subtotal | $79,200 |
| Add: | Current year (1989) service costs | 18,000 |
| Less: | Pension benefits paid during the year (1989) | (15,000) |
| Balance 12/31/89 | | $82,200 **D** |

**CPA-00884 Type1 M/C A-D Corr Ans: B PM#3 F 6-99**

96. CPA-00884 Nov 91 #30 Page 20

Which of the following defined benefit pension plan disclosures should be made in a company's financial statements?

I. The funded status of the plan.
II. The amount of net periodic pension cost for the period.
III. The fair value of plan assets.

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

**CPA-00884 Explanation**
Choice "b" is correct. I, II, and III.

Defined benefit pension plan disclosures should be made in a company's financial statements of the following:

I. The funded status of the plan (now shown on the face of the balance sheet).
II. The amount of net periodic pension cost for the period.
III. The fair value of plan assets.

**CPA-00885 Type1 M/C A-D Corr Ans: C PM#4 F 6-99**


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97. CPA-00885 Nov 91 I #23 Page 12

On June 1, 1988, Ward Corp. established a defined benefit pension plan for its employees. The following information was available at May 31, 1990:

| | |
|---|---|
| Projected benefit obligation | $14,500,000 |
| Accumulated benefit obligation | 12,000,000 |
| Unfunded accrued pension cost | 200,000 |
| Plan assets at fair market value | 7,000,000 |
| Unrecognized prior service cost | 2,550,000 |

What is the funded status of Ward's pension plan at May 31, 1990?

a. $5,000,000 underfunded.
b. $5,000,000 overfunded.
c. $7,500,000 underfunded.
d. $7,500,000 overfunded.

**CPA-00885 Explanation**
Choice "c" is correct. The funded status of the pension plan is the FV of the Plan Assets - PBO = $7,000,000 - $14,500,000 = $(7,500,000). Because the PBO > FV of Plan Assets, this is an underfunded pension plan.

**CPA-00910 Type1 M/C A-D Corr Ans: D PM#5 F 6-99**

98. CPA-00910 Nov 92 #26 Page 9

On July 31, 1991, Tern Co. amended its single employee defined benefit pension plan by granting increased benefits for services provided prior to 1991. This prior service cost will be reflected in the financial statement(s) for:

a. Years before 1991 only.
b. Year 1991 only.
c. Year 1991, and years before and following 1991.
d. Year 1991, and following years only.

**CPA-00910 Explanation**
**Rule:** Prior service costs are the costs of retroactive benefits granted in a plan amendment and/or initiation of a new plan. Unrecognized prior service costs are amortized over future periods benefited.

Choice "d" is correct. Year 1991, and following years only.

Choice "a" is incorrect. No retroactive adjustment is made when a plan amendment is made.

Choice "b" is incorrect. Unrecognized prior service costs are amortized over the periods benefited, not reflected in just one year.

Choice "c" is incorrect. Plan amendments call for prospective treatment; retroactive charges to past periods are not made.

**CPA-00912 Type1 M/C A-D Corr Ans: A PM#6 F 6-99**

99. CPA-00912 Nov 89 I #32 Page 30

On November 10, 1988, a Garry Corp. truck was in an accident with an auto driven by Dacey. On January 10, 1989, Garry received notice of a lawsuit seeking $800,000 in damages for personal injuries suffered by Dacey. Garry Corp.'s counsel believes it is reasonably possible that Dacey will be awarded an estimated amount in the range between $250,000 and $500,000, and that $400,000 is a better estimate of potential liability than any other amount. Garry's accounting year ends on December 31, and the 1988 financial statements were issued on March 6, 1989. What amount of loss should Garry accrue at December 31, 1988?

a. $0


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b. $250,000
c. $400,000
d. $500,000

**CPA-00912 Explanation**
Choice "a" is correct. $0.

**Rule:** Only footnote disclosure is required for a "reasonably possible" (not "probable") loss.

The disclosure should include the range of $250,000 - $500,000 and indicate that the best estimate is $400,000.

Choices "b", "c", and "d" are incorrect. No amount should be accrued for losses which are only "reasonably possible."

**CPA-00913 Type1 M/C A-D Corr Ans: C PM#7 F 6-99**

100. CPA-00913 May 90 I #60 Page 29

On November 25, 1989, an explosion occurred at a Rex Co. plant causing extensive property damage to area buildings. By March 10, 1990, claims had been asserted against Rex. Rex's management and counsel concluded that it is probable Rex will be responsible for damages, and that $3,500,000 would be a reasonable estimate of its liability. Rex's $10,000,000 comprehensive public liability policy has a $500,000 deductible clause. Rex's December 31, 1989 financial statements, issued on March 25, 1990, should report this item as:

a. A footnote disclosure only indicating the probable loss of $3,500,000.
b. An accrued liability of $3,500,000.
c. An accrued liability of $500,000.
d. A footnote disclosure only indicating the probable loss of $500,000.

**CPA-00913 Explanation**
Choice "c" is correct. An accrued liability of $500,000 should be reported on the 12-31-89 FS issued on 3-25-90 because the explosion occurred before year-end, the loss was probable, and an amount could be reasonably estimated. However, insurance covers losses in excess of $500,000 and the total policy limit of $10,000,000 exceeds the $3,500,000 estimate; therefore, only the "deductible" of $500,000 need be accrued.

Choice "a" is incorrect. The loss occurred during 1989 and therefore should be accrued as well as disclosed.

Choice "b" is incorrect. All but $500,000 would be covered by insurance and therefore only $500,000 should be accrued.

Choice "d" is incorrect. The $500,000 should be accrued as well as disclosed in the footnotes.

**CPA-00914 Type1 M/C A-D Corr Ans: D PM#8 F 6-99**

101. CPA-00914 May 91 II #15 Page 31

On November 1, 1990, Beni Corp. was awarded a judgment of $1,500,000 in connection with a lawsuit. The decision is being appealed by the defendant, and it is expected that the appeal process will be completed by the end of 1991. Beni's attorney feels that it is highly probable that an award will be upheld on appeal, but that the judgment may be reduced by an estimated 40%. In addition to footnote disclosure, what amount should be reported as a receivable in Beni's balance sheet at December 31, 1990?

a. $1,500,000
b. $900,000
c. $600,000
d. $0


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**CPA-00914 Explanation**
Choice "d" is correct. $0 should be accrued as a receivable at 12/31/90.

**Rule:** Gain contingencies which are reasonably possible (or probable) and for which an amount can be reasonably estimated, should not be "accrued" but should be disclosed in a note to the financial statements in a manner that does not give the impression that realization of a gain is likely.

Gain contingencies should never be accrued in the financial statements.

Choices "a", "b", and "c" are incorrect.

**CPA-00915 Type1 M/C A-D Corr Ans: C PM#9 F 6-99**

102. CPA-00915 May 91 #16 Page 30

A manufacturer of household appliances may incur a loss due to the discovery of a defect in one of its products. The occurrence of the loss is reasonably possible and the resulting costs can be reasonably estimated. This possible loss should be:

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

**CPA-00915 Explanation**
Choice "c" is correct. No accrual, Yes disclosed in footnotes.

**Rule:** Only footnote disclosure is required for a "reasonably possible" (not "probable") loss. The nature of the contingency should be disclosed as well as the nature of the possible loss or range of loss or that an estimate cannot be made.

Choices "a" and "b" are incorrect. No amount should be accrued for losses which are only "reasonably possible."

Choice "d" is incorrect. The contingency should be disclosed in the footnotes.

**CPA-00916 Type1 M/C A-D Corr Ans: B PM#10 F 6-99**

103. CPA-00916 May 92 I #36 Page 30

On January 17, 1991, an explosion occurred at a Sims Co. plant causing extensive property damage to area buildings. Although no claims had yet been asserted against Sims by March 10, 1991, Sims' management and counsel concluded that it is likely that claims will be asserted and that it is reasonably possible Sims will be responsible for damages. Sims' management believed that $1,250,000 would be a reasonable estimate of its liability. Sims' $5,000,000 comprehensive public liability policy has a $250,000 deductible clause. In Sims' December 31, 1990, financial statements, which were issued on March 25, 1991, how should this item be reported?

a. As an accrued liability of $250,000.
b. As a footnote disclosure indicating the possible loss of $250,000.
c. As a footnote disclosure indicating the possible loss of $1,250,000.
d. No footnote disclosure or accrual is necessary.

**CPA-00916 Explanation**
Choice "b" is correct. As a footnote disclosure indicating the possible loss of $250,000.

**Rule:** Only footnote disclosure is required for a "reasonably possible" loss. The nature of the contingency should be disclosed as well as the nature of the possible loss or range of loss. Since insurance appears to be available for the entire loss except the deductible portion, only the possible loss of $250,000 needs to be included in the footnote.


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Note: Even though the explosion occurred (Jan. 17, 1991) after the date of the FS (Dec. 31, 1990) disclosure is still required since the statements had not yet been issued.

Choice "a" is incorrect. No accrual since the loss occurred on Jan. 17, 1991 (after the date of the Dec. 31, 1990 FS), and the loss is not probable but rather reasonably possible.

**CPA-00917 Type1 M/C A-D Corr Ans: A PM#11 F 6-99**

104. CPA-00917 Nov 92 II #53 Page 31

During January 1992, Haze Corp. won a litigation award for $15,000, which was tripled to $45,000 to include punitive damages. The defendant, who is financially stable, has appealed only the $30,000 punitive damages. Haze was awarded $50,000 in an unrelated suit it filed, which is being appealed by the defendant. Counsel is unable to estimate the outcome of these appeals. In its 1992 financial statements, Haze should report what amount of pretax gain?

a. $15,000
b. $45,000
c. $50,000
d. $95,000

**CPA-00917 Explanation**
**Rule:** "Gain contingencies" should not be "accrued" but should be disclosed in a note to the financial statements in a manner that does not give the impression that realization of a gain is likely.

The only amount, which is no longer a contingency, is the $15,000 awarded in litigation, which is not being appealed. This should be accrued as pretax gain (income) (and as a receivable).

Choice "a" is correct. $15,000 pretax gain.

**CPA-00918 Type1 M/C A-D Corr Ans: B PM#12 F 6-99**

105. CPA-00918 Nov 92 #17 Page 29

Invern, Inc. has a self-insurance plan. Each year, retained earnings is appropriated for contingencies in an amount equal to insurance premiums saved less recognized losses from lawsuits and other claims. As a result of a 1991 accident, Invern is a defendant in a lawsuit in which it will probably have to pay damages of $190,000. What are the effects of this lawsuit's probable outcome on Invern's 1991 financial statements?

a. An increase in expenses and no effect on liabilities.
b. An increase in both expenses and liabilities.
c. No effect on expenses and an increase in liabilities.
d. No effect on either expenses or liabilities.

**CPA-00918 Explanation**
Choice "b" is correct. An increase in both expenses and liabilities would result because the contingency is "probable" and the amount can be "reasonably estimated." As such, the loss would be "accrued," which would result in an increase in expenses and accrued liability of $190,000. The fact that Invern is self-insured would not be a factor.

Choices "a", "c", and "d" are incorrect, as both expenses and liabilities would increase.

**CPA-00919 Type1 M/C A-D Corr Ans: C PM#13 F 6-99**

106. CPA-00919 May 94 #11 Page 29

Brite Corp. had the following liabilities at December 31, 1993:

| | |
|---|---|
| Accounts payable | $ 55,000 |
| Unsecured notes, 8%, due 7-1-94 | 400,000 |


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| | |
|---|---|
| Accrued expenses | 35,000 |
| Contingent liability | 450,000 |
| Deferred income tax liability | 25,000 |
| Senior bonds, 7%, due 3-31-94 | 1,000,000 |

The contingent liability is an accrual for possible losses on a $1,000,000 lawsuit filed against Brite. Brite's legal counsel expects the suit to be settled in 1995, and has estimated that Brite will be liable for damages in the range of $450,000 to $750,000.

The deferred income tax liability is not related to an asset or liability for financial reporting and is expected to reverse in 1995.

What amount should Brite report in its December 31, 1993, balance sheet for current liabilities?

a. $515,000
b. $940,000
c. $1,490,000
d. $1,515,000

**CPA-00919 Explanation**

| | |
|---|---|
| Accounts payable | $ 55,000 |
| Unsecured notes 8% due 7-1-94 | 400,000 |
| Accrued expenses | 35,000 |
| Senior bonds 7% due 3-31-94 | 1,000,000 |
| Total current liabilities | $1,490,000 |

Choice "c" is correct. $1,490,000 current liabilities.

**Rules:** Current liabilities should include only those liabilities which are due within the next operating cycle (normally the next year).

A contingent liability should be accrued only if it is probable and the amount can be reasonably estimated. If only a range can be estimated, use the most likely amount, or at least the minimum of the range.

This would be the $450,000, except it would be a long-term liability and not current since it is not expected to settle until 1995.

The deferred income tax liability is not current as it is not expected to reverse until 1995.

**CPA-00920 Type1 M/C A-D Corr Ans: A PM#14 F 6-99**

107. CPA-00920 Nov 95 #3 Page 31

What is the underlying concept governing the generally accepted accounting principles pertaining to recording gain contingencies?

a. Conservatism.
b. Relevance.
c. Consistency.
d. Reliability.

**CPA-00920 Explanation**

**Rule:** Contingencies that might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization. The accounting concept of conservatism applies: "anticipate all losses but not gains."

Choice "a" is correct. Conservatism.

Choices "b", "c", and "d" are incorrect, per above.

**CPA-00923 Type1 M/C A-D Corr Ans: D PM#15 F 6-99**

108. CPA-00923 May 92 I #35 Page 52


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During 1990, Gum Co. introduced a new product carrying a two-year warranty against defects. The estimated warranty costs related to dollar sales are 2% within 12 months following the sale and 4% in the second 12 months following the sale. Sales and actual warranty expenditures for the years ended December 31, 1990 and 1991, are as follows:

| | *Sales* | *Actual warranty expenditures* |
|---|---|---|
| 1990 | $150,000 | $2,250 |
| 1991 | 250,000 | 7,500 |
| | $400,000 | $9,750 |

What amount should Gum report as estimated warranty liability in its December 31, 1991, balance sheet?

a. $2,500
b. $4,250
c. $11,250
d. $14,250

**CPA-00923 Explanation**
Choice "d" is correct. $14,250

| | Sales | Warranty Liability | | | | Total |
|---|---|---|---|---|---|---|
| | | Yr of sale 2% | | Yr after 4% | | |
| 1990 | 150,000 | 3,000 | + | 6,000 | = | 9,000 |
| 1991 | 250,000 | 5,000 | + | 10,000 | = | 15,000 |
| Total estimated warranty | | | | | | 24,000 |
| Less: Actual warranty expenditures | | | | | | 9,750 |
| Estimated warranty liability 12-31-91 | | | | | | 14,250 |

**CPA-00925 Type1 M/C A-D Corr Ans: B PM#16 F 6-99**

109. CPA-00925 May 92 II #15 Page 54

The following information pertains to Rik Co.'s two employees:

| Name | Weekly salary | Number of weeks worked in 1991 | Vacation rights vest or accumulate |
|---|---|---|---|
| Ryan | $800 | 52 | Yes |
| Todd | $600 | 52 | No |

Neither Ryan nor Todd took the usual two-week vacation in 1991. In Rik's December 31, 1991, financial statements, what amount of vacation expense and liability should be reported?

a. $2,800
b. $1,600
c. $1,400
d. $0

**CPA-00925 Explanation**
Choice "b" is correct. $1,600 of vested/accumulated vacation expense and liability should be reported in the Dec. 31, 1991 FS (for Ryan who is vested; but not for Todd who is not vested).

**Rule:** Employees' compensation for future absences should be accrued if:

1. Services are already rendered and
2. The amount can be reasonably estimated and
3. The obligation relates to vested or accumulated rights and
4. Payment of the compensation is probable.


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**CPA-00937 Type1 M/C A-D Corr Ans: A PM#17 F 6-99**

110. CPA-00937 Nov 92 I #24 Page 31

Case Cereal Co. frequently distributes coupons to promote new products. On October 1, 1991, Case mailed 1,000,000 coupons for $.45 off each box of cereal purchased. Case expects 120,000 of these coupons to be redeemed before the December 31, 1991, expiration date. It takes 30 days from the redemption date for Case to receive the coupons from the retailers. Case reimburses the retailers an additional $.05 for each coupon redeemed. As of December 31, 1991, Case had paid retailers $25,000 related to these coupons and had 50,000 coupons on hand that had not been processed for payment. What amount should Case report as a liability for coupons in its December 31, 1991, balance sheet?

a. $35,000
b. $29,000
c. $25,000
d. $22,500

**CPA-00937 Explanation**
Choice "a" is correct. $35,000.

Total liability for coupon redemptions:

| | |
|---|---|
| 120,000 x (.45 + .05) | $60,000 |
| Amount paid to date | <25,000> |
| Liability at 12/31/91 | $35,000 **A** |

**CPA-00939 Type1 M/C A-D Corr Ans: B PM#18 F 6-99**

111. CPA-00939 Nov 92 I #58 Page 54

On January 1, 1991, Baker Co. decided to grant its employee's 10 vacation days and five sick days each year. Neither vacation days nor sick days vest. Sick days may not be carried over to the next year. Each employee took an average of three sick days in 1991. During 1991, each of Baker's six employees earned $100 per day and earned 10 vacation days. Any earned but unused vacation days may be carried over to the following year. These vacation days were taken during 1992.

What amount should Baker accrue as compensated absence liability as of December 31, 1991?

a. $0
b. $6,000
c. $7,200
d. $9,000

**CPA-00939 Explanation**
Choice "b" is correct. $6,000.

Vacation days earned: 6 employees x 10 days x $100 $6,000

**Vacation pay is accrued if it vests or accumulates. Sick pay is accrued only if it vests.**

**CPA-00942 Type1 M/C A-D Corr Ans: B PM#19 F 6-99**

112. CPA-00942 Nov 92 #7 Page 31

In June 1992, Northan Retailers sold refundable merchandise coupons. Northan received $10 for each coupon redeemable from July 1 to December 31, 1992, for merchandise with a retail price of $11. At June 30, 1992, how should Northan report these coupon transactions?

a. Unearned revenues at the merchandise's retail price.
b. Unearned revenues at the cash received amount.
c. Revenues at the merchandise's retail price.
d. Revenues at the cash received amount.


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**CPA-00942 Explanation**
Choice "b" is correct. Unearned revenue at the coupon sales price (the cash received amount). It is unearned because the revenue is earned when the coupons are redeemed and the cost of the merchandise is matched with the recognition of revenue. The transaction is recorded at the cash received amount (coupon sales price), because it is more objective than the retail price of the merchandise for which it can be exchanged.

Choice "a" is incorrect. Cash received for the coupon (the sales price of the coupon) is more objective than retail price of the merchandise the coupon will buy.

Choice "c" is incorrect. Revenue cannot be recognized until the merchandise is traded for the coupons and the related expense incurred.

Choice "d" is incorrect. Revenue cannot be recognized until the merchandise is traded for the coupons and the related expense is incurred and "matched."

**CPA-00946 Type1 M/C A-D Corr Ans: C PM#20 F 6-99**

113. CPA-00946 Nov 92 #25 Page 54

At December 31, 1991, Taos Co. estimates that its employees have earned vacation pay of $100,000. Employees will receive their vacation pay in 1992. Should Taos accrue a liability at December 31, 1991, if the rights to this compensation accumulated over time or if the rights are vested?

| | *Accumulated* | *Vested* |
|---|---|---|
| a. | Yes | No |
| b. | No | No |
| c. | Yes | Yes |
| d. | No | Yes |

**CPA-00946 Explanation**
Choice "c" is correct. Yes - Yes. All four conditions above have been met.

**Rule:** Employees' compensation for future absences (mostly vacation) should be accrued if:

1. Services have already been rendered, and
2. The obligation relates to vested or accumulated rights, and
3. The amount can be reasonably estimated, and
4. Payment is probable.

Choice "a" is incorrect. Since the rights have vested.

Choice "b" is incorrect. Since both the rights have accumulated over time and vested.

Choice "d" is incorrect. Since the rights have accumulated over time.

**CPA-00949 Type1 M/C A-D Corr Ans: D PM#21 F 6-99**

114. CPA-00949 May 93 I #30 Page 54

North Corp. has an employee benefit plan for compensated absences that gives employees 10 paid vacation days and 10 paid sick days. Both vacation and sick days can be carried over indefinitely. Employees can elect to receive payment in lieu of vacation days; however, no payment is given for sick days not taken. At December 31, 1992, North's unadjusted balance of liability for compensated absences was $21,000. North estimated that there were 150 vacation days and 75 sick days available at December 31, 1992. North's employees earn an average of $100 per day. In its December 31, 1992, balance sheet, what amount of liability for compensated absences is North required to report?

a. $36,000
b. $22,500
c. $21,000


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d. $15,000

**CPA-00949 Explanation**
Choice "d" is correct. $15,000 liability for compensated absences.

150 vacation days × $100 per day = $15,000

**Rule:** Accrued compensated absences generally include "vacation pay" but not "sick pay." Sick pay usually (and in this fact situation) does not vest.

Note: The $21,000 unadjusted balance on the books is a "distractor."

**CPA-00952 Type1 M/C A-D Corr Ans: D PM#22 F 6-99**

115. CPA-00952 Nov 93 I #28 Page 54

Ross Co. pays all salaried employees on a Monday for the five-day workweek ended the previous Friday. The last payroll recorded for the year ended December 31, 1992, was for the week ended December 25, 1992. The payroll for the week ended January 1, 1993, included regular weekly salaries of $80,000 and vacation pay of $25,000 for vacation time earned in 1992 not taken by December 31, 1992. Ross had accrued a liability of $20,000 for vacation pay at December 31, 1991. In its December 31, 1992, balance sheet, what amount should Ross report as accrued salary and vacation pay?

a. $64,000
b. $68,000
c. $69,000
d. $89,000

**CPA-00952 Explanation**

| | |
|---|---|
| Payroll for the week ended Friday 1/1/93 | $80,000 |
| Less: One day (1/1/93) not in 1992 ($80,000 × 1/5) | (16,000) |
| Net salary accrual at 12/31/92 | 64,000 |
| Vacation pay earned in 1992 not taken by 12/31/92 | 25,000 |
| Accrued salary and vacation pay at 12/31/92 | $89,000 **D** |

Choice "d" is correct. $89,000 accrued salary and vacation pay at 12/31/92.

Note: It must be assumed that the $20,000 vacation pay accrued at 12/31/91 was taken in 1992.

**CPA-00953 Type1 M/C A-D Corr Ans: B PM#23 F 6-99**

116. CPA-00953 Nov 93 T #28 Page 54

If the payment of employees' compensation for future absences is probable, the amount can be reasonably estimated, and the obligation relates to rights that accumulate, the compensation should be:

a. Accrued if attributable to employees' services not already rendered.
b. Accrued if attributable to employees' services already rendered.
c. Accrued if attributable to employees' services whether already rendered or not.
d. Recognized when paid.

**CPA-00953 Explanation**
Choice "b" is correct. Employees compensation for future absences should be accrued if:

1. The employees' right to receive compensation is attributable to services already rendered.
2. The liability relates to vested or accumulated rights.
3. Payment is probable.
4. The amount can be reasonably estimated.

Choice "a" is incorrect. Services must be rendered.

Choice "c" is incorrect. Services must be rendered.


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Choice "d" is incorrect. Cash basis is not acceptable.

**CPA-00957 Type1 M/C A-D Corr Ans: A PM#24 F 6-99**

117. CPA-00957 May 95 #21 Page 52

In December 1994, Mill Co. began including one coupon in each package of candy that it sells and offering a toy in exchange for 50 cents and five coupons. The toys cost Mill 80 cents each. Eventually 60% of the coupons will be redeemed. During December, Mill sold 110,000 packages of candy and no coupons were redeemed. In its December 31, 1994, balance sheet, what amount should Mill report as estimated liability for coupons?

a. $3,960
b. $10,560
c. $19,800
d. $52,800

**CPA-00957 Explanation**

| | |
|---|---|
| Sales of candy packages | 110,000 |
| Redemption rate | x 60% |
| Coupons expected to be redeemed | 66,000 |
| Less redemptions | (0) |
| Estimate of unredeemed coupons 12/31/94 | 66,000 |
| Divide by 5 coupons per toy | ÷ 5 |
| Toys to be redeemed | 13,200 |
| Net cost of toy (cost 80¢ - 50¢ received) | $ .30 |
| Estimated liability for coupons | $ 3,960+ |

Choice "a" is correct. $3,960 estimated liability for coupons at Dec 31, 1994.

**CPA-00963 Type1 M/C A-D Corr Ans: B PM#25 F 6-99**

118. CPA-00963 Nov 89 II #20 Page 53

Beck, the active partner in Beck & Cris, receives an annual bonus of 25% of partnership net income after deducting the bonus. For the year ended December 31, 1988, partnership net income before the bonus amounted to $300,000. Becks 1988 bonus should be:

a. $56,250
b. $60,000
c. $62,500
d. $75,000

**CPA-00963 Explanation**

Choice "b" is correct. $60,000


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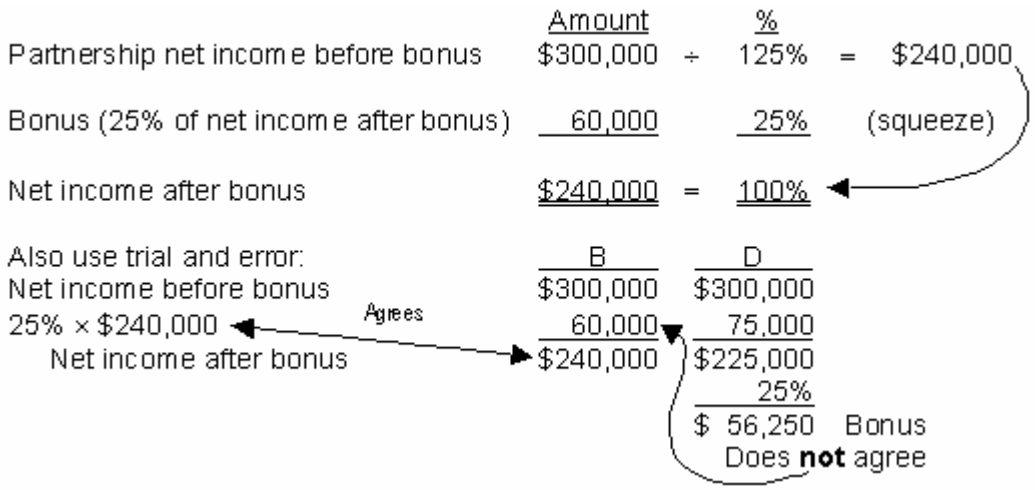


**CPA-00984 Type1 M/C A-D Corr Ans: B PM#26 F 6-99**

119. CPA-00984 Nov 94 #48 Page 53

Able Co. provides an incentive compensation plan under which its president receives a bonus equal to 10% of the corporation's income before income tax but after deduction of the bonus. If the tax rate is 40% and net income after bonus and income tax was $360,000, what was the amount of the bonus?

a. $36,000
b. $60,000
c. $66,000
d. $90,000

**CPA-00984 Explanation**
Choice "b" is correct. $60,000 bonus.

Step 1 - Determine pre-tax income

After tax income - $360,000 (after bonus & income tax)
Pre-tax income - $360,000 ÷ 60%
Pre-tax income - 600,000 after deduction for bonus

Step 2 - Determine bonus

Bonus = Pre-tax income after deduction for bonus x 10%
Bonus = $600,000 x 10%
Bonus = $60,000

**CPA-00991 Type1 M/C A-D Corr Ans: C PM#27 F 6-99**

120. CPA-00991 May 90 I #30 Page 28

Marr Co. sells its products in reusable containers. The customer is charged a deposit for each container delivered and receives a refund for each container returned within two years after the year of delivery. Marr accounts for the containers not returned within the time limit as being retired by sale at the deposit amount. Information for 1989 is as follows:

Container deposits at December 31, 1988 from deliveries in:

| | | |
|---|---|---|
| 1987 | $150,000 | |
| 1988 | 430,000 | $580,000 |

Deposits for containers delivered in 1989 780,000
Deposits for containers returned in 1989 from deliveries in:


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| | | |
|---|---|---|
| 1987 | $ 90,000 | |
| 1988 | 250,000 | |
| 1989 | 286,000 | 626,000 |

In Marr's December 31, 1989 balance sheet, the liability for deposits on returnable containers should be:

a. $494,000
b. $584,000
c. $674,000
d. $734,000

**CPA-00991 Explanation**
Choice "c" is correct. $674,000 liability for deposits on returnable containers at Dec. 31, 1989.

| Year | Deposits | | Less Returned | | Bal | Expired | | Liab |
|---|---|---|---|---|---|---|---|---|
| 1987 | 150,000 | - | 90,000 | = | 60,000 | (60,000) | = | 0 |
| 1988 | 430,000 | - | 250,000 | = | 180,000 | -----> | | 180,000 |
| 1989 | 780,000 | - | 286,000 | = | 494,000 | -----> | | 494,000 |
| Liability Dec. 31, 1989 | | | | | | | | $674,000 |

Or alternatively: Activity by Year of Delivery

| | 1987 | 1988 | 1989 | | Combined |
|---|---|---|---|---|---|
| Bal Dec. 31, 1988 | 150,000 | 430,000 | -- | = | 580,000 |
| Add deposits in 1989 | -- | -- | 780,000 | = | 780,000 |
| Subtotal | 150,000 | 430,000 | 780,000 | = | 1,360,000 |
| Less returns in 1989 | (90,000) | (250,000) | (286,000) | = | (626,000) |
| Less containers not returned | (60,000) | -- | -- | = | (60,000) |
| Bal Dec. 31, 1989 | 0 | 180,000 | +494,000 | = | 674,000 |

**CPA-01016 Type1 M/C A-D Corr Ans: C PM#28 F 6-99**

121. CPA-01016 Nov 90 I #28 Page 31

Dunn Trading Stamp Co. records stamp service revenue and provides for the cost of redemptions in the year stamps are sold to licensees. Dunn's past experience indicates that only 80% of the stamps sold to licensees will be redeemed. Dunn's liability for stamp redemptions was $6,000,000 at December 31, 1988. Additional information for 1989 is as follows:

| | |
|---|---|
| Stamp service revenue from stamps sold to licensees | $4,000,000 |
| Cost of redemptions (stamps sold prior to 1/1/89) | 2,750,000 |

If all the stamps sold in 1989 were presented for redemption in 1990, the redemption cost would be $2,250,000. What amount should Dunn report as a liability for stamp redemptions at December 31, 1989?

a. $7,250,000
b. $5,500,000
c. $5,050,000
d. $3,250,000

**CPA-01016 Explanation**
Choice "c" is correct. $5,050,000 liability for stamp redemptions at 12/31/89.

| | Liab for Stamp Redemptions |
|---|---|
| Begin balance 12/31/88 | $6,000,000 |
| Add: Redemption cost of 1989 sales ($2,250,000 × 80%) | 1,800,000 |
| | 7,800,000 |


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| | |
|---|---|
| Less: Cost of redeeming prior year's sales | (2,750,000) |
| Ending balance 12/31/89 | $5,050,000 |

**CPA-01034 Type1 M/C A-D Corr Ans: D PM#29 F 6-99**

122. CPA-01034 Nov 91 I #39 Page 54

East Corp. manufactures stereo systems that carry a two-year warranty against defects. Based on past experience, warranty costs are estimated at 4% of sales for the warranty period. During 1990, stereo system sales totaled $3,000,000, and warranty costs of $67,500 were incurred. In its income statement for the year ended December 31, 1990, East should report warranty expense of:

a. $52,500
b. $60,000
c. $67,500
d. $120,000

**CPA-01034 Explanation**
Choice "d" is correct. $120,000 warranty expense for the year ended 12-31-90.

| | |
|---|---|
| Sales during 1990 | $3,000,000 |
| Warranty cost estimate rate | x 4% |
| Warranty expense for 1990 | 120,000 |
| Warranty costs incurred during 1990 | (67,500) |
| Liability for warranty cost | $ 52,500 |

**CPA-01037 Type1 M/C A-D Corr Ans: C PM#30 F 6-99**

123. CPA-01037 Nov 92 I #29 Page 53

Toddler Care Co. offers three payment plans on its 12-month contracts. Information on the three plans and the number of children enrolled in each plan for the September 1, 1991, through August 31, 1992, contract year follows:

| *Plan* | *Initial payment per child* | *Monthly fees per child* | *Number of children* |
|---|---|---|---|
| #1 | $500 | $- | 15 |
| #2 | 200 | 30 | 12 |
| #3 | - | 50 | 9 |
| | | | 36 |

Toddler received $9,900 of initial payments on September 1, 1991, and $3,240 of monthly fees during the period September 1 through December 31, 1991. In its December 31, 1991, balance sheet, what amount should Toddler report as deferred revenues?

a. $3,300
b. $4,380
c. $6,600
d. $9,900

**CPA-01037 Explanation**
Choice "c" is correct. $6,600.

| | |
|---|---|
| Initial yearly payments received 9-1-91 | $9,900 |
| Unearned portion (1/1/92 - 8/31/92) | x 8/12 |
| Deferred revenue at 12/31/91 | $6,600 |

Note: Monthly fees are earned in the same month they are received.

**CPA-04362 Type1 M/C A-K Corr Ans: G PM#31 F 6-99**


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124. CPA-04362 PI May 93 #4(a) 1 Page 3

The following information pertains to Sparta Co.'s defined benefit pension plan.

| | |
|---|---|
| Discount rate | 8% |
| Expected rate of return | 10% |
| Average service life | 12 years |

At January 1, 1992:

| | |
|---|---|
| Projected benefit obligation | $600,000 |
| Fair value of pension plan assets | 720,000 |
| Unrecognized prior service cost | 240,000 |
| Unamortized pension gain | 96,000 |

At December 31, 1992:

| | |
|---|---|
| Projected benefit obligation | 910,000 |
| Fair value of pension plan assets | 825,000 |

Service cost for 1992 was $90,000. There were no contributions made or benefits paid during the year. Sparta uses the straight-line method of amortization over the maximum period permitted.

Calculate the amount to be recognized as a component of Sparta's net periodic pension cost at December 31, 1992.

Amount to Be Calculated:

- Interest cost.

A. $1,000
B. $2,000
C. $5,000
D. $10,000
E. $20,000
F. $45,000
G. $48,000
H. $72,000
I. $75,000
J. $100,000
K. $105,000

**CPA-04362 Explanation**
**Choice "G" is correct. $48,000** ($600,000 x 8%).

**CPA-04363 Type1 M/C A-K Corr Ans: H PM#32 F 6-99**

125. CPA-04363 PI May 93 #4(a) 2 Page 3

The following information pertains to Sparta Co.'s defined benefit pension plan.

| | |
|---|---|
| Discount rate | 8% |
| Expected rate of return | 10% |
| Average service life | 12 years |

At January 1, 1992:

| | |
|---|---|
| Projected benefit obligation | $600,000 |
| Fair value of pension plan assets | 720,000 |
| Unrecognized prior service cost | 240,000 |
| Unamortized pension gain | 96,000 |

At December 31, 1992:

| | |
|---|---|
| Projected benefit obligation | 910,000 |


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| | |
|---|---|
| Fair value of pension plan assets | 825,000 |

Service cost for 1992 was $90,000. There were no contributions made or benefits paid during the year. Sparta uses the straight-line method of amortization over the maximum period permitted.

Calculate the amount to be recognized as a component of Sparta's net periodic pension cost at December 31, 1992.

Amount to Be Calculated:

- Expected return on plan assets.

A. $1,000
B. $2,000
C. $5,000
D. $10,000
E. $20,000
F. $45,000
G. $48,000
H. $72,000
I. $75,000
J. $100,000
K. $105,000

**CPA-04363 Explanation**
**Choice "H" is correct. $72,000** (10% x $720,000).

**CPA-04364 Type1 M/C A-K Corr Ans: K PM#33 F 6-99**

126. CPA-04364 PI May 93 #4(a) 3 Page 3

The following information pertains to Sparta Co.'s defined benefit pension plan.

| | |
|---|---|
| Discount rate | 8% |
| Expected rate of return | 10% |
| Average service life | 12 years |

At January 1, 1992:

| | |
|---|---|
| Projected benefit obligation | $600,000 |
| Fair value of pension plan assets | 720,000 |
| Unrecognized prior service cost | 240,000 |
| Unamortized pension gain | 96,000 |

At December 31, 1992:

| | |
|---|---|
| Projected benefit obligation | 910,000 |
| Fair value of pension plan assets | 825,000 |

Service cost for 1992 was $90,000. There were no contributions made or benefits paid during the year. Sparta uses the straight-line method of amortization over the maximum period permitted.

Amount to Be Calculated:

- Actual return on plan assets.

A. $1,000
B. $2,000
C. $5,000
D. $10,000
E. $20,000
F. $45,000
G. $48,000


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H. $72,000
I. $75,000
J. $100,000
K. $105,000

**CPA-04364 Explanation**
**Choice "K" is correct. $105,000** ($825,000 - $720,000).

**CPA-04366 Type1 M/C A-K Corr Ans: E PM#34 F 6-99**

127. CPA-04366 PI May 93 #4(a) 4 Page 3

The following information pertains to Sparta Co.'s defined benefit pension plan.

| | |
|---|---|
| Discount rate | 8% |
| Expected rate of return | 10% |
| Average service life | 12 years |

At January 1, 1992:

| | |
|---|---|
| Projected benefit obligation | $600,000 |
| Fair value of pension plan assets | 720,000 |
| Unrecognized prior service cost | 240,000 |
| Unamortized pension gain | 96,000 |

At December 31, 1992:

| | |
|---|---|
| Projected benefit obligation | 910,000 |
| Fair value of pension plan assets | 825,000 |

Service cost for 1992 was $90,000. There were no contributions made or benefits paid during the year. Sparta uses the straight-line method of amortization over the maximum period permitted.

Calculate the amount to be recognized as a component of Sparta's net periodic pension cost at December 31, 1992.

Amount to Be Calculated:

- Amortization of prior service costs.

A. $1,000
B. $2,000
C. $5,000
D. $10,000
E. $20,000
F. $45,000
G. $48,000
H. $72,000
I. $75,000
J. $100,000
K. $105,000

**CPA-04366 Explanation**
Choice "E" is correct. $20,000 ($240,000/12). A 15-year life is only applicable to transition costs.

**CPA-04367 Type1 M/C A-K Corr Ans: B PM#35 F 6-99**

128. CPA-04367 PI May 93 #4(a) 5 Page 3

The following information pertains to Sparta Co.'s defined benefit pension plan.

| | |
|---|---|
| Discount rate | 8% |
| Expected rate of return | 10% |


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| | |
|---|---|
| Average service life | 12 years |
| At January 1, 1992: | |
| Projected benefit obligation | $600,000 |
| Fair value of pension plan assets | 720,000 |
| Unrecognized prior service cost | 240,000 |
| Unamortized pension gain | 96,000 |
| At December 31, 1992: | |
| Projected benefit obligation | 910,000 |
| Fair value of pension plan assets | 825,000 |

Service cost for 1992 was $90,000. There were no contributions made or benefits paid during the year. Sparta uses the straight-line method of amortization over the maximum period permitted.

Calculate the amount to be recognized as a component of Sparta's net periodic pension cost at December 31, 1992.

Amount to Be Calculated:

- Minimum amortization of unrecognized pension gain.

A. $1,000
B. $2,000
C. $5,000
D. $10,000
E. $20,000
F. $45,000
G. $48,000
H. $72,000
I. $75,000
J. $100,000
K. $105,000

**CPA-04367 Explanation**
**Choice "B" is correct. $2,000.**

| | | |
|---|---|---|
| 1. | Beginning of year FMV | $720,000 |
| 2. | Beginning of year PBO | $600,000 |
| 3. | Corridor (10% of larger of #1 or 2) | $72,000 |
| 4. | Excess of unamortized prior pension cost over #3 ($96,000 - $72,000) | $24,000 |
| 5. | Amortized over average service life ($24,000/12) | $2,000 |

**CPA-04368 Type1 M/C I,D Corr Ans: D PM#36 F 6-99**

129. CPA-04368 PI May 93 #4(a) 6 Page 3

The following information pertains to Sparta Co.'s defined benefit pension plan.

| | |
|---|---|
| Discount rate | 8% |
| Expected rate of return | 10% |
| Average service life | 12 years |
| At January 1, 1992: | |
| Projected benefit obligation | $600,000 |
| Fair value of pension plan assets | 720,000 |
| Unrecognized prior service cost | 240,000 |
| Unamortized pension gain | 96,000 |
| At December 31, 1992: | |


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| | |
|---|---|
| Projected benefit obligation | 910,000 |
| Fair value of pension plan assets | 825,000 |

Service cost for 1992 was $90,000. There were no contributions made or benefits paid during the year. Sparta uses the straight-line method of amortization over the maximum period permitted.

Determine whether the component increases (I) or decreases (D) the funded status of Sparta's pension plan.

Item to Be Answered:

- Service cost.

D. Decreases.
I. Increases.

**CPA-04368 Explanation**
**Choice "D" is correct.** Service cost increase the PBO and decreases the funded status.

**CPA-04369 Type1 M/C I,D Corr Ans: I PM#37 F 6-99**

130. CPA-04369 PI May 93 #4(a) 7 Page 3

The following information pertains to Sparta Co.'s defined benefit pension plan.

| | |
|---|---|
| Discount rate | 8% |
| Expected rate of return | 10% |
| Average service life | 12 years |

At January 1, 1992:

| | |
|---|---|
| Projected benefit obligation | $600,000 |
| Fair value of pension plan assets | 720,000 |
| Unrecognized prior service cost | 240,000 |
| Unamortized pension gain | 96,000 |

At December 31, 1992:

| | |
|---|---|
| Projected benefit obligation | 910,000 |
| Fair value of pension plan assets | 825,000 |

Service cost for 1992 was $90,000. There were no contributions made or benefits paid during the year. Sparta uses the straight-line method of amortization over the maximum period permitted.

Determine whether the component increases (I) or decreases (D) the funded status of Sparta's pension plan.

Item to Be Answered:

- Excess of actual return on plan assets over expected return on plan assets.

D. Decreases.
I. Increases.

**CPA-04369 Explanation**
**Choice "I" is correct.** The excess of actual over expected return on plan assets is recognized as a component of other comprehensive income (OCI) and recorded as an increase in the funded status of the pension plan:

**DR.** Pension benefit asset/liability
**DR.** Deferred tax exp. - OCI
**CR.** Deferred tax liability
**CR.** OCI


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**CPA-05207 Type1 M/C A-D Corr Ans: B PM#38 F 6-99**

131. CPA-05207 Released 2006 Page 49

Which of the following should be disclosed in a company's financial statements related to deferred taxes?

I. The types and amounts of existing temporary differences.
II. The types and amounts of existing permanent differences.
III. The nature and amount of each type of operating loss and tax credit carryforward.

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

**CPA-05207 Explanation**
Choice "b" is correct. The normal rule for disclosure is to disclose "everything," the more the better. However, every rule has an exception. In this question, one of the options is permanent differences. There are no deferred taxes for permanent differences. So the types and amounts of exiting permanent differences do not have to be disclosed. The types and amounts of temporary differences and the nature and types of operating loss and tax credit carryforwards, however, should be disclosed.

Choice "a" is incorrect. The types and amounts of existing permanent differences are not required disclosures.

Choice "c" is incorrect. The types and amounts of existing permanent differences are not required disclosures.

Choice "d" is incorrect. The types and amounts of existing permanent differences are not required disclosures.

Note that II (permanent differences) is in all three wrong answers.

**CPA-05454 Type1 M/C A-D Corr Ans: B PM#39 F 6-99**

132. CPA-05454 Released 2007 Page 49

Baker Co. sells consumer products that are packaged in boxes. Baker offered an unbreakable glass in exchange for two box tops and $1 as a promotion during the current year. The cost of the glass was $2.00. Baker estimated at the end of the year that it would be probable that 50% of the box tops will be redeemed. Baker sold 100,000 boxes of the product during the current year and 40,000 box tops were redeemed during the year for the glasses. What amount should Baker accrue as an estimated liability at the end of the current year, related to the redemption of box tops?

a. $0
b. $5,000
c. $20,000
d. $25,000

**CPA-05454 Explanation**
Choice "b" is correct. The cost of a premium, such as the unbreakable glass, is charged to expense during the period the related goods are sold. As this is a current year promotion, the expense should be fully recognized in the current year, with a liability recorded at year-end for premiums expected to be redeemed in the next period. This estimated liability is calculated as follows:

| | |
|---|---|
| Total estimated box top redemptions (100,000 boxes sold x 50%) | 50,000 |
| Less: Box tops redeemed | 40,000 |
| Box tops to be redeemed | 10,000 |
| Outstanding premium claims (10,000 / 2 box tops per glass) | 5,000 |
| Estimated liability [5,000 claims x ($2 cost - $1 paid by customer)] | $5,000 |


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Choice "a" is incorrect. As this is a current year promotion, the expense should be fully recognized in the current year, with a liability recorded at year-end for premiums expected to be redeemed in the next period.

Choice "c" is incorrect. This is the cost of the premiums claimed during the current period (40,000 box tops redeemed / 2 box tops per glass x $1 net cost per glass).

Choice "d" is incorrect. This is the estimated total cost of all premiums expected to be redeemed from this offer (100,000 boxes sold x 50% / 2 box tops per glass x $1 net cost per glass). This amount is expensed during the current period, but a liability is recognized only for the amount of unredeemed box tops expected to be redeemed in the next period (see the calculation above).


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# CPA PassMaster Questions–Financial 7
# Export Date: 10/30/08


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**Financial Instruments**

**CPA-00928 Type1 M/C A-D Corr Ans: A PM#1 F 7-01**

1. CPA-00928 FARE R03 #4 Page 5

On November 2, 2001, Platt Co. entered into a 90-day futures contract to purchase 50,000 Swiss francs when the contract quote was $.70. The purchase was for speculation in price movement. The following exchange rates existed during the contract period:

| | *30-day futures* | *Spot rate* |
|---|---|---|
| November 2, 2001 | $.62 | $.63 |
| December 31, 2001 | .65 | .64 |
| January 30, 2002 | .65 | .68 |

What amount should Platt report as foreign currency exchange loss in its income statement for the year ended December 31, 2001?

a. $2,500
b. $3,000
c. $3,500
d. $4,000

**CPA-00928 Explanation**
Choice "a" is correct. Any gain or loss on futures contracts not designated as a hedge is recognized in current income. The loss as of December 31, 2001 is:

| | |
|---|---|
| Contract rate | $.70 |
| 30-day futures rate on 12/31/01 | .65 |
| | .05 × 50,000 SF = $2,500 loss |

The December 31, 2001 30-day futures rate is used since, as of December 31, 2001, 30 days remain in the contract period. If the futures contract were purchased at year-end instead of on November 2, 2001, 5¢ per Swiss franc would have been saved. It would have only cost us 65¢ per Swiss franc instead of our contract rate of 70¢; therefore, 5¢ per Swiss franc was recorded as a loss.

**CPA-00930 Type1 M/C A-D Corr Ans: D PM#3 F 7-01**

2. CPA-00930 FARE C98 #1 Page 3

Fair value disclosure of financial instruments may be made in the:

| | *Body of financial statements* | *Footnotes to financial statements* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | No |
| d. | Yes | Yes |

**CPA-00930 Explanation**
Choice "d" is correct. The fair value of financial instruments may be disclosed in either the body of the financial statements or in the footnotes. If disclosed in the footnotes, one footnote must have a summary table showing the fair values and related carrying values.

**CPA-00931 Type1 M/C A-D Corr Ans: B PM#4 F 7-01**

3. CPA-00931 FARE C98 #2 Page 3

Disclosures about the following kinds of risks are required for most financial instruments.

| *Concentration of credit risk* | *Market risk* |
|---|---|


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

**CPA-00931 Explanation**
Choice "b" is correct. Concentration of credit risk - the risk that the other party to the instrument will not perform - must be disclosed. Disclosure of market risk - the risk of loss from changes in market prices - is encouraged, but not required.

**CPA-00933 Type1 M/C A-D Corr Ans: B PM#5 F 7-01**

4. CPA-00933 FARE C98 #3 Page 3

Which of the following assets are financial instruments?

| | *Investment in bonds* | *Prepaid expenses* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |

**CPA-00933 Explanation**
Choice "b" is correct. An investment in bonds represents a contract with the right to receive cash, usually in the form of both interest and principal, and an obligation to the issuing party to pay cash. Prepaid expenses do not represent a right to receive cash or an ownership interest.

**CPA-00934 Type1 M/C A-D Corr Ans: D PM#6 F 7-01**

5. CPA-00934 FARE C98 #4 Page 3

Which of the following must be disclosed for most financial instruments?

| | *Carrying value* | *Fair value* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | No |
| d. | Yes | Yes |

**CPA-00934 Explanation**
Choice "d" is correct. Both carrying value (amount) and fair value must be disclosed for most financial instruments (when it is practicable to estimate fair value).

**CPA-00936 Type1 M/C A-D Corr Ans: A PM#7 F 7-01**

6. CPA-00936 FARE C98 #5 Page 4

In order for a financial instrument to be a derivative for accounting purposes, the financial instrument must:

I. Have one or more underlyings.
II. Require an initial net investment.

a. I only.
b. II only.
c. Both I and II.
d. Neither I nor II.

**CPA-00936 Explanation**


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Choice "a" is correct. SFAS No.133 defines derivatives for accounting purposes as having one or more underlyings (and one or more notional amounts), and as **not** requiring an initial net investment (or having an initial net investment that is smaller than would be required for other types of similar contracts).

**CPA-00938 Type1 M/C A-D Corr Ans: C PM#8 F 7-01**

7. CPA-00938 FARE C98 #6 Page 4

The determination of the value or settlement amount of a derivative involves a calculation which uses:

I. An underlying.
II. A notional amount.

a. I only.
b. II only.
c. Both I and II.
d. Neither I nor II.

**CPA-00938 Explanation**
Choice "c" is correct. The value or settlement of a derivative is determined by the multiplication (or other arithmetic interaction) of a notional amount and an underlying. For example, a number of shares of stock (the notional amount) times a price per share (the underlying) would give the value or settlement amount of a derivative with those elements.

**CPA-00941 Type1 M/C A-D Corr Ans: B PM#9 F 7-01**

8. CPA-00941 FARE C98 #7 Page 6

On December 31, 199X, the end of its fiscal year, Smarti Company held a derivative instrument which it had acquired for speculative purposes during November, 199X. Since its acquisition the fair value of the derivative had increased materially. On December 31, how should the increase in fair value of the derivative instrument be reported by Smarti in its financial statements?

a. Recognized as a deferred credit until the instrument is settled.
b. Recognized in current net income for 199X.
c. Recognized as a component of other comprehensive income for 199X.
d. Disregarded until the instrument is settled.

**CPA-00941 Explanation**
Choice "b" is correct. Gains (and losses) resulting from the change in fair value of derivatives not held (or issued) for hedging purposes should be recognized in net income in the period during which the fair value changes. To accomplish that, the derivative would be adjusted to its new fair value and a gain or loss recognized in current net income.

Choice "a" is incorrect, because changes in the fair value of derivatives are never recognized as deferred credits (or deferred debits) on the balance sheet.

Choice "c" is incorrect, because derivatives not held (or issued) for hedging purposes are speculative in nature with changes in fair value and the related gain or loss recognized in current net income.

Choice "d" is incorrect, because changes in the fair value of derivatives not held (or issued) for hedging purposes must be recognized in the period in which the fair value changes, not deferred until a later period of settlement.

**CPA-00945 Type1 M/C A-D Corr Ans: C PM#11 F 7-01**

9. CPA-00945 FARE C98 #9 Page 6

Gains and losses from changes in the fair value of a derivative designated and qualified as a fair value hedge should be:


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a. Disregarded until the derivative is settled.
b. Recognized as a deferred debit or deferred credit in the balance sheet until the derivative is settled.
c. Recognized in current net income in the period in which the fair value of the derivative changes.
d. Recognized as a component of other comprehensive income in the period in which the fair value of the derivative changes.

**CPA-00945 Explanation**
Choice "c" is correct. Gains and losses resulting from the change in fair value of derivatives designated and qualified as fair value hedges should be recognized in net income in the period in which the fair value of the derivative changes. Any gain or loss for the period on the hedged item also is recognized in net income. If the hedge is fully effective, the gain or loss on the derivative will exactly offset the loss or gain on the hedged item.

Choices "a", "b", and "d" are incorrect, because gains and losses on fair value hedges must be recognized in current income.

**CPA-00948 Type1 M/C A-D Corr Ans: A PM#12 F 7-01**

10. CPA-00948 FARE C98 #10 Page 5

Qualified derivatives may be used to hedge the cash flow associated with an/a:

| | *Asset* | *Forecasted transaction* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |

**CPA-00948 Explanation**
Choice "a" is correct. A qualified derivative may be used (designated) to hedge exposure to variability in cash flow associated with an asset, liability or a forecasted transaction (but not a firm commitment, which would be a fair value hedge).

**CPA-00951 Type1 M/C A-D Corr Ans: C PM#13 F 7-01**

11. CPA-00951 FARE C98 #11 Page 6

A change in the fair value of a derivative qualified as a cash flow hedge is determined to be either effective in offsetting a change in the hedged item or ineffective in offsetting such a change. How should the effective and ineffective portions of the change in value of a derivative which qualifies as a cash flow hedge be reported in financial statements?

| | *Effective portion in* | *Ineffective portion in* |
|---|---|---|
| a. | Current income | Current income |
| b. | Current income | Other comprehensive income |
| c. | Other comprehensive income | Current income |
| d. | Other comprehensive income | Other comprehensive income |

**CPA-00951 Explanation**
Choice "c" is correct. Changes in (gains and losses on) the effective portion of a cash flow hedge are deferred and reported in "other comprehensive income;" changes in the ineffective portion are reported in current income. Gains and losses which are deferred and reported in "other comprehensive income" must be reclassified and recognized in income in the period(s) in which the hedged item affects income.

**CPA-00954 Type1 M/C A-D Corr Ans: C PM#14 F 7-01**


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12. CPA-00954 FARE R96 #8 Page 4

Which of the following risks are inherent in an interest rate swap agreement?

I. The risk of exchanging a lower interest rate for a higher interest rate.
II. The risk of nonperformance by the counterparty to the agreement.

a. I only.
b. II only.
c. Both I and II.
d. Neither I nor II.

**CPA-00954 Explanation**
Choice "c" is correct. An interest rate swap agreement is a financial instrument that is both a contractual right and a contractual obligation to both parties. Such an agreement has an off-balance-sheet risk of accounting loss resulting from both credit and market risk. Credit risk results from the risk of nonperformance by the counter-party to the agreement (option II). Market risk is the risk of exchanging a lower interest rate for a higher interest rate (option I). Thus, both risks I and II are inherent in interest rate swap agreements. SFAS 108.42, .45

Choice "a" is incorrect. An interest rate swap agreement is subject to more than just the risk of exchanging a lower interest rate for a higher interest rate.

Choice "b" is incorrect. An interest rate swap agreement is subject to more than just the risk of nonperformance by the counter-party to the agreement.

Choice "d" is incorrect. An interest rate swap agreement is subject to both types of risk.

**CPA-00958 Type1 M/C A-D Corr Ans: C PM#15 F 7-01**

13. CPA-00958 FARE R96 #9 Page 3

If it is **not** practicable for an entity to estimate the fair value of a financial instrument, which of the following should be disclosed?

I. Information pertinent to estimating the fair value of the financial instrument.
II. The reasons it is not practicable to estimate fair value.

a. I only.
b. II only.
c. Both I and II.
d. Neither I nor II.

**CPA-00958 Explanation**
Choice "c" is correct. According to SFAS 109, in the event that it is not practicable for an entity to estimate the fair value of a financial instrument, both the information pertinent to estimating the fair value of the financial instrument and the reasons it is not practicable to estimate fair value. SFAS 109.14

Choice "a" is incorrect. In the event that it is not practicable for an entity to estimate the fair value of a financial instrument, it is not sufficient to disclose merely the information pertinent to estimating the fair value of the financial instrument.

Choice "b" is incorrect. In the event that it is not practicable for an entity to estimate the fair value of a financial instrument, it is not sufficient to disclose merely the reasons it is not practicable to estimate fair value.

Choice "d" is incorrect. In the event that it is not practicable for an entity to estimate the fair value of a financial instrument, specific disclosure is required.

**CPA-00965 Type1 M/C A-D Corr Ans: A PM#16 F 7-01**

14. CPA-00965 FARE May 95 #4 Page 3


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Disclosure of information about significant concentrations of credit risk is required for:

a. All financial instruments.
b. Financial instruments with off-balance-sheet credit risk only.
c. Financial instruments with off-balance-sheet market risk only.
d. Financial instruments with off-balance-sheet risk of accounting loss only.

**CPA-00965 Explanation**
Choice "a" is correct. An entity should disclose all significant concentrations of credit risk arising from all financial instruments. SFAS 105 para. 20

**CPA-04658 Type1 M/C A-D Corr Ans: B PM#17 F 7-01**

15. CPA-04658 Released 2005 Page 3

Where in its financial statements should a company disclose information about its concentration of credit risks?

a. No disclosure is required.
b. The notes to the financial statements.
c. Supplementary information to the financial statements.
d. Management's report to shareholders.

**CPA-04658 Explanation**
Choice "b" is correct. Concentration of credit risk is required disclosure in the notes to the Financial Statements.

Choice "a" is incorrect. Disclosure of concentration of credit risk is required.

Choice "c" is incorrect. Disclosure is in the Notes not supplementary information.

Choice "d" is incorrect. Disclosure is in the Notes not in management's report.

**CPA-05221 Type1 M/C A-D Corr Ans: D PM#26 F 7-01**

16. CPA-05221 Released 2006 Page 3

Whether recognized or unrecognized in an entity's financial statements, disclosure of the fair values of the entity's financial instruments is required when:

| | *It is practicable to estimate those values* | *Aggregated fair values are material to the entity* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | No |
| d. | Yes | Yes |

**CPA-05221 Explanation**
Choice "d" is correct. Disclosure of the fair values of an entity's financial instruments is required when it is practicable to estimate those values and when the aggregate fair values are material (materiality is always an issue in disclosure, so the only real criteria here is practicability).

Choice "a" is incorrect. Disclosure of the fair values of an entity's financial instruments is required when it is practicable to estimate those values and when the aggregate fair values are material.

Choice "b" is incorrect. Disclosure of the fair values of an entity's financial instruments is required when it is practicable to estimate those values and when the aggregate fair values are material.

Choice "c" is incorrect. Disclosure of the fair values of an entity's financial instruments is required when it is practicable to estimate those values and when the aggregate fair values are material.


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**CPA-05193 Type1 M/C A-D Corr Ans: D PM#27 F 7-01**

17. CPA-05193 Released 2006 Page 3

Which of the following financial instruments is **not** considered a derivative financial instrument?

a. Interest-rate swaps.
b. Currency futures.
c. Stock-index options.
d. Bank certificates of deposit.

**CPA-05193 Explanation**
Choice "d" is correct. A bank certificate of deposit is **not** a derivative financial instrument. Derivatives include futures, forwards, options, and swaps.

Choice "a" is incorrect. Interest rate swaps (or currency swaps) are derivative financial instruments.

Choice "b" is incorrect. Currency futures (or any other futures or forwards) are derivative financial instruments.

Choice "c" is incorrect. Stock-index options (or any other options) are derivative financial instruments.

**Stockholders' Equity**

**CPA-00971 Type1 M/C A-D Corr Ans: A PM#2 F 7-02**

18. CPA-00971 FARE R99 #10 Page 18

On January 15, 2000, Rico Co. declared its annual cash dividend on common stock for the year ended January 31, 2000. The dividend was paid on February 9, 2000, to stockholders of record as of January 28, 2000. On what date should Rico decrease retained earnings by the amount of the dividend?

a. January 15, 2000
b. January 31, 2000
c. January 28, 2000
d. February 9, 2000

**CPA-00971 Explanation**
Choice "a" is correct. The date of declaration is the date the board of directors formally approves a divided. A liability is created (dividends payable), and retained earnings is reduced (debited).

**CPA-00976 Type1 M/C A-D Corr Ans: A PM#4 F 7-02**

19. CPA-00976 FARE Nov 95 #18 Page 20

Nest Co. issued 100,000 shares of common stock. Of these, 5,000 were held as treasury stock at December 31, 1993. During 1994, transactions involving Nest's common stock were as follows:

May 3 - 1,000 shares of treasury stock were sold.

August 6 - 10,000 shares of previously unissued stock were sold.

November 18 - A 2-for-1 stock split took effect.

Laws in Nest's state of incorporation protect treasury stock from dilution. At December 31, 1994, how many shares of Nest's common stock were issued and outstanding?

| | *Shares* | |
|---|---|---|
| | *Issued* | *Outstanding* |
| a. | 220,000 | 212,000 |
| b. | 220,000 | 216,000 |
| c. | 222,000 | 214,000 |
| d. | 222,000 | 218,000 |


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**CPA-00976 Explanation**
Choice "a" is correct. 220,000 shares issued, and 212,000 shares outstanding.

| | *Shares Issued* | *In treasury* | *Shares outstanding* |
|---|---|---|---|
| Dec. 31, 1993 status | 100,000 | (5,000) | 95,000 |
| May 3, 1000 sh treasury stock sold | - | 1,000 | 1,000 |
| subtotal | 100,000 | (4,000) | 96,000 |
| Aug. 6, sale of previously unissued stk | 10,000 | - | 10,000 |
| subtotal | 110,000 | (4,000) | 106,000 |
| Nov. 18, 2-for-1 stock split | 10,000 | (4,000) | 106,000 |
| Dec. 31, 1994 status | 220,000 | (8,000) | 212,000 |

Note: Because the state of incorporation protects treasury stock from dilution, the 2-for-1 stock split also increases treasury shares.

**CPA-00981 Type1 M/C A-D Corr Ans: A PM#5 F 7-02**

20. CPA-00981 FARE Nov 95 #19 Page 13

Cyan Corp. issued 20,000 shares of $5 par common stock at $10 per share. On December 31, 1993, Cyan's retained earnings were $300,000. In March 1994, Cyan reacquired 5,000 shares of its common stock at $20 per share. In June 1994, Cyan sold 1,000 of these shares to its corporate officers for $25 per share. Cyan uses the cost method to record treasury stock. Net income for the year ended December 31, 1994, was $60,000. At December 31, 1994, what amount should Cyan report as retained earnings?

a. $360,000
b. $365,000
c. $375,000
d. $380,000

**CPA-00981 Explanation**
Choice "a" is correct. $360,000 retained earnings at 12/31/94 ($300 + $60). Because all treasury stock transactions were recorded under the "cost method," and the resale of treasury stock was at a price that exceeded its acquisition price, none of the treasury stock transactions affected retained earnings.

**CPA-01003 Type1 M/C A-D Corr Ans: C PM#7 F 7-02**

21. CPA-01003 FARE Nov 95 #21 Page 17

A company issued rights to its existing shareholders without consideration. The rights allowed the recipients to purchase unissued common stock for an amount in excess of par value. When the rights are issued, which of the following accounts will be increased?

| | *Common stock* | *Additional paid-in capital* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | No |
| d. | No | Yes |

**CPA-01003 Explanation**
Choice "c" is correct. No entry is made when the rights are issued since no consideration is given. If the rights are exercised and stock is issued, then common stock and additional paid-in capital increase.

Choice "a" is incorrect. If the rights are exercised and stock is issued, then common stock and additional paid-in capital will increase.


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Choice "b" is incorrect. The common stock account will increase, by par value of stock issued, only when stock is issued upon exercise of the rights.

Choice "d" is incorrect. Additional paid-in capital will increase, by the difference of the purchase price and the par value, only when stock is issued upon exercise of the rights.

**CPA-01004 Type1 M/C A-D Corr Ans: C PM#8 F 7-02**

22. CPA-01004 FARE Nov 95 #22 Page 17

In September 1989, West Corp. made a dividend distribution of one right for each of its 120,000 shares of outstanding common stock. Each right was exercisable for the purchase of 1/100 of a share of West's $50 variable rate preferred stock at an exercise price of $80 per share. On March 20, 1993, none of the rights had been exercised, and West redeemed them by paying each stockholder $0.10 per right. As a result of this redemption, West's stockholders' equity was reduced by:

a. $120
b. $2,400
c. $12,000
d. $36,000

**CPA-01004 Explanation**
Choice "c" is correct. In 1989, no dividend was recorded since none of the rights were exercised and no value was assigned. In 1993, redemption reduced equity by $12,000 [120,000 rights x $.10 per share].

Choice "a" is incorrect. Since each right is exercisable for 1/100 of a share, the total potential shares to be purchased with the rights totals 1,200 shares (120,000 rights @ $.10 per share). This choice erroneously multiplies the redemption price of $.10 times 1,200 shares.

Choice "b" is incorrect. This choice erroneously divides the 120,000 rights by the $50 par value. This is a meaningless amount.

Choice "d" is incorrect. This choice erroneously multiplies the 1,200 shares by the $30 difference between $50 par and $80 exercise price. This amount would be credited to APIC if the rights were exercised.

**CPA-01007 Type1 M/C A-D Corr Ans: A PM#9 F 7-02**

23. CPA-01007 FARE Nov 94 #28 Page 17

East Co. issued 1,000 shares of its $5 par common stock to Howe as compensation for 1,000 hours of legal services performed. Howe usually bills $160 per hour for legal services. On the date of issuance, the stock was trading on a public exchange at $140 per share. By what amount should the additional paid-in capital account increase as a result of this transaction?

a. $135,000
b. $140,000
c. $155,000
d. $160,000

**CPA-01007 Explanation**
Choice "a" is correct. The fair market value surrendered for the legal services equals $140,000 ($140 $\times$ 1,000 shares). The billing rate is similar to a list price and would be used for valuation purposes if no other information was available. The par value of the stock is $5,000 ($5 $\times$ 1,000 shares) and the additional paid in capital equals $135,000 ($140,000 less $5,000).

Choice "b" is incorrect. $140,000 is the total fair market value that should be allocated to par value and additional paid-in capital.

Choice "c" is incorrect. The billing rate is not the appropriate basis for valuation.


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Choice "d" is incorrect. The billing rate is not the appropriate basis for valuation.

**CPA-01009 Type1 M/C A-D Corr Ans: A PM#10 F 7-02**

24. CPA-01009 FARE Nov 94 #29 Page 9

During 1992, Brad Co. issued 5,000 shares of $100 par convertible preferred stock for $110 per share. One share of preferred stock can be converted into three shares of Brad's $25 par common stock at the option of the preferred shareholder. On December 31, 1993, when the market value of the common stock was $40 per share, all of the preferred stock was converted. What amount should Brad credit to Common Stock and to Additional Paid-in Capital- Common Stock as a result of the conversion?

| | *Common stock* | *Additional paid-in capital* |
|---|---|---|
| a. | $375,000 | $175,000 |
| b. | $375,000 | $225,000 |
| c. | $500,000 | $50,000 |
| d. | $600,000 | $0 |

**CPA-01009 Explanation**

| *Shares* | *$100 per pref stk* | *$25 per com stk* | *Add'l paid-in capital* | *Total* |
|---|---|---|---|---|
| Preferred | 5,000 | $500,000 | $50,000 | $550,000 |
| Conversion: | | | | |
| Pref to | (5,000) | (500,000) | (50,000) | (550,000) |
| Common | 15,000 | 375,000 | 175,000 | 550,000 |

The correct answer can also be determined using journal entries:

Issuance of Preferred Stock:

| | | | |
|---|---|---|---|
| Dr. | Cash | 550,000 | |
| Cr. | Preferred Stock | | 500,000 |
| Cr. | APIC - PS | | 50,000 |

Conversion to Common Stock:

| | | | |
|---|---|---|---|
| Dr. | Preferred Stock | 500,000 | |
| Dr. | APIC - PS | 50,000 | |
| Cr. | Common Stock | | 375,000 |
| Cr. | APIC - CS | | 175,000 |

Choice "a" is correct.

$375,000 common stock.
$175,000 additional paid-in capital.

**CPA-01011 Type1 M/C A-D Corr Ans: A PM#11 F 7-02**

25. CPA-01011 FARE Nov 94 #30 Page 18

When a company declares a cash dividend, retained earnings is decreased by the amount of the dividend on the date of:

a. Declaration.
b. Record.
c. Payment.
d. Declaration or record, whichever is earlier.


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**CPA-01011 Explanation**
Choice "a" is correct. When a company declares a cash dividend, retained earnings is decreased by the amount of the dividend on the date of declaration by the board of directors.

Choice "b" is incorrect. Record date determines who will receive the dividend.

Choice "c" is incorrect. Payment date determines when the checks will be mailed.

Choice "d" is incorrect. Declaration date always precedes the record date, which is followed by the payment date.

**CPA-01014 Type1 M/C A-D Corr Ans: B PM#12 F 7-02**

26. CPA-01014 FARE Nov 94 #31 Page 18

Long Co. had 100,000 shares of common stock issued and outstanding at January 1, 1993. During 1993, Long took the following actions:

March 15 - Declared a 2-for-1 stock split, when the fair value of the stock was $80 per share.

December 15 - Declared a $.50 per share cash dividend.

In Long's statement of stockholders' equity for 1993, what amount should Long report as dividends?

a. $50,000
b. $100,000
c. $850,000
d. $950,000

**CPA-01014 Explanation**

| *Date* | *Activity* | |
|---|---|---|
| Jan. 1, 1993 | Shares outstanding | 100,000 |
| Mar. 15, 1993 | 2-for-1 stock split | 100,000 |
| | Total shares outstanding Dec. 15 | 200,000 |
| Dec. 15, 1993 | Declared cash dividend per share | $ .50 |
| | Dividends declared for 1993 | $100,000 |

Choice "b" is correct. $100,000 dividends declared in the 1993 statement of stockholders' equity.

**CPA-01018 Type1 M/C A-D Corr Ans: C PM#13 F 7-02**

27. CPA-01018 FARE Nov 94 #32 Page 13

If a corporation sells some of its treasury stock at a price that exceeds its cost, this excess should be:

a. Reported as a gain in the income statement.
b. Treated as a reduction in the carrying amount of remaining treasury stock.
c. Credited to additional paid-in capital.
d. Credited to retained earnings.

**CPA-01018 Explanation**
**Rule:** There is no gain or loss on the purchase and/or sale of treasury stock. Any "difference" goes to "paid-in capital," or if there is not enough paid-in capital to absorb a loss, the loss would be debited (subtracted) from "retained earnings."

Choice "c" is correct. When treasury stock is sold at a price that exceeds its cost, the excess would be credited to "paid-in capital."

Choice "a" is incorrect. There is no gain recognized on the sale of treasury stock sold in excess of cost.


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Choice "b" is incorrect. An "excess" (gain) from the sale of treasury stock would not reduce the carrying amount of the remaining treasury stock.

Choice "d" is incorrect. Excesses (gains) from sales of treasury stock are not credited to retained earnings.

**CPA-01025 Type1 M/C A-D Corr Ans: C PM#14 F 7-02**

28. CPA-01025 FARE Nov 94 #37 Page 11

The primary purpose of a quasi-reorganization is to give a corporation the opportunity to:

a. Obtain relief from its creditors.
b. Revalue understated assets to their fair values.
c. Eliminate a deficit in retained earnings.
d. Distribute the stock of a newly-created subsidiary to its stockholders in exchange for part of their stock in the corporation.

**CPA-01025 Explanation**
Choice "c" is correct. The primary purpose of a quasi-reorganization is to eliminate a retained earnings deficit so that future earnings will be available for dividends rather than limited to offsetting the retained earnings deficit. ARB 43 Ch 1A para. 2

Choice "a" is incorrect. A quasi-reorganization is not related to debt relief.

Choice "b" is incorrect. A quasi-reorganization is not related to revaluing understated assets to their fair values.

Choice "d" is incorrect. A quasi-reorganization is not a treasury stock transaction.

**CPA-01028 Type1 M/C A-D Corr Ans: D PM#15 F 7-02**

29. CPA-01028 FARE May 94 #31 Page 18

East Corp., a calendar-year company, had sufficient retained earnings in 1993 as a basis for dividends, but was temporarily short of cash. East declared a dividend of $100,000 on April 1, 1993, and issued promissory notes to its stockholders in lieu of cash. The notes, which were dated April 1, 1993, had a maturity date of March 31, 1994, and a 10% interest rate.

How should East account for the scrip dividend and related interest?

a. Debit retained earnings for $110,000 on April 1, 1993.
b. Debit retained earnings for $110,000 on March 31, 1994.
c. Debit retained earnings for $100,000 on April 1, 1993, and debit interest expense for $10,000 on March 31, 1994.
d. Debit retained earnings for $100,000 on April 1, 1993, and debit interest expense for $7,500 on December 31, 1993.

**CPA-01028 Explanation**
Choice "d" is correct.

| | |
|---|---|
| Debit retained earnings on April 1, 1993 for (and credit notes payable to stockholders) | $100,000 |
| Debit interest expense on Dec. 31, 1993 for (and credit accrued interest payable) | 7,500 |

**CPA-01031 Type1 M/C A-D Corr Ans: B PM#16 F 7-02**

30. CPA-01031 FARE May 94 #32 Page 18


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On January 2, 1994, Lake Mining Co.'s board of directors declared a cash dividend of $400,000 to stockholders of record on January 18, 1994, payable on February 10, 1994. The dividend is permissible under law in the state where Lake is incorporated. Selected balances from its December 31, 1993 balance sheet are as follows:

| | |
|---|---|
| Accumulated depletion | $100,000 |
| Capital stock | 500,000 |
| Additional paid-in capital | 150,000 |
| Retained earnings | 300,000 |

The $400,000 dividend includes a liquidating dividend of:

a. $0
b. $100,000
c. $150,000
d. $300,000

**CPA-01031 Explanation**

| | |
|---|---|
| Total cash dividend declared | $ 400,000 |
| Less retained earnings | (300,000) |
| liquidating dividend | $ 100,000 |

Choice "b" is correct. $100,000 liquidating dividend (amount in excess of retained earnings balance).

**CPA-01041 Type1 M/C A-D Corr Ans: A PM#18 F 7-02**

31. CPA-01041 Th Nov 93 #15 Page 17

On November 2, 1992, Finsbury, Inc. issued warrants to its stockholders giving them the right to purchase additional $20 par value common shares at a price of $30. The stockholders exercised all warrants on March 1, 1993. The shares had market prices of $33, $35, and $40 on November 2, 1992, December 31, 1992, and March 1, 1993, respectively. What were the effects of the warrants on Finsbury's additional paid-in capital and net income?

| | *Additional Paid-in capital* | *Net income* |
|---|---|---|
| a. | Increased in 1993 | No effect |
| b. | Increased in 1992 | No effect |
| c. | Increased in 1993 | Decreased in 1992 and 1993 |
| d. | Increased in 1992 | Decreased in 1992 and 1993 |

**CPA-01041 Explanation**
**Rule:** That portion of proceeds in excess of stocks par value is credited to "additional paid-in-capital" at the time the rights are exercised.

Choice "a" is correct. The rights were exercised in 1993. The exercise of stock rights increases additional paid-in capital, but has no effect on "net income."

Choice "b" is incorrect, because the rights were not exercised until 1993.

Choices "c" and "d" are incorrect, because the exercise of stock rights has no effect on income.

**CPA-01043 Type1 M/C A-D Corr Ans: C PM#19 F 7-02**

32. CPA-01043 PI Nov 93 #48 Page 19

Cobb Co. purchased 10,000 shares (2% ownership) of Roe Co. on February 12, 1993. Cobb received a stock dividend of 2,000 shares on March 31, 1993, when the carrying amount per share on Roe's books


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was $35 and the market value per share was $40. Roe paid a cash dividend of $1.50 per share on September 15, 1993. In Cobb's income statement for the year ended October 31, 1993, what amount should Cobb report as dividend income?

a. $98,000
b. $88,000
c. $18,000
d. $15,000

**CPA-01043 Explanation**
Choice "c" is correct. Stock dividends are not recorded as income on the books of the recipient. The total number of shares increases in a stock dividend and the subsequent cash dividend is $1.50 on 12,000 shares or $18,000.

Choice "a" is incorrect. Stock dividends do not produce income for the recipient.

Choice "b" is incorrect. Stock dividends do not produce income for the recipient.

Choice "d" is incorrect. Cash dividends are paid on the number of shares outstanding. Cobb has 12,000 shares.

**CPA-01046 Type1 M/C A-D Corr Ans: A PM#20 F 7-02**

33. CPA-01046 PII May 93 #1 Page 13

Rudd Corp. had 700,000 shares of common stock authorized and 300,000 shares outstanding at December 31, 1991. The following events occurred during 1992:

| | |
|---|---|
| January 31 | Declared 10% stock dividend |
| June 30 | Purchased 100,000 shares |
| August 1 | Reissued 50,000 shares |
| November 30 | Declared 2-for-l stock split |

At December 31, 1992, how many shares of common stock did Rudd have outstanding?

a. 560,000
b. 600,000
c. 630,000
d. 660,000

**CPA-01046 Explanation**
Choice "a" is correct. 560,000 shares of common stock outstanding at 12/31/92 is calculated as follows:

| | |
|---|---|
| Shares outstanding, 12/31/91 | 300,000 |
| 10% stock dividend (10% × 300,000), 1/31/92 | 30,000 |
| Treasury shares purchased, 6/30/92 | (100,000) |
| Treasury shares reissued, 8/1/92 | 50,000 |
| Shares outstanding, 8/1/92 | 280,000 |
| 2-for-1 stock split, 11/30/92 | × 2 |
| Shares outstanding, 12/31/92 | 560,000 |

**CPA-01048 Type1 M/C A-D Corr Ans: D PM#21 F 7-02**

34. CPA-01048 PII May 93 #2 Page 13

Beck Corp. issued 200,000 shares of common stock when it began operations in 1990 and issued an additional 100,000 shares in 1991. Beck also issued preferred stock convertible to 100,000 shares of common stock. In 1992, Beck purchased 75,000 shares of its common stock and held it in Treasury. At December 31, 1992, how many shares of Beck's common stock were outstanding?

a. 400,000


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b. 325,000
c. 300,000
d. 225,000

**CPA-01048 Explanation**
Choice "d" is correct. 225,000 shares outstanding at 12/31/92 is calculated as follows:

| | |
|---|---|
| Shares outstanding, 1990 | 200,000 |
| Additional shares issued, 1991 | 100,000 |
| | 300,000 |
| Treasury shares purchased, 1992 | (75,000) |
| Shares outstanding, 12/31/92 | 225,000 |

**CPA-01050 Type1 M/C A-D Corr Ans: A PM#22 F 7-02**

35. CPA-01050Th May 93 #2 Page 18

A property dividend should be recorded in 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).

**CPA-01050 Explanation**
Choice "a" is correct. A property dividend should be recorded in retained earnings at the property's market value at date of declaration.

Choice "b" is incorrect. Date of issuance (payment) is too late-use declaration date.

Choice "c" is incorrect. Book value at date of declaration is used to measure gain or loss.

Choice "d" is incorrect. Book value at date of issuance (payment) is inappropriate - use market value at declaration date.

**CPA-01052 Type1 M/C A-D Corr Ans: B PM#23 F 7-02**

36. CPA-01052PII May 93 #3 Page 11

The following changes in Vel Corp.'s account balances occurred during 1992:

| | *Increase* |
|---|---|
| Assets | $89,000 |
| Liabilities | 27,000 |
| Capital stock | 60,000 |
| Additional paid-in capital | 6,000 |

Except for a $13,000 dividend payment and the year's earnings, there were no changes in retained earnings for 1992. What was Vel's net income for 1992?

a. $4,000
b. $9,000
c. $13,000
d. $17,000

**CPA-01052 Explanation**

| Balance sheet changes | |
|---|---|
| Assets | 89 |
| Liabilities | 27 |
| Capital stock | 60 |
| Additional paid-in capital | 6 |


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| | |
|---|---|
| Retained earnings (squeeze) | (4) |
| Total liabilities and equity | 89 |
| Retained earnings changes | |
| Begin R/E | 0 |
| Add net income (squeeze) | 9 |
| Less dividends paid | (13) |
| Ending R/E | (4) |

Choice "b" is correct. $9,000 net income for 1992.

**CPA-01056 Type1 M/C A-D Corr Ans: B PM#24 F 7-02**

37. CPA-01056 PII May 93 #4 Page 9

At December 31, 1991 and 1992, Carr Corp. had outstanding 4,000 shares of $100 par value 6% cumulative preferred stock and 20,000 shares of $10 par value common stock. At December 31, 1991, dividends in arrears on the preferred stock were $12,000. Cash dividends declared in 1992 totaled $44,000. Of the $44,000, what amounts were payable on each class of stock?

| | *Preferred stock* | *Common stock* |
|---|---|---|
| a. | $44,000 | $0 |
| b. | $36,000 | $8,000 |
| c. | $32,000 | $12,000 |
| d. | $24,000 | $20,000 |

**CPA-01056 Explanation**
**Rule:** Cumulative preferred stock dividends are paid on par value (not sales price) of preferred stock and have a "preference" over common stock dividends until all past preferred stock dividends are paid.

| | | *4,000 shs preferred stock* | *20,000 shs common stock* | *Total* |
|---|---|---|---|---|
| 1. | Dividends in arrears | $12,000 | 0 | $12,000 |
| 2. | 6% preferred stk div (4,000 sh $\times$ $100 $\times$ 6%) current year | 24,000 | 0 | 24,000 |
| 3. | Equivalent or balance to common stock dividends payable | 0 | $8,000 | 8,000 |
| | | $36,000 | $8,000 | $44,000 |

Choice "b" is correct. $36,000 preferred stock dividend payable $8,000 common stock dividend payable.

**CPA-01058 Type1 M/C A-D Corr Ans: A PM#25 F 7-02**

38. CPA-01058 PII May 93 #5 Page 11

At December 31, 1991, Eagle Corp. reported $1,750,000 of appropriated retained earnings for the construction of a new office building, which was completed in 1992 at a total cost of $1,500,000. In 1992, Eagle appropriated $1,200,000 of retained earnings for the construction of a new plant. Also, $2,000,000 of cash was restricted for the retirement of bonds due in 1993. In its 1992 balance sheet, Eagle should report what amount of appropriated retained earnings?

a. $1,200,000
b. $1,450,000
c. $2,950,000
d. $3,200,000

**CPA-01058 Explanation**
**Rule:** When the purpose of the appropriation has been achieved, it should be restored to unappropriated retained earnings.


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Choice "a" is correct. $1,200,000 appropriated retained earnings at Dec. 31, 1992 (for the construction of a new plant only).

Choices "b" and "c" are incorrect. When the new ($1,500,000) office building was completed in 1992, $1,750,000 was restored to unappropriated retained earnings.

Choice "d" is incorrect. "Cash restricted for the retirement of bonds" (an asset account called "sinking fund cash") typically reduces regular cash and does not affect retained earnings. (There may also be an appropriation, but this would have to be specifically mentioned in the question.)

**CPA-01061 Type1 M/C A-D Corr Ans: A PM#26 F 7-02**

39. CPA-01061PI May 93 #6 Page 8

On April 1, 1993, Hyde Corp., a newly formed company, had the following stock issued and outstanding:

- Common stock, no par, $1 stated value, 20,000 shares originally issued for $30 per share.
- Preferred stock, $10 par value, 6,000 shares originally issued for $50 per share.

Hyde's April 1, 1993, statement of stockholders' equity should report:

| | *Common Stock* | *Preferred stock* | Additional *paid-in capital* |
|---|---|---|---|
| a. | $20,000 | $60,000 | $820,000 |
| b. | $20,000 | $300,000 | $580,000 |
| c. | $600,000 | $300,000 | $0 |
| d. | $600,000 | $60,000 | $240,000 |

**CPA-01061 Explanation**

Choice "a" is correct. Common and preferred stock are recorded at the number of shares issued times stated or par value. Any excess is paid-in capital.

| | | |
|---|---|---|
| Cash | 600,000 | |
| Common stock | | 20,000 |
| Paid-in capital | | 580,000 |
| Cash | 300,000 | |
| Preferred stock | | 60,000 |
| Paid-in capital | | 240,000 |

Choice "b" is incorrect. Preferred stock is reported at the number of shares issued times par value (6,000 $\times$ $10).

Choice "c" is incorrect. Preferred stock is reported at the number of shares issued times par value (6,000 $\times$ $10). Common stock is reported at the number of shares issued times stated value (20,000 $\times$ $1).

Choice "d" is incorrect. Common stock is reported at the number of shares issued times stated value ($20,000 $\times$ $1).

**CPA-01094 Type1 M/C A-D Corr Ans: C PM#27 F 7-02**

40. CPA-01094Th May 93 #10 Page 15

In 1990, Fogg, Inc. issued $10 par value common stock for $25 per share. No other common stock transactions occurred until March 31, 1992, when Fogg acquired some of the issued shares for $20 per share and retired them. Which of the following statements correctly states an effect of this acquisition and retirement?

a. 1992 net income is decreased.
b. 1992 net income is increased.
c. Additional paid-in capital is decreased.


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d. Retained earnings is increased.

**CPA-01094 Explanation**
Illustration with assumed shares

| | Common assumed shares | Additional stock at $10 par | Total paid-in capital | Retained earnings | Stkhldrs equity |
|---|---|---|---|---|---|
| 1990 stock issued at $25 | 1,000 | 10,000 | 15,000 | 0 | 25,000 |
| 1992 stock retired at $20 | (100) | (1,000) | (1,000) | 0 | (2,000) |
| | 900 | 9,000 | 14,000 | 0 | 23,000 |

Choice "c" is correct. Additional paid-in capital is decreased upon the acquisition and retirement of shares at a cost ($20) less than initial selling price ($25). Since 1/10 of the shares are assumed retired, 1/10 of common stock at par is retired. The difference between the cost of retirement ($2,000) and par retired ($1,000) is the decrease in additional paid-in capital.

Choices "a" and "b" are incorrect. "Net income" is not affected, but net income per share is increased.

Choice "d" is incorrect. Retained earnings would be decreased for any amount more than initial selling price of $25.

**CPA-01095 Type1 M/C A-D Corr Ans: D PM#28 F 7-02**

41. CPA-01095 PI May 93 #11 Page 15

On December 1, 1992, Line Corp. received a donation of 2,000 shares of its $5 par value common stock from a stockholder. On that date, the stock's market value was $35 per share. The stock was originally issued for $25 per share. By what amount would this donation cause total stockholders' equity to decrease?

a. $70,000
b. $50,000
c. $20,000
d. $0

**CPA-01095 Explanation**
Choice "d" is correct. $0 decrease in total stockholders' equity due to donation of its own stock from a stockholder because there is no cost to the corporation. The entry would be:

**Dr.** Donated treasury stock (@ FMV)
**Cr.** Additional paid-in capital (@ FMV)

Both accounts enter into total stockholders' equity; therefore, there is no change in total stockholders' equity. When (if) the shares are reissued, the entry would be:

**Dr.** Cash (@ sales price)
**Dr.** Additional paid-in capital (for sp<carrying value)
**Cr.** Donated treasury stock (@ carrying value) additional paid-in capital (for sp>carrying value)

**CPA-01097 Type1 M/C A-D Corr Ans: D PM#29 F 7-02**

42. CPA-01097 Th May 93 #13 Page 9

Quoit, Inc. issued preferred stock with detachable common stock warrants. The issue price exceeded the sum of the warrants' fair value and the preferred stock's par value. The preferred stock's fair value was not determinable. What amount should be assigned to the warrants outstanding?

a. Total proceeds.
b. Excess of proceeds over the par value of the preferred stock.


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c. The proportion of the proceeds that the warrants' fair value bears to the preferred stock's par value.
d. The fair value of the warrants.

**CPA-01097 Explanation**
Choice "d" is correct. The fair value of the warrants is credited to paid in capital.

Choice "a" is incorrect. If total proceeds were allocated to warrants, no value would be allocated to the common stock.

Choice "b" is incorrect. Par value is normally a nominal amount, even zero. (No par stock.)

Choice "c" is incorrect. An allocation of the warrants' fair value and the preferred stocks' par value would not make sense, since par value is unrelated to fair value.

**CPA-01099 Type1 M/C A-D Corr Ans: D PM#30 F 7-02**

43. CPA-01099Th May 93 #14 Page 22

In a compensatory stock option plan for which the grant and exercise dates are different, the stock options outstanding account should be reduced at the:

a. Date of grant.
b. Beginning of the vesting period.
c. Beginning of the service period.
d. Exercise date.

**CPA-01099 Explanation**
Choice "d" is correct. Stock options outstanding are reduced at the exercise date.

Choice "a" is incorrect. Stock options outstanding are increased at the date of grant.

Choice "b" is incorrect. The beginning of the vesting period is not used.

Choice "c" is incorrect. The beginning of the service period is the beginning of the period over which the compensation expense is amortized.

**CPA-04681 Type1 M/C A-D Corr Ans: A PM#31 F 7-02**

44. CPA-04681Released 2005 Page 19

Universe Co. issued 500,000 shares of common stock in the current year. Universe declared a 30% stock dividend. The market value was $50 per share, the par value was $10, and the average issue price was $30 per share. By what amount will Universe decrease stockholders' equity for the dividend?

a. $0
b. $1,500,000
c. $4,500,000
d. $7,500,000

**CPA-04681 Explanation**
Choice "a" is correct. The net effect on Universe's stockholders equity is zero, as the reduction to retained earnings is offset by an equal increase in common stock.

**Journal Entry**:

| | | | |
|---|---|---|---|
| **DR** | Retained earnings (.30 x 500,000 x $10) | $1,500,000 | |
| **CR** | Common stock ($10 per value) | | $1,500,000 |

Choices "b", "c", and "d" are incorrect, per the above.

**CPA-04682 Type1 M/C A-D Corr Ans: B PM#32 F 7-02**


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45. CPA-04682 Released 2005 Page 13

Murphy Co. had 200,000 shares outstanding of $10 par common stock on March 30 of the current year. Murphy reacquired 30,000 of those shares at a cost of $15 per share, and recorded the transaction using the cost method on April 15. Murphy reissued the 30,000 shares at $20 per share, and recognized a $50,000 gain on its income statement on May 20. Which of the following statements is correct?

a. Murphy's comprehensive income for the current year is correctly stated.
b. Murphy's net income for the current year is overstated.
c. Murphy's net income for the current year is understated.
d. Murphy should have recognized a $50,000 loss on its income statement for the current year.

**CPA-04682 Explanation**
Choice "b" is correct. Net income or retained earnings will never be increased through treasury stock transactions. Murphy Co. incorrectly recognized a gain from the issuance of the treasury stock and as such overstated Murphy's net income for the current period.

Choices "a", "c", and "d" are incorrect, per the above.

**CPA-05228 Type1 M/C A-D Corr Ans: B PM#33 F 7-02**

46. CPA-05228 Released 2006 Page 13

Porter Co. began its business last year and issued 10,000 shares of common stock at $3 per share. The par value of the stock is $1 per share. During January of the current year, Porter bought back 500 shares at $6 per share, which were reported by Porter as treasury stock. The treasury stock shares were reissued later in the current year at $10 per share. Porter used the cost method to account for its equity transactions. What amount should Porter report as paid-in capital related to its treasury stock transactions on its balance sheet for the current year?

a. $1,500
b. $2,000
c. $4,500
d. $20,000

**CPA-05228 Explanation**
Choice "b" is correct. Using the cost method, the treasury stock transactions include the reissuance of the treasury shares at $10 per share ($4 per share to APIC x 500 shares), or $2,000. The additional paid-in capital from the original issuance of the stock is not paid-in capital related to the treasury stock and is not included.

Choice "a" is incorrect. This answer apparently includes the 500 shares at $3 per share, which is the amount of additional paid-in capital generated on the original issuance of the stock. Additional paid-in capital from the original issuance of the stock is not included.

Choice "c" is incorrect. This answer apparently includes the 500 shares at $9 per share, which is the difference between the price at which the treasury shares were reissued ($10 reissuance price - $1 par value = $9 x 500 = $4,500).

Choice "d" is incorrect. This answer apparently includes the 10,000 shares originally issued at the additional paid-in capital amount that was generated in the original issuance ($3 issuance price - $1 per share = $2 x 10,000 = $20,000).

**CPA-05442 Type1 M/C A-D Corr Ans: A PM#35 F 7-02**

47. CPA-05442 Released 2007 Page 13

Baker Co. issued 100,000 shares of common stock in the current year. On October 1, Baker repurchased 20,000 shares of its common stock on the open market for $50.00 per share. At that date, the stock's par value was $1.00 and the average issue price was $40.00 per share. Baker uses the cost


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method for treasury stock transactions. On December 1, Baker reissued the stock for $60.00 per share. What amount should Baker report as treasury stock gain at December 31?

a. $0
b. $200,000
c. $400,000
d. $980,000

**CPA-05442 Explanation**
Choice "a" is correct. Corporations are not permitted to report income statement gains and losses from treasury stock transactions. Instead, treasury stock "gains and losses" are reported as direct adjustments to stockholders' equity. Gains are recorded by crediting APIC - Treasury Stock, while losses are recorded by first reducing any existing APIC - Treasury Stock to $0, and then debiting any additional loss to Retained Earnings.

Baker's treasury stock transactions would be recorded as follows:

10/1 - Repurchase of Treasury Stock

| | | | |
|---|---|---|---|
| DR | Treasury stock | $1,000,000 | |
| CR | Cash | | $1,000,000 |

12/1 - Resell Treasury Stock

| | | | |
|---|---|---|---|
| DR | Cash | $1,200,000 | |
| CR | Treasury stock | | $1,000,000 |
| CR | APIC - Treasury stock | | 200,000 |

Choice "b" is incorrect. This amount would be reported as APIC - Treasury stock on the balance sheet, not as a gain on the income statement.

Choice "c" is incorrect. The treasury stock repurchase is reported at the price paid, not the average purchase price.

Choice "d" is incorrect. The difference between the par value of the stock and the price paid to repurchase the stock is not reported as a gain.

**Earnings Per Share**

**CPA-01102 Type1 M/C A-D Corr Ans: A PM#1 F 7-03**

48. CPA-01102 FARE R01 #9 Page 29

Deck Co. had 120,000 shares of common stock outstanding at January 1, 1998. On July 1, 1998, it issued 40,000 additional shares of common stock. Outstanding all year were 10,000 shares of nonconvertible cumulative preferred stock. What is the number of shares that Deck should use to calculate 1998 earnings per share?

a. 140,000
b. 150,000
c. 160,000
d. 170,000

**CPA-01102 Explanation**
Choice "a" is correct. 140,000 shares of common stock is the weighted average for earnings per share. The calculation is as follows:

| | |
|---|---|
| 1-1-98: Outstanding all year | 120,000 |
| 7-1-98: 40,000 issued × 6/12 | 20,000 |
| Weighted average | 140,000 |

*Note:* The preferred stock is not considered since it is **non**convertible.


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**CPA-01105 Type1 M/C A-D Corr Ans: B PM#2 F 7-03**

49. CPA-01105 FARE C98 #10 Page 29

Which of the following items, if dilutive and if other conditions are met, would enter into the determination of the weighted average shares outstanding to be used in the basic earnings per share (basic EPS) calculation?

I. Stock options.
II. Contingent shares.

a. I only.
b. II only.
c. Both I and II.
d. Neither I nor II.

**CPA-01105 Explanation**
Choice "b" is correct. Contingent shares (that are dilutive) are included in the calculation of basic earnings per share (EPS) if (and as of the date) all conditions for issuance are met. Stock options do not enter into the calculation of basic EPS.

Choices "a" and "c" are incorrect, because stock options do not enter into the calculation of the basic EPS, but will enter into the calculation of dilutive EPS if dilutive (i.e., the average market price of the common stock during the period exceeds the exercise price of the option).

Choice "d" is incorrect. If contingent shares are dilutive (on EPS) and meet conditions for issuance, they would enter into the calculation of basic EPS.

**CPA-01107 Type1 M/C A-D Corr Ans: C PM#3 F 7-03**

50. CPA-01107 FARE C98 #11 Page 28

Elizabeth Corporation acquired Allen Corporation at the end of 19X8. Under terms of the acquisition agreement, Elizabeth agreed to provide former Allen shareholders 1,000 additional shares of Elizabeth stock for each new retail outlet opened during 19X9. Two new outlets were opened during 19X9:

- One on May 1, 19X9
- One on September 1, 19X9

What number of shares related to the openings of the new retail outlets should enter into the calculation of Elizabeth's basic earnings per share as of December 31, 19X9, the end of its fiscal year?

a. 2,000
b. 1,250
c. 1,000
d. -0-

**CPA-01107 Explanation**
**Rule:** Contingent shares are included in the calculation of basic EPS as of the date all conditions have been satisfied. (In this question, the dates the new outlets were opened.)

Choice "c" is correct. 1,000 shares, computed as follows:

| Total Shares | × | Period Outstanding | = | Weighted Average |
|---|---|---|---|---|
| 1,000 | | May-Aug. 4/12 | | 333 1/3 |
| 2,000 | | Sept.-Dec. 4/12 | | 666 2/3 |
| | | | | 1,000 shares |

**CPA-01123 Type1 M/C A-D Corr Ans: A PM#4 F 7-03**

51. CPA-01123 FARE R98 #5 Page 28


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In computing the weighted-average number of shares outstanding during the year, which of the following midyear events must be treated as if it had occurred at the beginning of the year?

a. Declaration and distribution of stock dividend.
b. Purchase of treasury stock.
c. Sale of additional common stock.
d. Sale of preferred convertible stock.

**CPA-01123 Explanation**
Choice "a" is correct. In computing the weighted-average number of shares outstanding for earnings per share (EPS) determination, a stock dividend (or a stock split) to the same class of shareholders must be retroactively recognized and treated as if it had occurred at the beginning of the year. In addition, EPS for all prior periods presented must be adjusted as though the shares had been outstanding for the entire period presented.

Choices "b", "c", and "d" are incorrect. The issuance (sale) of new shares and the repurchase of a firm's shares (treasury stock) are included in the weighted-average number of share outstanding calculation from the date of the sale or purchase of the shares.

**CPA-01193 Type1 M/C A-D Corr Ans: B PM#5 F 7-03**

52. CPA-01193 FARE C97 #1 Page 35

Earnings per share disclosure is required for which of the following:

a. Wholly-owned subsidiaries of public companies.
b. Companies who have made a filing with the SEC in preparation for a sale of public securities.
c. Non-public companies.
d. Investment companies.

**CPA-01193 Explanation**
Choice "b" is correct. EPS disclosures are required for all companies with publicly traded common stock or potential common stock including:

- Stock options
- Stock warrants
- Convertible securities
- "Contingent stock" agreement

Also required by companies that have made a filing or are in the process of filing with a regulatory agency (e.g., the SEC) in preparation for a public sale of common stock.

Choices "a", "c", and "d" are incorrect, per above rule.

**CPA-01195 Type1 M/C A-D Corr Ans: B PM#6 F 7-03**

53. CPA-01195 FARE C97 #3 Page 34

Which one of the following is **not** considered contingent shares for purposes of computing EPS?

a. Shares issuable upon achieving a specific net income target.
b. Shares issuable upon exercise of a stock option.
c. Shares issuable upon the passage of a specific period of time.
d. Shares issuable upon the issuance of a patent.

**CPA-01195 Explanation**
Choice "b" is correct. Shares issuable upon the exercise of a stock option are not considered contingent shares as the option holder is required to pay the strike price to exercise the options.

Choices "a", "c", and "d" are incorrect. These shares are contingent shares as they are issuable for no cash consideration after the occurrence of the specified condition.


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**CPA-01201 Type1 M/C A-D Corr Ans: A PM#10 F 7-03**

54. CPA-01201 Th Nov 93 #16 Page 27

When computing the weighted average of common shares outstanding for basic earnings per share, convertible securities are:

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

**CPA-01201 Explanation**
Choice "a" is correct. When computing basic earnings per share, convertible securities are ignored for purposes of computing the weighted average of common shares outstanding.

**CPA-01203 Type1 M/C A-D Corr Ans: B PM#11 F 7-03**

55. CPA-01203 PI May 93 #60 Page 29

The following information pertains to Jet Corp.'s outstanding stock for 1992:

| | |
|---|---|
| Common stock, $5 par value | |
| Shares outstanding, 1/1/92 | 20,000 |
| 2-for-1 stock split, 4/1/92 | 20,000 |
| Shares issued, 7/1/92 | 10,000 |
| Preferred stock, $10 par value, 5% cumulative | |
| Shares outstanding, 1/1/92 | 4,000 |

What are the number of shares Jet should use to calculate 1992 earnings per share?

a. 40,000
b. 45,000
c. 50,000
d. 54,000

**CPA-01203 Explanation**

| | | | | | | |
|---|---|---|---|---|---|---|
| 1/1/92 | Shares outstanding | 20,000 | | | | |
| 4/1/92 | 2-for-1 stock split | 20,000 | | | | |
| | | 40,000 | × | 1/2 (6 mos) | = | 20,000 |
| 7/1/92 | Share issued | 10,000 | | | | |
| | | 50,000 | × | 1/2 (6 mos) | = | 25,000 |
| Weighted average shares O/S | | | | | | 45,000 |

Choice "b" is correct. 45,000 shares should be used to calculate 1992 EPS.

**CPA-01205 Type1 M/C A-D Corr Ans: C PM#12 F 7-03**

56. CPA-01205 FARE Nov 92 #23 Page 28

On January 31, 1992, Pack, Inc. split its common stock 2 for 1, and Young, Inc. issued a 5% stock dividend. Both companies issued their December 31, 1991, financial statements on March 1, 1992. Should Pack's 1991 earnings per share (EPS) take into consideration the stock split, and should Young's 1991 EPS take into consideration the stock dividend?

| | *Pack's 1991 EPS* | *Young's 1991 EPS* |
|---|---|---|
| a. | Yes | No |


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| | | |
|---|---|---|
| b. | No | No |
| c. | Yes | Yes |
| d. | No | Yes |

**CPA-01205 Explanation**
**Rule:** If stock dividend or a stock split (or reverse split) changes common stock outstanding, the computation of EPS shall give retroactive recognition for all periods presented using the new number of shares because the reader's primary interest is presumed to be related to current capitalization.

Choice "c" is correct. Yes - Yes.

**CPA-01209 Type1 M/C A-D Corr Ans: B PM#13 F 7-03**

57. CPA-01209 PI Nov 91 #60 Page 29

Strauch Co. has one class of common stock outstanding and no other securities that are potentially convertible into common stock. During 1989, 100,000 shares of common stock were outstanding. In 1990, two distributions of additional common shares occurred: On April 1, 20,000 shares of treasury stock were sold, and on July 1, a 2-for-1 stock split was issued. Net income was $410,000 in 1990 and $350,000 in 1989. What amounts should Strauch report as earnings per share in its 1990 and 1989 comparative income statements?

| | *1990* | *1989* |
|---|---|---|
| a. | $1.78 | $3.50 |
| b. | $1.78 | $1.75 |
| c. | $2.34 | $1.75 |
| d. | $2.34 | $3.50 |

**CPA-01209 Explanation**
Choice "b" is correct. $1.78 and $1.75 EPS 1990 and 1989.

| | 1990 | 1989 |
|---|---|---|
| Net income | 410,000 | 350,000 |
| Weighted Avg. Shares | ÷ 230,000 | ÷ 200,000 |
| EPS | $ 1.78 | $ 1.75 |

| | Shares O/S | | Mo's O/S | | Stock Split | Total |
|---|---|---|---|---|---|---|
| 1/1/90 to 4/1/90 | 100,000 | × | 3 | × | 2 | 600,000 |
| 4/1/90 to 7/1/90 | 120,000 | × | 3 | × | 2 | 720,000 |
| 7/1/90 to 12/31/90 | 240,000 | × | 6 | × | 1 | 1,440,000 |
| | | | 12 | | | 2,760,000 |

Weighted shares O/S (2,760,000 ÷ 12) = 230,000

* Note that prior year EPS data needs to be adjusted for stock splits occurring in subsequent years.

**CPA-01210 Type1 M/C A-D Corr Ans: A PM#14 F 7-03**

58. CPA-01210 FARE May 91 #29 Page 32

In determining earnings per share, interest expense, net of applicable income taxes, on convertible debt that is dilutive should be:

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


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**CPA-01210 Explanation**
Choice "a" is correct. Interest expense (net of income tax) on debt considered would be added back to the numerator for diluted EPS if the effects are dilutive.

Choices "b", "c", and "d" are incorrect, per the above rule.

**CPA-01211 Type1 M/C A-D Corr Ans: B PM#15 F 7-03**

59. CPA-01211 FARE Nov 90 #34 Page 33

When computing diluted earnings per share, convertible securities are:

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

**CPA-01211 Explanation**
Choice "b" is correct. Recognized only if they are dilutive.

**Rule:** Convertible securities are recognized when computing diluted EPS only if the conversion is dilutive.

Choices "a", "c", and "d" are incorrect, per the above rule.

**CPA-01213 Type1 M/C A-D Corr Ans: B PM#16 F 7-03**

60. CPA-01213 PI Nov 90 #52 Page 27

Poe Co. had 300,000 shares of common stock issued and outstanding at December 31, 1988. No common stock was issued during 1989. On January 1, 1989, Poe issued 200,000 shares of nonconvertible preferred stock. During 1989, Poe declared and paid $75,000 cash dividends on the common stock and $60,000 on the preferred stock. Net income for the year ended December 31, 1989 was $330,000. What should be Poe's 1989 earnings per common share?

a. $1.10
b. $0.90
c. $0.85
d. $0.65

**CPA-01213 Explanation**
Choice "b" is correct. $0.90 earnings per common share.

| | |
|---|---|
| Net income | $330,000 |
| Less: Preferred dividends paid | (60,000) |
| Income available for common stock | $270,000 |

$$EPS = \frac{NI - Pref\ div}{Wtd\ shares\ O/S} = \frac{\$270,000}{300,000} = \$0.90$$

**CPA-01214 Type1 M/C A-D Corr Ans: D PM#17 F 7-03**

61. CPA-01214 PII May 90 #51 Page 27

Peters Corp.'s capital structure was as follows:

| | *December 31* | |
|---|---|---|
| | *19X1* | *19X2* |
| Outstanding shares of stock: | | |
| Common | 110,000 | 110,000 |
| Convertible preferred | 10,000 | 10,000 |
| 8% convertible bonds | $1,000,000 | $1,000,000 |


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During 19X2, Peters paid dividends of $3.00 per share on its preferred stock. The preferred shares are convertible into 20,000 shares of common stock. The 8% bonds are convertible into 30,000 shares of common stock. Net income for 19X2 was $850,000. Assume that the income tax rate is 30%. The basic earnings per share for 19X2 is:

a. $6.31
b. $6.54
c. $7.08
d. $7.45

**CPA-01214 Explanation**
Choice "d" is correct. $7.45 basic earnings per share for 19X2.

Note: Preferred dividends reduce the amount of "income" available to common stockholders.

$$\frac{\text{Net income less preferred dividends}}{\text{Weighted shares O/S}} = \frac{\$850{,}000 - 30{,}000}{110{,}000} = \$7.45$$

"Net income" is $850,000. The 30% income tax rate and the convertible bonds are distractors.

**CPA-01217 Type1 M/C A-D Corr Ans: B PM#18 F 7-03**

62. CPA-01217 PI Nov 89 #54 Page 32

Jones Corp.'s capital structure was as follows:

| | *December 31* | |
|---|---|---|
| | *1988* | *1987* |
| Outstanding shares of stock: | | |
| Common | 110,000 | 110,000 |
| Convertible preferred | 10,000 | 10,000 |
| 8% convertible bonds | $1,000,000 | $1,000,000 |

During 1988, Jones paid dividends of $3.00 per share on its preferred stock. The preferred shares are convertible into 20,000 shares of common stock. The 8% bonds are convertible into 30,000 shares of common stock. Net income for 1988 is $850,000. Assume that the income tax rate is 30%.

The diluted earnings per share for 1988 is:

a. $5.48
b. $5.66
c. $5.81
d. $6.26

**CPA-01217 Explanation**
Choice "b" is correct. $5.66 diluted EPS.

**Rule:** All potentially dilutive convertible bonds and preferred stock are used in computing diluted EPS.

| | |
|---|---|
| Adjusted net income | |
| Net income | $ 850,000 |
| Add: Interest exp. ($1,000,000 × 8%) | 80,000 |
| Less: Tax deduction eliminated (30%) | (24,000) |
| Adjusted net income | $ 906,000 |
| Adjusted shares outstanding | |
| Shares outstanding - common | 110,000 |
| Conversion of preferred shares | 20,000 |
| Conversion of bonds | 30,000 |
| Adjusted shares outstanding | 160,000 |


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$$\frac{\text{Adj net income}}{\text{Adj SHS/OS}} = \frac{\$906{,}000}{160{,}000} = \underline{\underline{\$5.6625}}$$

**CPA-01218 Type1 M/C A-D Corr Ans: B PM#19 F 7-03**

63. CPA-01218 FARE Nov 88 #33 Page 30

Dilutive stock options would generally be used in the calculation of:

| | *Basic earnings per share* | *Diluted earnings per share* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | Yes |
| d. | Yes | No |

**CPA-01218 Explanation**
Choice "b" is correct. Dilutive stock options would be used in the calculation of diluted EPS.

**CPA-04775 Type1 M/C A-D Corr Ans: B PM#20 F 7-03**

64. CPA-04775 Released 2005 Page 27

During the current year, Comma Co. had outstanding: 25,000 shares of common stock, 8,000 shares of $20 par, 10% cumulative preferred stock, and 3,000 bonds that are $1,000 par and 9% convertible. The bonds were originally issued at par, and each bond was convertible into 30 shares of common stock. During the year, net income was $200,000, no dividends were declared, and the tax rate was 30%. What amount was Comma's basic earnings per share for the current year?

a. $3.38
b. $7.36
c. $7.55
d. $8.00

**CPA-04775 Explanation**
Choice "b" is correct. The formula:

$$\text{Basic EPS} = \frac{\text{Income available to common shareholders}}{\text{Weighted average number of common shares outstanding}}$$

$$\text{Basic EPS} = \frac{\$200{,}000 \text{ NI less cumulative PS dividend}}{25{,}000 \text{ shares of common stock}}$$

$$\text{Basic EPS} = \frac{\$200{,}000 - (8{,}000 \times \$20 \times 10\%)}{25{,}000 \text{ shares of common stock}}$$

$$7.36 = \frac{\$184{,}000}{25{,}000}$$

**CPA-05417 Type1 M/C A-D Corr Ans: A PM#20 F 7-03**

65. CPA-05417 Released 2007 Page 27

Jen Co. had 200,000 shares of common stock and 20,000 shares of 10%, $100 par value cumulative preferred stock. No dividends on common stock were declared during the year. Net income was $2,000,000. What was Jen's basic earnings per share?

a. $9.00


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b. $9.09
c. $10.00
d. $11.11

**CPA-05417 Explanation**
Choice "a" is correct. When a company has cumulative preferred stock, the preferred dividends deducted from net income to derive income available to common shareholders are equal to the dividends accumulated in the period, regardless of whether they have been declared. Given this, Jen Co.'s basic EPS is calculated as follows:

$$\frac{\text{Net income} - \text{Preferred dividends}}{\text{Weighted Avg. Number of common shares outstanding}} = \frac{\$2{,}000{,}000 - \$200{,}000^{1}}{200{,}000} = \$9.00/\text{share}$$

[1] Accumulated preferred dividends = 20,000 shares x $100 par x 10% = $200,000

Choice "b" is incorrect. The accumulated preferred dividends of $200,000 are subtracted from net income in the numerator to calculate EPS. The number of preferred share should not be added to the denominator when determining the weighted average number of common shares outstanding.

Choice "c" is incorrect. The preferred dividends accumulated during the period must be deducted from net income when calculating basic EPS, regardless of whether the dividends have been declared.

Choice "d" is incorrect. The accumulated preferred dividends of $200,000 are subtracted from net income in the numerator to calculate EPS. The number of preferred share should not be subtracted from the denominator when determining the weighted average number of common shares outstanding.

**CPA-05446 Type1 M/C A-D Corr Ans: C PM#22 F 7-03**

66. CPA-05446 Released 2007 Page 28

The following information pertains to Ceil Co., a company whose common stock trades in a public market:

| | |
|---|---|
| Shares outstanding at 1/1 | 100,000 |
| Stock dividend at 3/31 | 24,000 |
| Stock issuance at 6/30 | 5,000 |

What is the weighted-average number of shares Ceil should use to calculate its basic earnings per share for the year ended December 31?

a. 120,500
b. 123,000
c. 126,500
d. 129,000

**CPA-05446 Explanation**
Choice "c" is correct. When calculating the weighted - average number of shares to be used in the earnings-per-share calculation, stock dividends are treated as if they occurred at the beginning of the period. Ceil Co.'s weighted average number of shares should therefore be calculated as:

| | |
|---|---|
| 124,000 shares x 6/12 = | $ 62,000 |
| 129,000 shares x 6/12 = | 64,500 |
| Weighted average | $126,500 |

Choice "a" is incorrect. This weighted average calculation does not treat the stock dividend retroactively. Stock dividends must be treated as if they occurred at the beginning of the period.

Choice "b" is incorrect. This weighted average calculation treats the stock issuance as if it occurred at the beginning of the year and does not make a retroactive adjustment for the stock dividend. Stock issuances are not adjusted retroactively, but instead are time weighted for the period of the year in which the shares are outstanding. Stock dividends and stock splits must be treated retroactively.


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Choice "d" is incorrect. This is the total number of shares outstanding at December 31, not the weighted average number of shares outstanding for the year.

**Statement of Cash Flows**

**CPA-01219 Type1 M/C A-D Corr Ans: B PM#1 F 7-04**

67. CPA-01219 FARE R97 #3 Page 38

In its 1996 income statement, Kilm Co. reported cost of goods sold of $450,000. Changes occurred in several balance sheet accounts as follows:

| | | |
|---|---|---|
| Inventory | $160,000 | decrease |
| Accounts payable-suppliers | 40,000 | decrease |

What amount should Kilm report as cash paid to suppliers in its 1996 cash flow statement, prepared under the direct method?

a. $250,000
b. $330,000
c. $570,000
d. $650,000

**CPA-01219 Explanation**
Choice "b" is correct. In order to compute the cash paid to suppliers, Kilm Co. must determine how much inventory was purchased and the change in accounts payable. AP increases with purchases and decreases with payment. Thus,

Purchases = COGS + change in inventory
= $450,000 + ($160,000) = $290,000

However, since AP decreased, Kilm paid more cash to suppliers that just the amount for purchases:

Cash paid = Purchases – change in AP
= $290,000 – ($40,000) = $330,000

Choice "a" is incorrect. The decrease in AP is added to purchases (subtraction of a negative number). Recall that the decrease in AP means Kilm paid more cash to suppliers than just the amount for purchases.

Choice "c" is incorrect. The decrease in inventory is subtracted from COGS to determine purchases. (Remember COGS = beginning inventory + purchases – ending inventory; beginning inventory – ending inventory = net change in inventory.)

Choice "d" is incorrect. The decrease in AP is added to purchases (subtraction of a negative number). Recall that the decrease in AP means Kilm paid more cash to suppliers than just the amount for purchases. In addition, the decrease in inventory is subtracted from COGS to determine purchases. (Remember COGS = beginning inventory + purchases – ending inventory; beginning inventory – ending inventory = net change in inventory.)

**CPA-01221 Type1 M/C A-D Corr Ans: D PM#2 F 7-04**

68. CPA-01221 FARE Nov 95 #47 Page 36

Mend Co. purchased a three-month U.S. Treasury bill. Mend's policy is to treat as cash equivalents all highly liquid investments with an original maturity of three months or less when purchased. How should this purchase be reported in Mend's statement of cash flows?

a. As an outflow from operating activities.
b. As an outflow from investing activities.
c. As an outflow from financing activities.
d. Not reported.


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**CPA-01221 Explanation**
Choice "d" is correct. The U.S. Treasury bill is considered to be a cash equivalent item so purchasing the T-bill merely changes the form of cash held, it does not change the cash position of the entity. Thus, the purchase is not reported on the statement of cash flows. SFAS 95 para. 16

Choice "a" is incorrect. Changes between cash and cash equivalent items do not affect the cash position of the entity and are not reported as an outflow from operating activities on the statement of cash flows.

Choice "b" is incorrect. Changes between cash and cash equivalent items do not affect the cash position of the entity and are not reported as an outflow from investing activities on the statement of cash flows. However, purchase of other forms of debt instruments is an investing activity.

Choice "c" is incorrect. Changes between cash and cash equivalent items do not affect the cash position of the entity and are not reported as an outflow from financing activities on the statement of cash flows.

**CPA-01223 Type1 M/C A-D Corr Ans: D PM#3 F 7-04**

69. CPA-01223 FARE Nov 95 #48 Page 42

Which of the following is **not** disclosed on the statement of cash flows when prepared under the direct method, either on the face of the statement or in a separate schedule?

a. The major classes of gross cash receipts and gross cash payments.
b. The amount of income taxes paid.
c. A reconciliation of net income to net cash flow from operations.
d. A reconciliation of ending retained earnings to net cash flow from operations.

**CPA-01223 Explanation**
Choice "d" is correct. A reconciliation of ending retained earnings to net cash flow from operations is not disclosed on the statement of cash flows either on the direct or indirect method, nor is it shown in a separate schedule. Instead, the reconciliation is from "net income" to "net cash from operations."

Choices "a", "b", and "c" are incorrect. The following are required disclosures of a statement of cash flows under the direct method:

a. The major classes of gross cash receipts and gross cash payments.
b. The amount of income taxes paid.
c. A reconciliation of net income to net cash flow from operations.

**CPA-01227 Type1 M/C A-D Corr Ans: C PM#6 F 7-04**

70. CPA-01227 FARE May 95 #49 Page 40

Which of the following information should be disclosed as supplemental information in the statement of cash flows?

| | *Cash flow per share* | *Conversion of debt to equity* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |

**CPA-01227 Explanation**
Choice "c" is correct. No - Yes. Conversion of debt to equity should be disclosed as supplemental information in the statement of cash flows.

Cash flow per share should not be disclosed.


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**CPA-01228 Type1 M/C A-D Corr Ans: C PM#7 F 7-04**

71. CPA-01228 FARE Nov 94 #7 Page 42

Which of the following should **not** be disclosed in an enterprise's statement of cash flows prepared using the indirect method?

a. Interest paid, net of amounts capitalized.
b. Income taxes paid.
c. Cash flow per share.
d. Dividends paid on preferred stock.

**CPA-01228 Explanation**
Choice "c" is correct. Financial statements should not report an amount of cash flow per share. Neither cash flow nor any component of it is an alternative to net income as an indicator of an enterprise's performance, as reporting per share amounts might imply. SFAS 95 para. 33

Choice "a" is incorrect. Interest paid, net of capitalized amounts, is disclosed under the indirect method. SFAS 95 para. 23

Choice "b" is incorrect. Income taxes paid is disclosed under the indirect method. SFAS 95 para. 23

Choice "d" is incorrect. Dividends paid on preferred stock is disclosed. SFAS 95 para. 20

**CPA-01231 Type1 M/C A-D Corr Ans: C PM#8 F 7-04**

72. CPA-01231 FARE May 94 #5 Page 36

The primary purpose of a statement of cash flows is to provide relevant information about:

a. Differences between net income and associated cash receipts and disbursements.
b. An enterprise's ability to generate future positive net cash flows.
c. The cash receipts and cash disbursements of an enterprise during a period.
d. An enterprise's ability to meet cash operating needs.

**CPA-01231 Explanation**
Choice "c" is correct. The primary purpose of a statement of cash flows is to provide relevant information about the cash receipts and cash disbursements of an enterprise during an accounting period. SFAS 95 para. 4

Choice "a" is incorrect. The operating activities section of the statement of cash flows provides information about the differences between net income and associated cash receipts and disbursements. However, this is not the primary purpose of a statement of cash flows.

Choice "b" is incorrect. The statement of cash flows is an analysis of historical cash flows rather than a projection of an enterprise's ability to generate future cash flows.

Choice "d" is incorrect. The statement of cash flows is an analysis of historical cash flows rather than a projection of an enterprise's ability to meet cash operating needs.

**CPA-01232 Type1 M/C A-D Corr Ans: B PM#9 F 7-04**

73. CPA-01232 FARE May 94 #50 Page 40

Fara Co. reported bonds payable of $47,000 at December 31, 1992, and $50,000 at December 31, 1993. During 1993, Fara issued $20,000 of bonds payable in exchange for equipment. There was no amortization of bond premium or discount during the year. What amount should Fara report in its 1993 statement of cash flows for redemption of bonds payable?

a. $3,000
b. $17,000
c. $20,000


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d. $23,000

**CPA-01232 Explanation**

| | |
|---|---|
| Beginning balance 12/31/92 | 47,000 |
| Add: issuance of bonds for equipment | 20,000 |
| subtotal | 67,000 |
| Less: redemption of bonds payable | (17,000) |
| Ending balance 12/31/93 | 50,000 |

Choice "b" is correct. $17,000 redemption of bonds payable.

**CPA-01233 Type1 M/C A-D Corr Ans: A PM#10 F 7-04**

74. CPA-01233 PI Nov 93 #5 Page 38

Lino Co.'s worksheet for the preparation of its 1992 statement of cash flows included the following:

| | *December 31* | *January 1* |
|---|---|---|
| Accounts receivable | $29,000 | $23,000 |
| Allowance for uncollectible accounts | 1,000 | 800 |
| Prepaid rent expense | 8,200 | 12,400 |
| Accounts payable | 22,400 | 19,400 |

Lino's 1992 net income is $150,000. What amount should Lino include as net cash provided by operating activities in the statement of cash flows?

a. $151,400
b. $151,000
c. $148,600
d. $145,400

**CPA-01233 Explanation**

Choice "a" is correct. $151,400 net cash provided by operating activities, as follows:

| | |
|---|---|
| Net income | $150,000 |
| Increase in A/R | (6,000) |
| Increase in allowance | 200 |
| Decrease in prepaid | 4,200 |
| Increase in A/P | 3,000 |
| | $151,400 |

**CPA-01234 Type1 M/C A-D Corr Ans: B PM#11 F 7-04**

75. CPA-01234 PI Nov 93 #6 Page 38

Karr, Inc. reported net income of $300,000 for 1992. Changes occurred in several balance sheet accounts as follows:

| | |
|---|---|
| Equipment | $25,000 increase |
| Accumulated depreciation | 40,000 increase |
| Note payable | 30,000 increase |

*Additional information:*

- During 1992, Karr sold equipment costing $25,000, with accumulated depreciation of $12,000, for a gain of $5,000.
- In December 1992, Karr purchased equipment costing $50,000 with $20,000 cash and a 12% note payable of $30,000.
- Depreciation expense for the year was $52,000.

In Karr's 1992 statement of cash flows, net cash provided by operating activities should be:


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a. $340,000
b. $347,000
c. $352,000
d. $357,000

**CPA-01234 Explanation**
Choice "b" is correct. Cash provided by operations is computed as follows:

| | |
|---|---|
| Net income | $300,000 |
| Depreciation expense | 52,000 |
| Gain on sale of equipment | (5,000) |
| Cash provided by operations | $347,000 |

The journal entry for the equipment sold is:

| | | |
|---|---|---|
| Cash | 18,000 | |
| Accumulated depreciation | 12,000 | |
| Gain | | 5,000 |
| Equipment | | 25,000 |

The depreciation expense is added to income and the gain deducted. SFAS 95 para. 21

**CPA-01235 Type1 M/C A-D Corr Ans: A PM#12 F 7-04**

76. CPA-01235 PI Nov 93 #7 Page 39

Karr, Inc. reported net income of $300,000 for 1992. Changes occurred in several balance sheet accounts as follows:

| | | |
|---|---|---|
| Equipment | $25,000 | increase |
| Accumulated depreciation | 40,000 | increase |
| Note payable | 30,000 | increase |

*Additional information:*
- During 1992, Karr sold equipment costing $25,000, with accumulated depreciation of $12,000, for a gain of $5,000.
- In December 1992, Karr purchased equipment costing $50,000 with $20,000 cash and a 12% note payable of $30,000.
- Depreciation expense for the year was $52,000.

In Karr's 1992 statement of cash flows, net cash used in investing activities should be:

a. $2,000
b. $12,000
c. $22,000
d. $35,000

**CPA-01235 Explanation**
Choice "a" is correct. Cash used for investing activities is computed as follows:

| | |
|---|---|
| • Sale of equipment | $ 18,000 |
| • Purchase of equipment | (20,000) |
| • Cash used for investing | $ 2,000 |

The $30,000 note is noncash financing activity. The journal entry for the sale of equipment is:

| | | |
|---|---|---|
| Cash | 18,000 | |
| Accumulated depreciation | 12,000 | |
| Gain | | 5,000 |
| Equipment | | 25,000 |

SFAS 95 para. 15


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**CPA-01239 Type1 M/C A-D Corr Ans: C PM#13 F 7-04**

77. CPA-01239 PI Nov 93 #8 Page 40

During 1992, Xan, Inc. had the following activities related to its financial operations:

| | |
|---|---|
| Payment for the early retirement of long-term bonds payable (carrying amount $370,000) | $375,000 |
| Distribution in 1992 of cash dividend declared in 1991 to preferred shareholders | 31,000 |
| Carrying amount of convertible preferred stock in Xan, converted into common shares | 60,000 |
| Proceeds from sale of Treasury stock (carrying amount at cost, $43,000) | 50,000 |

In Xan's 1992 statement of cash flows, net cash used in financing operations should be:

a. $265,000
b. $296,000
c. $356,000
d. $358,000

**CPA-01239 Explanation**
Choice "c" is correct. $356,000 net cash used in financing operations.

Note: Conversion of preferred stock into common stock is a noncash financing disclosure.

| | |
|---|---|
| Payment to retire bonds | $(375,000) |
| Payment of dividend | (31,000) |
| Proceeds from Treasury stock | 50,000 |
| | $(356,000) |

**CPA-01241 Type1 M/C A-D Corr Ans: D PM#14 F 7-04**

78. CPA-01241 PI Nov 93 #9 Page 38

Duke Co. reported cost of goods sold of $270,000 for 1992. Additional information is as follows:

| | *December 31* | *January 1* |
|---|---|---|
| Inventory | $60,000 | $45,000 |
| Accounts payable | 26,000 | 39,000 |

If Duke uses the direct method, what amount should Duke report as cash paid to suppliers in its 1992 statement of cash flows?

a. $242,000
b. $268,000
c. $272,000
d. $298,000

**CPA-01241 Explanation**
Choice "d" is correct. $298,000 cash paid to suppliers under the direct method.

| | |
|---|---|
| COGS | $270,000 |
| Increase in inventory | 15,000 |
| Decrease in accounts payable | 13,000 |
| | $298,000 |

**CPA-01242 Type1 M/C A-D Corr Ans: A PM#15 F 7-04**

79. CPA-01242 Th Nov 93 #41 Page 39

In a statement of cash flows, if used equipment is sold at a gain, the amount shown as a cash inflow from investing activities equals the carrying amount of the equipment:


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a. Plus the gain.
b. Plus the gain and less the amount of tax attributable to the gain.
c. Plus both the gain and the amount of tax attributable to the gain.
d. With no addition or subtraction.

**CPA-01242 Explanation**
Choice "a" is correct. In a statement of cash flows, if used equipment is sold at a gain, the amount shown as a cash inflow from investing activities equals the carrying amount of the equipment plus the gain.

Choices "b" and "c" are incorrect. The amount of tax attributable to the gain remains as part of operating activities.

Choice "d" is incorrect. Gain must be added to the carrying amount to equal "cash proceeds from sale of equipment."

**CPA-01244 Type1 M/C A-D Corr Ans: C PM#16 F 7-04**

80. CPA-01244 Th Nov 93 #42 Page 40

On July 1, 1992, Dewey Co. signed a 20-year building lease that it reported as a capital lease. Dewey paid the monthly lease payments when due. How should Dewey report the effect of the lease payments in the financing activities section of its 1992 statement of cash flows?

a. An inflow equal to the present value of future lease payments at July 1, 1992, less 1992 principal and interest payments.
b. An outflow equal to the 1992 principal and interest payments on the lease.
c. An outflow equal to the 1992 principal payments only.
d. The lease payments should not be reported in the financing activities section.

**CPA-01244 Explanation**
Choice "c" is correct. Cash payments made to reduce debt principal are properly reported as a financing activity. Cash interest payments would be reported as a component of cash from operating activities. SFAS 95 para. 20

Choice "a" is incorrect. Under a leasing agreement, there is no cash inflow to the lessee.

Choice "b" is incorrect. Cash interest payments would be reported as a component of cash from operating activities.

Choice "d" is incorrect. Cash payments made to reduce debt principal are properly reported as a financing activity.

**CPA-01245 Type1 M/C A-D Corr Ans: D PM#17 F 7-04**

81. CPA-01245 Th May 93 #32 Page 39

On September 1, 1992, Canary Co. sold used equipment for a cash amount equaling its carrying amount for both book and tax purposes. On September 15, 1992, Canary replaced the equipment by paying cash and signing a note payable for new equipment. The cash paid for the new equipment exceeded the cash received for the old equipment. How should these equipment transactions be reported in Canary's 1992 statement of cash flows?

a. Cash outflow equal to the cash paid less the cash received.
b. Cash outflow equal to the cash paid and note payable less the cash received.
c. Cash inflow equal to the cash received and a cash outflow equal to the cash paid and noted payable.
d. Cash inflow equal to the cash received and a cash outflow equal to the cash paid.

**CPA-01245 Explanation**
Choice "d" is correct. Cash inflow equal to the cash received for the old equipment that was sold, and a cash outflow equal to the cash paid for the new equipment.


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Choice "a" is incorrect. Cash outflow should not be reduced by cash inflow received.

Choice "b" is incorrect. The note payable is not a cash outflow, and cash outflow should not be reduced by cash inflow received.

Choice "c" is incorrect. The note payable is not a cash outflow.

**CPA-01247 Type1 M/C A-D Corr Ans: C PM#18 F 7-04**

82. CPA-01247 Th May 93 #33 Page 38

How should a gain from the sale of used equipment for cash be reported in a statement of cash flows using the indirect method?

a. In investment activities as a reduction of the cash inflow from the sale.
b. In investment activities as a cash outflow.
c. In operating activities as a deduction from income.
d. In operating activities as an addition to income.

**CPA-01247 Explanation**
Choice "c" is correct. In a statement of cash flows using the indirect method, gain from the sale of used equipment for cash should be reported in operating activities as a deduction from income.

Choice "a" is incorrect. In the investment activities section, cash inflow from the sale should be reported for the entire proceeds from the sale.

Choice "b" is incorrect. In the investment activities section, cash outflows should be reported for purchases of fixed assets, stocks/bonds of other entities.

Choice "d" is incorrect. In the operating activities section, "loss" from the sale of used equipment should be reported as an addition to income.

**CPA-04657 Type1 M/C A-D Corr Ans: C PM#19 F 7-04**

83. CPA-04657 Released 2005 Page 37

In its cash flow statement for the current year, Ness Co. reported cash paid for interest of $70,000. Ness did not capitalize any interest during the current year. Decreases occurred in several balance sheet accounts as follows:

| | |
|---|---|
| Accrued interest payable | $17,000 |
| Prepaid interest | 23,000 |

In its income statement for the current year, what amount should Ness report as interest expense?

a. $30,000
b. $64,000
c. $76,000
d. $110,000

**CPA-04657 Explanation**
Choice "c" is correct. Interest expense is reported on a cash basis in the Statement of Cash Flows, and on the accrual basis in the Income Statement. Convert from accrual basis to cash basis:

| | |
|---|---|
| Cash basis interest expense | $70,000 |
| Add decrease in prepaid interest | 23,000 |
| Sub total | 93,000 |
| Subtract decrease in interest payable | (17,000) |
| Accrual basis interest expense | $76,000 |


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**CPA-04691 Type1 M/C A-D Corr Ans: D PM#20 F 7-04**

84. CPA-04691 Released 2005 Page 36

The following are held by Smite Co.:

| | |
|---|---|
| Cash in checking account | $20,000 |
| Cash in bond sinking fund account | 30,000 |
| Post-dated check from customer dated one month from balance sheet date | 250 |
| Petty cash | 200 |
| Commercial paper (matures in two months) | 7,000 |
| Certified of deposit (matures in six months) | 5,000 |

What amount should be reported as cash and cash equivalents on Smite's balance sheet?

a. $57,200
b. $32,200
c. $27,450
d. $27,200

**CPA-04691 Explanation**
Choice "d" is correct. Cash is defined as actual unrestricted cash and cash equivalents are defined as short-term, liquid investments that are so near maturity (original maturity date was within three months of the purchase date) that the risk of changes in the value because of interest rate changes is insignificant.

| | |
|---|---|
| Cash in checking account | $20,000 |
| Petty Cash | 200 |
| Commercial Paper (2 month maturity) | 7,000 |
| Cash and Cash equivalents | $27,200 |

**CPA-04653 Type1 M/C A-D Corr Ans: B PM#20 F 7-04**

85. CPA-04653 Released 2005 Page 36

Reed Co.'s 2001 statement of cash flows reported cash provided from operating activities of $400,000. For 2001, depreciation of equipment was $190,000, amortization of goodwill was $5,000, and dividends paid on common stock were $100,000. In Reed's 2001 statement of cash flows, what amount was reported as net income?

a. $105,000
b. $205,000
c. $305,000
d. $595,000

**CPA-04653 Explanation**
Choice "b" is correct. Start with cash flows from operating activities and subtract depreciation and amortization expenses. Dividends paid are not included because dividends paid are included in financing activities.

| | |
|---|---|
| Cash flows from operating activities | $400,000 |
| Depreciation on equipment | (190,000) |
| Amortization of goodwill | (5,000) |
| Net Income | $205,000 |

**CPA-05202 Type1 M/C A-D Corr Ans: C PM#22 F 7-04**

86. CPA-05202 Released 2006 Page 37

Payne Co. prepares its statement of cash flows using the indirect method. Payne's unamortized bond discount account decreased by $25,000 during the year. How should Payne report the change in unamortized bond discount in its statement of cash flows?


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a. As a financing cash inflow.
b. As a financing cash outflow.
c. As an addition to net income in the operating activities section.
d. As a subtraction from net income in the operating activities section.

**CPA-05202 Explanation**
Choice "c" is correct. Amortization of bond discount is an income-related item; thus, it is almost automatically an operating activity, not a financing activity. That knocks out two of the answers. Because the amortization of the discount was originally subtracted to get to net income in the first place, it is added back to net income for an indirect method statement of cash flows.

Choice "a" is incorrect. Amortization of bond discount is not a financing activity at all and certainly not a financing cash inflow.

Choice "b" is incorrect. Amortization of bond discount is not a financing activity at all and certainly not a financing cash outflow.

Choice "d" is incorrect. Because the amortization of the discount was originally subtracted to get to net income in the first place, it is added back to, **not** subtracted from, net income for an indirect method statement of cash flows.

**CPA-05219 Type1 M/C A-D Corr Ans: C PM#23 F 7-04**

87. CPA-05219 Released 2006 Page 37

Which of the following items is included in the financing activities section of the statement of cash flows?

a. Cash effects of transactions involving making and collecting loans.
b. Cash effects of acquiring and disposing of investments and property, plant, and equipment.
c. Cash effects of transactions obtaining resources from owners and providing them with a return on their investment.
d. Cash effects of transactions that enter into the determination of net income.

**CPA-05219 Explanation**
Choice "c" is correct. Financing activities include the cash effects of transactions obtaining resources from owners and providing them with a return on their investment.

Choice "a" is incorrect. The cash effects of transactions involving making and collecting loans are included in investing activities, **not** financing activities.

Choice "b" is incorrect. The cash effects of acquiring and disposing of investments and property, plant, and equipment are included in investing activities, **not** financing activities.

Choice "d" is incorrect. The cash effects of transactions that enter into the determination of net income are included in operating activities, **not** financing activities.

**CPA-05229 Type1 M/C A-D Corr Ans: C PM#24 F 7-04**

88. CPA-05229 Released 2006 Page 37

New England Co. had net cash provided by operating activities of $351,000; net cash used by investing activities of $420,000; and cash provided by financing activities of $250,000. New England's cash balance was $27,000 on January 1. During the year, there was a sale of land that resulted in a gain of $25,000 and proceeds of $40,000 were received from the sale. What was New England's cash balance at the end of the year?

a. $27,000
b. $40,000
c. $208,000
d. $248,000

**CPA-05229 Explanation**


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Choice "c" is correct. New England's cash balance at the end of the year includes the cash balance at the beginning of the year, the net cash provided by operating activities, the net cash used by investing activities, and the net cash provided by financing activities ($27,000 + $351,000 - $420,000 + $250,000 = $208,000). The sale of the land was included in the cash from the investing activities and does not have to be considered separately. When working this type of question, be sure to distinguish between the net cash used and the net cash provided.

Choice "a" is incorrect. The cash balance at the end of the year certainly includes more than just the cash balance at the beginning of the year.

Choice "b" is incorrect. The cash balance at the end of the year certainly includes more than just the proceeds from the land.

Choice "d" is incorrect. The proceeds from the sale of the land are already included in the net cash from investing activities. It does not have to be considered separately and does not have to be added.

**CPA-05423 Type1 M/C A-D Corr Ans: A PM#26 F 7-04**

89. CPA-05423 Released 2007 Page 39

Paper Co. had net income of $70,000 during the year. Dividend payment was $10,000. The following information is available:

| | |
|---|---|
| Mortgage repayment | $20,000 |
| Available-for-sale securities purchased | 10,000 increase |
| Bonds payable - issued | 50,000 increase |
| Inventory | 40,000 increase |
| Accounts payable | 30,000 decrease |

What amount should Paper report as net cash provided by operating activities in its statement of cash flows for the year?

a. $0
b. $10,000
c. $20,000
d. $30,000

**CPA-05423 Explanation**

Choice "a" is correct. The operating activities section includes cash flows from working capital (current assets and current liabilities) and other income statement items. Under the indirect method, net income is adjusted for non-cash items and increases/decrease in working capital items to arrive at net cash from operating activities. Increases in current assets and decreases in current liabilities are uses of cash, while decreases in current assets and increases in current liabilities increase cash.

| | |
|---|---|
| Net income | $70,000 |
| Less: Increase in inventory | (40,000) |
| Less: Decrease in AP | (30,000) |
| Net cash provided by operating activities | $ 0 |

Choice "b" is incorrect. The increase in available-for-sale securities decreases cash and is reported in the investing section, not the operating section, of the statement of cash flows.

Choice "c" is incorrect. The mortgage repayment is a cash outflow that is reported in the financing section.

Choice "d" is incorrect. Net income must be adjusted for the decrease in AP as well as the increase in inventory.

**CPA-05450 Type1 M/C A-D Corr Ans: D PM#27 F 7-04**

90. CPA-05450 Released 2007 Page 39


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Savor Co. had $100,000 in cash-basis pretax income for 1999. At December 31, 1999, accounts receivable had increased by $10,000 and accounts payable had decreased by $6,000 from their December 31, 1998, balances. Compared to the accrual basis method of accounting, Savor's cash pretax income is:

a. Higher by $4,000.
b. Lower by $4,000.
c. Higher by $16,000.
d. Lower by $16,000.

**CPA-05450 Explanation**
Choice "d" is correct. A $10,000 increase in accounts receivable means that $10,000 of the sales revenue recorded using the accrual basis during the year has not yet been paid by the customers. Under cash basis accounting, revenue is not recorded until the cash has been received, so this amount must be deducted to arrive at cash basis income.

The $6,000 decrease in accounts payable means that total cash payments to vendors during the year exceeded the current period's accrual basis expenses. Under the cash basis, expenses are recorded when payment is made, so the $6,000 must be deducted to arrive at cash basis income.

If cash-basis pretax income is $100,000, then accrual-basis pretax income must be $116,000 ($116,000 - $10,000 - $6,000 = $100,000).

Choice "a" is incorrect. The increase in accounts receivable must be subtracted from, not added to, accrual basis income to calculated cash basis income, as explained above.

Choice "b" is incorrect. The decrease in accounts payable must be subtracted from, not added to, accrual basis income to calculated cash basis income, as explained above.

Choice "c" is incorrect. Both the increase in accounts receivable and the decrease in accounts payable must be subtracted from, not added to, accrual basis income to calculated cash basis income, as explained above.

**CPA-05462 Type1 M/C A-D Corr Ans: B PM#28 F 7-04**

91. CPA-05462 Released 2007 Page 39

During the current year, Ace Co. amortized a bond discount. Ace prepares its statement of cash flows using the indirect method. In which section of the statement should Ace report the amortization of the bond discount?

a. Financing activities.
b. Operating activities.
c. Investing activities.
d. Supplemental disclosures.

**CPA-05462 Explanation**
Choice "b" is correct. When the indirect method is used, net income must be adjusted for all income statement items that do not affect operating cash receipts and disbursements. When a bond interest payment is made, the following journal entry is recorded:

DR Interest expense
CR Cash
CR Bond discount amortization

Interest expense exceeds the cash interest payment by the amount of the bond discount amortization. The bond discount amortization must therefore be added back to net income so that operating activities reflect only the cash paid for interest.

Choice "a" is incorrect. Although arising from debt, which is a financing activity, bond discount amortization is reported in operating activities because it is related to interest expense, which is an income statement (operating activities) item.


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Choice "c" is incorrect. Bond discount amortization is not related to investments and is therefore not reported in investing activities.

Choice "d" is incorrect. Bond discount amortization is reported in operating activities when the indirect method is used for the reasons described above.

**Supplemental Questions**

**CPA-01458 Type1 M/C A-D Corr Ans: D PM#1 F 7-99**

92. CPA-01458 Nov 89 #20 Page 10

A corporation was organized in January 1988 with authorized capital of $10 par value common stock. On February 1, 1988, shares were issued at par for cash. On March 1, 1988, the corporation's attorney accepted 5,000 shares of the common stock in settlement for legal services with a fair value of $60,000. Additional paid-in capital would increase on:

| | *February 1, 1988* | *March 1, 1988* |
|---|---|---|
| a. | Yes | No |
| b. | Yes | Yes |
| c. | No | No |
| d. | No | Yes |

**CPA-01458 Explanation**
Choice "d" is correct. No - Yes.

| | Dr | Cr |
|---|---|---|
| February 1, 1988 - sale of common stock at par | | |
| Cash | $1,000,000 | |
| Common stock at par value ($10 x 100,000 sh assumed) | | $1,000,000 |
| Additional paid-in capital | | 0 |
| March 1, 1988 - 5,000 shares of common for $60,000 legal services | | |
| Legal services (Organization cost) | 60,000 | |
| Common stock at par value ($10 x 5,000 sh) | | 50,000 |
| Additional paid-in capital (excess) | | 10,000 |

**CPA-01460 Type1 M/C A-D Corr Ans: B PM#2 F 7-99**

93. CPA-01460 Nov 89 #21 Page 18

A corporation declared a dividend, a portion of which was liquidating. How would this declaration affect each of the following?

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

**CPA-01460 Explanation**
Choice "b" is correct. Decrease - Decrease.

**Rule:** A "liquidating dividend" is a return of capital (which decreases additional paid-in capital) and not a distribution of earnings (which decreases retained earnings).

Assume 80% distribution of earnings and 20% liquidating:

| | | |
|---|---|---|
| Retained earnings (80%) | 80,000 | |
| Additional paid-in capital (20%) | 20,000 | |
| Cash (dividend payable) | | 100,000 |


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**CPA-01463 Type1 M/C A-D Corr Ans: A PM#3 F 7-99**

94. CPA-01463 May 90 #14 Page 18

Pott Co. owned shares in Rose Co. On December 1, 1989, Pott declared and distributed a property dividend of Rose shares when their fair value exceeded the carrying amount. As a consequence of the dividend declaration and distribution, the accounting effects would be:

| | *Property dividends recorded at* | *Retained earnings* |
|---|---|---|
| a. | Fair value | Decreased |
| b. | Fair value | Increased |
| c. | Cost | Increased |
| d. | Cost | Decreased |

**CPA-01463 Explanation**
Choice "a" is correct. Property dividends are recorded at "fair value." Retained earnings are "decreased" when property dividends are "declared."

**Rule:** Use FMV of asset (not cost) to reduce retained earnings when property dividend is declared. The cost of asset will be adjusted to FMV (difference treated as "gain or loss on disposal of asset") when a property dividend is declared. Retained earnings is reduced for both cash and property dividends.

**CPA-01466 Type1 M/C A-D Corr Ans: B PM#4 F 7-99**

95. CPA-01466 Nov 90 L #17 Page 20

All of the following distributions to stockholders are considered asset or capital distributions, **except**:

a. Liquidating dividends.
b. Stock splits.
c. Property distributions.
d. Cash dividends.

**CPA-01466 Explanation**
Choice "b" is correct. A "stock split" increases the number of shares. Only the number of shares changes. The capital stock and retained earnings do not change. It is not considered a capital or asset distribution.

Choice "a" is incorrect. Liquidating dividends are a return of capital and therefore a capital distribution.

Choice "c" is incorrect. A property distribution (e.g., of a fixed asset) is considered an asset distribution.

Choice "d" is incorrect. A cash dividend is considered an asset distribution.

**CPA-01467 Type1 M/C A-D Corr Ans: C PM#5 F 7-99**

96. CPA-01467 Nov 90 #32 Page 19

How would the declaration of a 15% stock dividend by a corporation affect each of the following?

| | *Retained earnings* | *Total stockholders' equity* |
|---|---|---|
| a. | No effect | No effect |
| b. | No effect | Decrease |
| c. | Decrease | No effect |
| d. | Decrease | Decrease |

**CPA-01467 Explanation**
Choice "c" is correct. Decrease to retained earnings - no effect on shareholder's equity.


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**Rule:** A stock dividend (less than 20-25% of stock outstanding) is treated by transferring the FMV of the stock dividend at declaration date from retained earnings to capital stock and paid-in capital. There is no effect on total shareholder's equity because all transfers take place within shareholder's equity.

**CPA-01471 Type1 M/C A-D Corr Ans: D PM#6 F 7-99**

97. CPA-01471 May 91 I #12 Page 13

Mag, Inc.'s December 31, 1990, unadjusted current assets and stockholders' equity sections are as follows:

| | |
|---|---|
| *Current Assets:* | |
| Cash | $ 15,000 |
| Investments in marketable equity securities (including $75,000 of Mag, Inc. common stock) | 100,000 |
| Trade accounts receivable | 85,000 |
| Inventories | 37,000 |
| Total | $237,000 |
| *Stockholders' Equity:* | |
| Common stock | $556,000 |
| Retained earnings (deficit) | (56,000) |
| Total | $500,000 |

The investments and inventories are reported at their costs, which approximate market values.

Mag's stockholders' equity at December 31,1990, should be:

a. $556,000
b. $500,000
c. $481,000
d. $425,000

**CPA-01471 Explanation**

Choice "d" is correct. $425,000 ($500,000 - $75,000). Shares of its own stock held by a corporation should be recorded as treasury stock and shown as a reduction in the stockholders' equity section of the B/S.

Choices "a" and "c" are incorrect. Retained earnings (deficit) is a component of stockholders' equity.

Choice "b" is incorrect. Shares of the company's own stock should be reclassed out of investments.

**CPA-01490 Type1 M/C A-D Corr Ans: A PM#7 F 7-99**

98. CPA-01490 May 91 I #19 Page 13

Pugh Co. reported the following in its statement of stockholders' equity on January 1, 1990:

| | |
|---|---|
| Common stock, $5 par value, authorized 200,000 shares, issued 100,000 shares | $ 500,000 |
| Additional paid-in capital | 1,500,000 |
| Retained earnings | 516,000 |
| | 2,516,000 |
| Less treasury stock, at cost, 5,000 shares | (40,000) |
| Total stockholders' equity | $2,476,000 |

The following events occurred in 1990:

May 1 - 1,000 shares of treasury stock were sold for $10,000.

July 9 - 10,000 shares of previously unissued common stock were sold for $12 per share.

October 1 - The distribution of a 2-for-1 stock split resulted in the common stock's per share par value being halved.


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Pugh accounts for treasury stock under the cost method. Laws in the state of Pugh's incorporation protect shares held in treasury from dilution when stock dividends or stock splits are declared.

In Pugh's December 31, 1990, statement of stockholders' equity, the par value of the issued common stock should be:

a. $550,000
b. $518,000
c. $291,000
d. $275,000

**CPA-01490 Explanation**
Choice "a" is correct. $550,000. At year-end there will be 220,000 shares issued with a par value of $2.50.

**CPA-01491 Type1 M/C A-D Corr Ans: D PM#8 F 7-99**

99. CPA-01491 May 91 I #20 Page 13

Pugh Co. reported the following in its statement of stockholders' equity on January 1, 1990:

| | |
|---|---|
| Common stock, $5 par value, authorized 200,000 shares, issued 100,000 shares | $ 500,000 |
| Additional paid-in capital | 1,500,000 |
| Retained earnings | 516,000 |
| | 2,516,000 |
| Less treasury stock, at cost, 5,000 shares | (40,000) |
| Total stockholders' equity | $2,476,000 |

The following events occurred in 1990:

May 1 - 1,000 shares of treasury stock were sold for $10,000.

July 9 - 10,000 shares of previously unissued common stock were sold for $12 per share.

October 1 - The distribution of a 2-for-1 stock split resulted in the common stock's per share par value being halved.

Pugh accounts for treasury stock under the cost method. Laws in the state of Pugh's incorporation protect shares held in treasury from dilution when stock dividends or stock splits are declared.

The number of outstanding common shares at December 31, 1990, should be:

a. 222,000
b. 220,000
c. 216,000
d. 212,000

**CPA-01491 Explanation**
Choice "d" is correct. $212,000.

| | |
|---|---|
| Original shares outstanding | 100,000 |
| Less: Shares in treasury | (5,000) |
| Plus: Treasury shares sold | 1,000 |
| Plus: New shares issued | 10,000 |
| Total shares O/S before split | 106,000 |
| Two-for-one stock split | x2 |
| Shares O/S after stock split | 212,000 |

**CPA-01492 Type1 M/C A-D Corr Ans: B PM#9 F 7-99**

100. CPA-01492 May 91 II #12 Page 19

The following stock dividends were declared and distributed by Sol Corp.:

*Percentage of common*


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| *shares outstanding at declaration date* | *Fair value* | *Par value* |
|---|---|---|
| 10 | $15,000 | $10,000 |
| 28 | 40,000 | 30,800 |

What aggregate amount should be debited to retained earnings for these stock dividends?

a. $40,800
b. $45,800
c. $50,000
d. $55,000

**CPA-01492 Explanation**
Choice "b" is correct. $45,800.

For a small stock dividend (i.e., less than 20% of the shares outstanding prior to the split) the FMV of the shares is capitalized from Retained Earnings. For a large stock dividend "a stock split effected in the form of a dividend" only the amount legally required to be capitalized is transferred from Retained Earnings (typically the par value of the stock).

Choice "a" is incorrect. Fair value not par value should be used on a small stock dividend (less than 20% of the shares outstanding prior to the dividend).

Choice "c" is incorrect. Fair value should be used for a small dividend, and par value should be used for a large stock dividend.

Choice "d" is incorrect. Par value should be used for a large stock dividend.

**CPA-01493 Type1 M/C A-D Corr Ans: A PM#10 F 7-99**

101. CPA-01493 Nov 91 II #1 Page 20

Of the 125,000 shares of common stock issued by Vey Corp., 25,000 shares were held as treasury stock at December 31, 1989. During 1990, transactions involving Vey's common stock were as follows:

January 1 through October 31 - 13,000 treasury shares were distributed to officers as part of a stock compensation plan.
November 1 - A 3-for-1 stock split took effect.
December 1 - Vey purchased 5,000 of its own shares to discourage an unfriendly takeover. These shares were not retired.

At December 31, 1990, how many shares of Vey's common stock were issued and outstanding?

| | *Issued* | *Shares Outstanding* |
|---|---|---|
| a. | 375,000 | 334,000 |
| b. | 375,000 | 324,000 |
| c. | 334,000 | 334,000 |
| d. | 324,000 | 324,000 |

**CPA-01493 Explanation**
Choice "a" is correct. 375,000 issued and 334,000 outstanding common shares.

| | Issued | Outstanding | Treasury stock |
|---|---|---|---|
| Balance 12-31-89 | 125,000 | 100,000 | 25,000 |
| Oct. 31 distributed to officers | -- | 13,000 | <13,000> |
| | 125,000 | 113,000 | 12,000 |
| Nov. 1 - 3-for-1 split* | x 3 | x 3 | x 3 |
| | 375,000 | 339,000 | 36,000 |
| Dec. 1 share purchase | -- | <5,000> | 5,000 |


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| | | | |
|---|---|---|---|
| Balance 12-31-90 | 375,000 | 334,000 | 41,000 |

* Note that the treasury stock is also affected by the stock split assuming it is held to satisfy stock option commitments.

**CPA-01494 Type1 M/C A-D Corr Ans: D PM#11 F 7-99**

102. CPA-01494 Nov 91 II #3 Page 18

Hoyt Corp.'s current balance sheet reports the following stockholders' equity:

| | |
|---|---|
| 5% cumulative preferred stock, par value $100 per share; 2,500 shares issued and outstanding | $250,000 |
| Common stock, par value $3.50 per share; 100,000 shares issued and outstanding | 350,000 |
| Additional paid-in capital in excess of par value of common stock | 125,000 |
| Retained earnings | 300,000 |

Dividends in arrears on the preferred stock amount to $25,000. If Hoyt were to be liquidated, the preferred stockholders would receive par value plus a premium of $50,000. The book value per share of common stock is:

a. $7.75
b. $7.50
c. $7.25
d. $7.00

**CPA-01494 Explanation**

Choice "d" is correct. $7.00 book value per common share.

| | |
|---|---|
| Preferred stock | 250,000 |
| Common stock | 350,000 |
| Additional paid-in capital | 125,000 |
| Retained earnings | 300,000 |
| Total stockholders equity | 1,025,000 |
| Less: PR stock interest | (325,000)* |
| | 700,000 |
| Total shares O/S | ÷ 100,000 |
| Book value per share | $ 7.00 |

| | |
|---|---|
| * Par value preferred | 250,000 |
| Premium on preferred | 50,000 |
| Div. In arrears | 25,000 |
| Total preferred stock interest | 325,000 |

Any preferred shareholder interest must be removed from shareholders' equity before computing book value per share.

**CPA-01495 Type1 M/C A-D Corr Ans: D PM#12 F 7-99**

103. CPA-01495 Nov 91 II #6 Page 18

Ole Corp. declared and paid a liquidating dividend of $100,000. This distribution resulted in a decrease in Ole's:

| | *Paid-in capital* | *Retained earnings* |
|---|---|---|
| a. | No | No |
| b. | Yes | Yes |
| c. | No | Yes |


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d. Yes No

**CPA-01495 Explanation**
Choice "d" is correct. Yes - No.

By definition, a liquidating dividend is one in which the company is returning a portion of capital originally contributed to the company in excess of retained earnings. A (pure) "liquidating dividend" implies there is no "retained earnings" left to decrease.

**CPA-01496 Type1 M/C A-D Corr Ans: C PM#13 F 7-99**

104. CPA-01496 Nov 91 #39 Page 13

Posy Corp. acquired treasury shares at an amount greater than their par value, but less than their original issue price. Compared to the cost method of accounting for treasury stock, does the par value method report a greater amount for additional paid-in capital and a greater amount for retained earnings?

| | *Additional paid-in capital* | *Retained earnings* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | No |
| d. | No | Yes |

**CPA-01496 Explanation**
Choice "c" is correct. No - No.

Compared to the cost method for reporting treasury stock, the par value method will report a lower amount for additional paid-in capital (APIC) and the same amount for retained earnings.

The easiest way to solve this problem is to make a set of assumptions consistent with the facts and record the proper entries.

Assumptions:

| | |
|---|---|
| Original issue | $100 |
| Acquisition cost | $80 |
| Par value | $60 |

| Cost method | DR | CR |
|---|---|---|
| Treasury stock | 80 | |
| Cash | | 80 |

| Par value method | DR | CR |
|---|---|---|
| Treasury stock | 60 | |
| APIC | 20 | |
| Cash | | 80 |

Note: The only difference is that a portion of the debit is transferred from treasury stock to APIC, thereby reducing the credit balance of APIC.

**CPA-01520 Type1 M/C A-D Corr Ans: C PM#14 F 7-99**

105. CPA-01520 Nov 91 #40 Page 13

Grid Corp. acquired some of its own common shares at a price greater than both their par value and original issue price but less than their book value. Grid uses the cost method of accounting for treasury stock. What is the impact of this acquisition on total stockholders' equity and the book value per common share?

| | *Total stockholders' equity* | *Book value per share* |
|---|---|---|
| a. | Increase | Increase |
| b. | Increase | Decrease |
| c. | Decrease | Increase |


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d. Decrease Decrease

**CPA-01520 Explanation**
Choice "c" is correct. Decrease - Increase.

The acquisition of treasury stock at a price less than their book value will:

1. Decrease stockholders' equity in total. All treasury stock transactions decrease total equity.

2. Increase book value per share. Book value per share is based on the number of outstanding common shares, which is reduced by the acquisition of treasury stock (the denominator is reduced). The numerator (book value) is also reduced by the cost to purchase the shares, but the overall effect on the ratio is an increase in book value per share. For example, if book value were $1,000 and there were 100 common shares, the book value per common share would be $10. If 10 shares were repurchased for $8 (which is less than the original book value per share), the new book value would be $920 and the reduced number of shares would be 90, thus, resulting in a new book value per common share of $10.22, which is larger than the original $10.

**CPA-01521 Type1 M/C A-D Corr Ans: C PM#15 F 7-99**

106. CPA-01521 May 92 II #4 Page 18

On December 1, 1991, Nilo Corp. declared a property dividend of marketable securities to be distributed on December 31, 1991, to stockholders of record on December 15, 1991. On December 1, 1991, the marketable securities had a carrying amount of $60,000 and a fair value of $78,000. What is the effect of this property dividend on Nilo's 1991 retained earnings, after all nominal accounts are closed?

a. $0
b. $18,000 increase.
c. $60,000 decrease.
d. $78,000 decrease.

**CPA-01521 Explanation**
Choice "c" is correct. $60,000 decrease.

Two factors will affect retained earnings as a result of this transaction. Nilo will recognize a gain on disposition of marketable securities as well as a dividend, as follows:

| | |
|---|---|
| Gain on marketable securities | 18,000 |
| Property dividend | (78,000) |
| | (60,000) |

Note that the question asks for the effect on retained earnings after all nominal accounts (income and expense accounts) are closed.

**CPA-01523 Type1 M/C A-D Corr Ans: A PM#16 F 7-99**

107. CPA-01523 May 92 I #3 Page 19

The following format was used by Gee, Inc. for its 1991 statement of owners' equity:

| | *Common stock $1 par* | *Additional paid-in capital* | *Retained earnings* |
|---|---|---|---|
| Balance at 1/1/91 | $90,000 | $800,000 | $175,000 |
| Additions and deductions: | | | |
| 100% stock dividend | | | |
| 5% stock dividend | | | |
| Balance at 12/31/9 | | | |


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When both the 100% and the 5% stock dividends were declared, Gee's common stock was selling for more than its $1 par value.
How would the 5% stock dividend affect the additional paid-in capital and retained earnings amounts reported in Gee's 1991 statement of owners' equity?

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

**CPA-01523 Explanation**
Choice "a" is correct. Increase, Decrease.

A 5% stock dividend is a true stock dividend, as opposed to a stock split effected in the form of a dividend. The fair market value of the stock dividend at declaration date is capitalized (transferred) from retained earnings to capital stock and paid-in capital.

**CPA-01527 Type1 M/C A-D Corr Ans: A PM#17 F 7-99**

108. CPA-01527 May 92 II #6 Page 11

The following information pertains to Meg Corp.:

- Dividends on its 1,000 shares of 6%, $10 par value cumulative preferred stock have not been declared or paid for 3 years.
- Treasury stock that cost $15,000 was reissued for $8,000.

What amount of retained earnings should be appropriated as a result of these items?

a. $0
b. $1,800
c. $7,000
d. $8,800

**CPA-01527 Explanation**
Choice "a" is correct. $0

**Rule:** There is no requirement to appropriate retained earnings for any purpose. Retained earnings may be set aside for future purposes by classifying a portion as "appropriated."

Note: "Losses" on treasury stock would reduce paid in capital in excess of par.

**CPA-01530 Type1 M/C A-D Corr Ans: D PM#18 F 7-99**

109. CPA-01530 May 92 #36 Page 18

Instead of the usual cash dividend, Evie Corp. declared and distributed a property dividend from its overstocked merchandise. The excess of the merchandise's carrying amount over its market value should be:

a. Ignored.
b. Reported as a separately disclosed reduction of retained earnings.
c. Reported as an extraordinary loss, net of income taxes.
d. Reported as a reduction in income before extraordinary items.

**CPA-01530 Explanation**
Choice "d" is correct. A loss is recognized for the merchandise's carrying amount over its market value. This results in a reduction in income before extraordinary items.


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**Rule:** Dividends declared and paid in the form of assets other than cash are recorded by the distributing corporation at fair market value at date of declaration.

Choice "a" is incorrect. The loss must be recognized; it cannot be ignored.

Choice "b" is incorrect. The loss cannot be charged directly to retained earnings as it is not a prior period adjustment or an accounting change.

Choice "c" is incorrect. The loss is not extraordinary, as it does not meet the "unusual and infrequent" test (per APBO No. 30).

**CPA-01532 Type1 M/C A-D Corr Ans: D PM#19 F 7-99**

110. CPA-01532 May 92 #43 Page 9

For the last 10 years, Woody Co. has owned cumulative preferred stock issued by Hadley, Inc. During 1991, Hadley declared and paid both the 1991 dividend and the 1990 dividend in arrears. How should Woody report the 1990 dividend in arrears that was received in 1991?

a. As a reduction in cumulative preferred dividends receivable.
b. As a retroactive change of the prior period financial statements.
c. Include, net of income taxes, after 1991 income from continuing operations.
d. Include in 1991 income from continuing operations.

**CPA-01532 Explanation**
Choice "d" is correct. Include in 1991 income from continuing operations. Cumulative preferred shareholders have preference over common shareholders, but the dividends are not guaranteed.

Choice "a" is incorrect. A receivable would not be recorded in 1990 because collectibility was not reasonably assured.

Choice "b" is incorrect. A retroactive change is justified only in the case of a change in accounting principle or a prior period adjustment, which this is not.

Choice "c" is incorrect. Including the 1990 dividend after income from continuing operations would mean treatment as an extraordinary item. It does not meet the "unusual and infrequent" test for an extraordinary item.

**CPA-01534 Type1 M/C A-D Corr Ans: C PM#20 F 7-99**

111. CPA-01534 May 92 II #1 Page 16

On March 1, 1992, Rya Corp. issued 1,000 shares of its $20 par value common stock and 2,000 shares of its $20 par value convertible preferred stock for a total of $80,000. At this date, Rya's common stock was selling for $36 per share, and the convertible preferred stock was selling for $27 per share. What amount of the proceeds should be allocated to Rya's convertible preferred stock?

a. $60,000
b. $54,000
c. $48,000
d. $44,000

**CPA-01534 Explanation**
Choice "c" is correct. $48,000 allocated to preferred.

**Rule:** Allocate "issue proceeds" of a basket purchase or sale of convertible preferred stock based on relative fair market values:

| | Shares | | $ | | Fair value | Allocated Basis |
|---|---|---|---|---|---|---|
| Common stock | 1000 | × | 36 | = | $36,000 | $32,000 |
| Preferred stock | 2000 | × | 27 | = | 54,000 | 48,000 |
| Total fair value | | | | | $90,000 | $80,000 |


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Allocate to preferred: 54/90 x $80,000 = $48,000

**CPA-01538 Type1 M/C A-D Corr Ans: A PM#21 F 7-99**

112. CPA-01538 Nov 92 I #7 Page 8

On September 1, 1992, Hyde Corp., a newly formed company, had the following stock issued and outstanding:

- Common stock, no par, $1 stated value, 5,000 shares originally issued for $15 per share.
- Preferred stock, $10 par value, 1,500 shares originally issued for $25 per share.

Hyde's September 1, 1992, statement of stockholders, equity should report:

| | *Common stock* | *Preferred stock* | *Additional paid-in capital* |
|---|---|---|---|
| a. | $5,000 | $15,000 | $92,500 |
| b. | $5,000 | $37,500 | $70,000 |
| c. | $75,000 | $37,500 | $0 |
| d. | $75,000 | $15,000 | $22,500 |

**CPA-01538 Explanation**

| | | |
|---|---|---|
| Common stock (5,000 shares x $1 stated value) | | $ 5,000 |
| Preferred stock (1,500 shares x $10 par value) | | $15,000 |
| Additional paid-in capital from: | | |
| Common stock ($15 - $1) x 5,000 shs = | $70,000 | |
| Preferred stock ($25 - $10) x 1,500 shs = | 22,500 | $92,500 |

**A**

Choice "a" is correct. $5,000, common stock; $15,000 preferred stock; $92,500 APIC.

**CPA-01543 Type1 M/C A-D Corr Ans: C PM#22 F 7-99**

113. CPA-01543 Nov 92 II #42 Page 15

Cross Corp. had outstanding 2,000 shares of 11% preferred stock, $50 par. On August 8, 1992, Cross redeemed and retired 25% of these shares for $22,500. On that date, Cross' additional paid-in capital from preferred stock totaled $30,000. To record this transaction, Cross should debit (credit) its capital accounts as follows:

| | *Preferred stock* | *Additional paid-in capital* | *Retained earnings* |
|---|---|---|---|
| a. | $25,000 | $7,500 | ($10,000) |
| b. | $25,000 | -- | ($ 2,500) |
| c. | $25,000 | ($2,500) | -- |
| d. | $22,500 | -- | -- |

**CPA-01543 Explanation**

**Rule:** If the reacquisition price is:

a) Less than original issues price, the "gain" is credited to APIC;
b) More than original issue price, the "loss" is debited to retained earnings.

| | *Preferred stock* | *Add. Paid-in capital* | *Retained earnings* | *Cash* |
|---|---|---|---|---|
| Recorded book values (2,000 sh x $50) | 100,000 | 30,000 | | |
| Percentage redeemed | x 25% | x 25% | | |


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| | | | | |
|---|---|---|---|---|
| Book value of redemption | 25,000 | 7,500 | | |
| Redemption/retirement debit (credit) | (25,000) | – 2,500 | ± 0 | = (22,500) |

Choice "c" is correct. $25,000 preferred stock debit. ($2,500) additional paid-in capital credit.

**CPA-01545 Type1 M/C A-D Corr Ans: D PM#23 F 7-99**

114. CPA-01545 Nov 92 II #45 Page 18

Mio Corp was the sole stockholder of Plasti Corp. On September 30, 1991, Mio declared a property dividend of Plasti's 2,000 outstanding shares of $1 par value common stock, distributable to Mio's stockholders. On that date, the book value of Plasti's stock was $1.50 per share. Immediately after the distribution, the market value of Plasti's stock was $4.50 per share. What amount should Mio report in its 1991 financial statements as gain on disposal of the Plasti stock?

a. $1,000
b. $2,000
c. $3,000
d. $6,000

**CPA-01545 Explanation**
**Rule:** The difference between book value and fair market value of property dividend should be recorded as gain/loss on disposal of asset.

| | *Per-share value* | *2000 sh total value* | |
|---|---|---|---|
| FMV of stock at declaration | $4.50 | $9,000 | |
| Book value of plastic stock investment | (1.50) | (3,000) | |
| Gain on disposal of stock | $3.00 | $6,000 | **D** |

Choice "d" is correct. $6,000 gain on disposal of plastic stock.

**CPA-01548 Type1 M/C A-D Corr Ans: B PM#24 F 7-99**

115. CPA-01548 Nov 92 #18 Page 16

When collectibility is reasonably assured, the excess of the subscription price over the stated value of the no par common stock subscribed should be recorded as:

a. No par common stock.
b. Additional paid-in capital when the subscription is recorded.
c. Additional paid-in capital when the subscription is collected.
d. Additional paid-in capital when the common stock is issued.

**CPA-01548 Explanation**
Choice "b" is correct. When collectibility is reasonably assured, the excess of the subscription price over the stated value of the no par common stock subscribed should be recorded as additional paid-in capital (APIC) when the subscription is received.

Entry to record subscription of 1,000 shares of common stock ($5 stated value or par value) at a price of $18 with down payment of $3 per share:

| | | |
|---|---|---|
| Cash (1,000 x $3) | 3,000 | |
| Subscription rec-com stock | 15,000 | |
| Common stock subscribed (1,000 shs x $5) | | 5,000 |
| Additional paid-in cap ($13 x 1,000) | | 13,000 |

Note: This is same "APIC" as if the stock had been fully paid for and issued.


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**CPA-01559 Type1 M/C A-D Corr Ans: C PM#25 F 7-99**

116. CPA-01559 Nov 92 #22 Page 19

A corporation issuing stock should charge retained earnings for the market value of the shares issued in a(an):

a. Employee stock bonus.
b. Pooling of interests.
c. 10% stock dividend.
d. 2-for-l stock split.

**CPA-01559 Explanation**
**Rule:**

1. Charge retained earnings for the market value of shares issued for stock dividend of less than 20-25%.
2. Use par value if more than 20-25% stock dividend.
3. If between 20-25% use either par or FMV.

Choice "c" is correct. 10% stock dividend.

Choice "a" is incorrect. Employee stock bonus is charged to wage expense.

Choice "b" is incorrect. In pooling of interest the "book value" of retained earnings of two companies are usually combined.

Choice "d" is incorrect. Retained earnings is not adjusted for stock splits. Memo entry only for change in par or stated value and number of shares outstanding.

**CPA-01561 Type1 M/C A-D Corr Ans: D PM#26 F 7-99**

117. CPA-01561 May 94 #8 Page 9

At December 31, 1992 and 1993, Apex Co. had 3,000 shares of $100 par, 5% cumulative preferred stock outstanding. No dividends were in arrears as of December 31, 1991. Apex did not declare a dividend during 1992. During 1993, Apex paid a cash dividend of $10,000 on its preferred stock. Apex should report dividends in arrears in its 1993 financial statements as a(an):

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

**CPA-01561 Explanation**
Cumulative preferred stock dividends:

| | |
|---|---|
| For 1992 (3,000 sh x $100 par x 5% rate) | $15,000 |
| For 1993 | 15,000 |
| | 30,000 |
| Less amount paid during 1993 | (10,000) |
| Disclosure of dividends in arrears in 1993 F/S | $20,000 |

Choice "d" is correct. Disclosure of $20,000 dividends in arrears in the 1993 financial statements.

**CPA-01562 Type1 M/C A-D Corr Ans: D PM#27 F 7-99**

118. CPA-01562 Nov 94 #39 Page 19

Stock dividends on common stock should be recorded at their fair market value by the investor when the related investment is accounted for under which of the following methods?


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

**CPA-01562 Explanation**
Choice "d" is correct. No - No.

**Rule:** Stock dividends and stock splits are not considered income to the recipient.

Therefore, investors do **not** record stock dividends at fair market value. They simply reallocate the investment account balance (under either method -- cost or equity) over more shares so that value per share decreases.

Choices "a", "b", and "c" are incorrect, per the rule above.

**CPA-01563 Type1 M/C A-D Corr Ans: A PM#28 F 7-99**

119. CPA-01563 Nov 88 I #41 Page 23

On January 1, 2004, Ward Corp. granted stock options to corporate executives for the purchase of 20,000 shares of the company's $20 par value common stock at $48 per share. All stock options were exercised on December 28, 2004. Using an acceptable option pricing model, Ward calculated total compensation cost of $240,000. The quoted market prices of Ward's $20 par value common stock were as follows:

| | |
|---|---|
| January 1, 2004 | $45 |
| December 28, 2004 | 60 |

As a result of the grant and exercise of the stock options and the issuance of the common stock, Ward's additional paid-in capital increased by:

a. $800,000
b. $740,000
c. $560,000
d. $500,000

**CPA-01563 Explanation**
Choice "a" is correct. $800,000 increase to additional paid-in capital.

Jan 1 , 2004 J.E.

| | | |
|---|---|---|
| Compensation Expense | 240,000 | |
| APIC - Stock options | | 240,000 |

December 28, 2004 J.E.

| | DR | CR | |
|---|---|---|---|
| Cash ($48 x 20,000 sh) | 960,000 | | |
| APIC - Stock options | 240,000 | | |
| Common stock (20,000 × $20) | | 400,000 | |
| APIC | | 800,000 | **A** |

**CPA-01565 Type1 M/C A-D Corr Ans: C PM#29 F 7-99**

120. CPA-01565 May 91 I #51 Page 23

On January 1, 20X1, Lord Corp. granted stock options for 10,000 shares at $38 per share as additional compensation for services to be rendered over the next three years. Using an acceptable option pricing model, Lord calculated total compensation cost of $90,000. The options are exercisable during a 4-year


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period beginning January 1, 20X4, by grantees still employed by Lord. Market price of Lord's stock was $47 per share at the grant date. No stock options were terminated during 20X1. In Lord's 20X1 income statement, what amount should be reported as compensation expense pertaining to the options?

a. $90,000
b. $40,000
c. $30,000
d. $0

**CPA-01565 Explanation**
Choice "c" is correct. $30,000.

The compensation should be allocated over the period for which the services are performed.

| | | |
|---|---|---|
| Fair value of options at grant date | $90,000 | |
| Services for 3 years | ÷ 3 | |
| Compensation expense - 20X1 | 30,000 | **C** |

**CPA-01566 Type1 M/C A-D Corr Ans: C PM#30 F 7-99**

121. CPA-01566 Nov 91 II #20 Page 22

Wall Corp.'s employee stock purchase plan specifies the following:

- For every $1 withheld from employees' wages for the purchase of Wall's common stock, Wall contributes $2.
- The stock is purchased from Wall's treasury stock at market price on the date of purchase.

The following information pertains to the plan's 1990 transactions:

| | |
|---|---|
| • Employee withholdings for the year | $ 350,000 |
| • Market value of 150,000 shares issued | 1,050,000 |
| • Carrying amount of treasury stock issued (cost) | 900,000 |

Before payroll taxes, what amount should Wall recognize as expense in 1990 for the stock purchase plan?

a. $1,050,000
b. $900,000
c. $700,000
d. $550,000

**CPA-01566 Explanation**
Choice "c" is correct. $700,000 expense recognized in 1990 for the stock purchase plan, because the plan states that the company will donate $2 for every $1 withheld from employees' wages. A total of $350,000 was withheld from employees and another $700,000 was contributed and expensed by the company because the stock is purchased from the treasury at market price on the date of purchase.

| Journal entry | DR | CR |
|---|---|---|
| Liability for employee withholdings | 350,000 | |
| Employee stock purchase expense | 700,000 | |
| Treasury stock | | 900,000 |
| Additional paid-in capital | | 150,000 |

**CPA-01567 Type1 M/C A-D Corr Ans: D PM#31 F 7-99**

122. CPA-01567 Nov 91 #38 Page 17

Tem Co. issued rights to its existing stockholders without consideration. A stockholder received a right to buy one share for each 20 shares held. The exercise price was in excess of par value, but less than the current market price. Retained earnings decreases when:

| *Rights are issued* | *Rights are exercised* |
|---|---|


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

**CPA-01567 Explanation**
Choice "d" is correct. No (when issued) - No (when exercised).

When stock rights are "issued" without consideration, no entry (only disclosure) is made by either the "issuer" or the "recipient."

At the time the rights are "exercised" (and the corporation receives a cash inflow), additional paid-in capital would be credited if the purchase price of the stock exceeded the par value (which is usually the case). Retained earnings is not affected because this is a "capital transaction," not an "operations" transaction.

| Journal entries | DR | CR |
|---|---|---|
| 1) Issuance of rights | No entry | |
| 2) Rights lapse | No entry | |
| 3) Exercise of rights | | |
| Cash (purchase price of stock: 2,000 sh x $15) | $30,000 | |
| Common stock (2,000 sh x $10) | | $20,000 |
| Additional paid-in capital | | 10,000 |

**CPA-01569 Type1 M/C A-D Corr Ans: B PM#32 F 7-99**

123. CPA-01569 Nov 92 II #56 Page 21

On June 1, 20X1, Oak Corp. granted stock options to certain key employees as additional compensation. The options were for 1,000 shares of Oak's $2 par value common stock at an option price of $15 per share. Market price of this stock on June 1,20X1, was $17 per share. Using an acceptable option pricing model Oak determined that total compensation cost under the stock option plan was $5,000. The options were exercisable beginning January 2, 20X2, and expire on December 31,20X3. On April 1, 20X2, when Oak's stock was trading at $21 per share, all the options were exercised. What amount of pretax compensation should Oak report in 20X1 in connection with the options?

a. $6,000
b. $5,000
c. $2,500
d. $2,000

**CPA-01569 Explanation**
Choice "b" is correct. $5,000 compensation expense for 20X1.

Compensation cost should be recognized as expense over the service period. Since the options are exercisable beginning in 20X2, the service period is only 20X1.

**CPA-01570 Type1 M/C A-D Corr Ans: A PM#33 F 7-99**

124. CPA-01570 Nov 93 I #12 Page 17

On March 4, 1992, Evan Co. purchased 1,000 shares of LVC common stock at $80 per share. On September 26, 1992, Evan received 1,000 stock rights to purchase an additional 1,000 shares at $90 per share. The stock rights had an expiration date of February 1, 1993. On September 30, 1992, LVC's common stock had a market value, ex-rights, of $95 per share and the stock rights had a market value of $5 each. What amount should Evan report on its September 30, 1992, balance sheet for investment in stock rights?

a. $4,000
b. $5,000
c. $10,000


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d. $15,000

**CPA-01570 Explanation**
Formula:

$$\text{Cost of stock rights} = \frac{\text{FMV of rights}}{\text{FMV of rights} + \text{FMV of stock ex-rights}} \times \text{Cost of stock}$$

$$= \frac{\$5,000}{\$5,000 + \$95,000} \times \$80,000$$

$$= 1/20 \times \$80,000$$

$$= \$4,000$$

Choice "a" is correct. $4,000 investment in stock rights.

**CPA-01572 Type1 M/C A-D Corr Ans: B PM#34 F 7-99**

125. CPA-01572 Nov 94 #33 Page 21

On January 2, 20X1, Farm Co. granted an employee an option to purchase 1,000 shares of Farm's common stock at $40 per share. The option became exercisable on December 31, 20X2, after the employee had completed two years of service, and was exercised on that date. The market prices of Farm's stock were as follows:

| | |
|---|---|
| January 2, 20X1 | $48 |
| December 31, 20X1 | 63 |
| December 31, 20X2 | 65 |

Using an acceptable option pricing model, Farm determined that the fair value of the options granted was $10,000. What amount should Farm recognize as compensation expense for 20X2?

a. $0
b. $5,000
c. $15,000
d. $25,000

**CPA-01572 Explanation**
Choice "b" is correct.

Compensation cost is measured on the grant date (in this problem, $10,000) and is charged to compensation expense over the service period (years 20X1 and 20X2).

| | |
|---|---|
| Total compensation cost | $10,000 |
| % Service period | 2 years |
| Compensation expense per year | $ 5,000 |

**CPA-01573 Type1 M/C A-D Corr Ans: D PM#35 F 7-99**

126. CPA-01573 May 92 II #3 Page 18

Bal Corp. declared a $25,000 cash dividend on May 8, 1991, to stockholders of record on May 23, 1991, payable on June 3, 1991. As a result of this cash dividend, working capital:

a. Was not affected.
b. Decreased on June 3.
c. Decreased on May 23.
d. Decreased on May 8.

**CPA-01573 Explanation**
Choice "d" is correct. Decreased on May 8.


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Working capital is decreased on the declaration date, May 8, per rule that the liability for a cash dividend is incurred and recorded on the declaration date.

Choices "a", "b", and "c" are incorrect.

**Rule:** A liability for a cash dividend is incurred and recorded on the declaration date.

**CPA-01574 Type1 M/C A-D Corr Ans: D PM#36 F 7-99**

127. CPA-01574 May 92 #37 Page 11

A retained earnings appropriation can be used to:

a. Absorb a fire loss when a company is self-insured.
b. Provide for a contingent loss that is probable and reasonable.
c. Smooth periodic income.
d. Restrict earnings available for dividends.

**CPA-01574 Explanation**
Choice "d" is correct. A "retained earnings appropriation" can be used to restrict earnings available for dividends.

**Rule:** A retained earnings appropriation debits (reduces) "unappropriated retained earnings" and sets up (credits) "appropriated retained earnings." It does not affect the income statement.

Choice "a" is incorrect. A fire loss would be absorbed by an "estimated liability for fire loss" account which is set up by a debit to a "provision for fire loss" expense account.

Choice "b" is incorrect. A "contingent loss" that is probable and reasonable is an expense account recorded when the related "liability for contingent loss" is recorded.

Choice "c" is incorrect. It is not appropriate to smooth periodic income by charging "retained earnings appropriated" and crediting the income statement.

**CPA-05432 Type1 M/C A-D Corr Ans: B PM#50 F 7-99**

128. CPA-05432 Released 2007 Page 51

Stent Co. had total assets of $760,000, capital stock of $150,000, and retained earnings of $215,000. What was Stent's debt-to-equity ratio?

a. 2.63
b. 1.08
c. 0.52
d. 0.48

**CPA-05432 Explanation**
Choice "b" is correct. To calculate Stent Co.'s debt-to-equity ratio, Stent's total liabilities and total equity must be derived from the facts:

Equity = Capital stock + Retained earnings = $150,000 + 215,000 = $365,000

Liabilities = Assets - Equity = $760,000 - 365,000 = $395,000

Stent's debt-to-equity ratio is then calculated as:

$$\frac{\text{Total liabilities}}{\text{Equity}} - \frac{\$395,000}{\$365,000} = 1.08$$

Choice "a" is incorrect. The denominator of the debt-to-equity ratio is total equity, not just capital stock. See the calculation above.


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Choice "c" is incorrect. The debt ratio, not the debt-to-equity ratio, is equal to liabilities divided by total assets.

Choice "d" is incorrect. The debt-to-equity ratio is not equal to equity divided by total assets.

**CPA-05460 Type1 M/C A-D Corr Ans: B PM#51 F 7-99**

129. CPA-05460 Released 2007 Page 48

The controller of Peabody, Inc. has been asked to present an analysis of accounts receivable collections at the upcoming staff meeting. The following information is used:

| | *12/31, year 2* | *12/31, year 1* |
|---|---|---|
| Accounts receivable | $100,000 | $130,000 |
| Allowance, doubtful accounts | (20,000) | (40,000) |
| Sales | 400,000 | 200,000 |
| Cost of goods sold | 350,000 | 70,000 |

What is the receivables turnover ratio as of December 31, year 2?

a. 5.0
b. 4.7
c. 3.5
d. 0.6

**CPA-05460 Explanation**

Choice "b" is correct. To calculate AR turnover, average net receivables must first be calculated:

Average net receivables = [($100,000 - $20,000) + ($130,000 - $40,000)]/2 = $85,000

Accounts receivable turnover is then calculated as:

AR Turnover = Net Credit Sales / Average net receivables = 400,000 / 85,000 = 4.7

Choice "a" is incorrect. AR turnover is calculated using average net receivables, not 12/31,year 2 net receivables. Whenever a ratio combines balance sheet and income statement items, the average of the balance sheet item should be used.

Choice "c" is incorrect. AR turnover should be calculated using net receivables, not gross receivables.

Choice "d" is incorrect. This answer is not reasonable given the facts and the AR turnover formula.

**CPA-04574 Type1 M/C A-L Corr Ans: K PM#53 F 7-99**

130. CPA-04574 PI May 92 #4a 1A Page 3

Following are selected balance sheet accounts of Zach Corp. at December 31, 1991 and 1990, and the increases or decreases in each account from 1990 to 1991. Also presented is selected income statement information for the year ended December 31, 1991, and additional information.

| *Selected balance sheet accounts* | *1991* | *1990* | *Increase (Decrease)* |
|---|---|---|---|
| Assets: | | | |
| Accounts receivable | $ 34,000 | $ 24,000 | $10,000 |
| Property, plant, and equipment | 277,000 | 247,000 | 30,000 |
| Accumulated depreciation | (178,000) | (167,000) | (11,000) |
| Liabilities and stockholders' equity: | | | |
| Bonds payable | 49,000 | 46,000 | 3,000 |
| Dividends payable | 8,000 | 5,000 | 3,000 |
| Common stock, $1 par | 22,000 | 19,000 | 3,000 |
| Additional paid-in capital | 9,000 | 3,000 | 6,000 |
| Retained earnings | 104,000 | 91,000 | 13,000 |


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*Selected income statement information for the year ended December 31, 1991*

| | |
|---|---|
| Sales revenue | $155,000 |
| Depreciation | 33,000 |
| Gain on sale of equipment | 13,000 |
| Net income | 28,000 |

*Additional information*

- Accounts receivable relate to sales of merchandise.
- During 1991, equipment costing $40,000 was sold for cash.
- During 1991, $20,000 of bonds payable were issued in exchange for property, plant, and equipment. There was no amortization of bond discount or premium.

This question represents an activity that will be reported in Zach's statement of cash flows for the year ended December 31, 1991. Determine the amount that should be reported in Zach's 1991 statement of cash flows.

Activity to Be Answered

- Cash collections from customers (direct method).

A. $10,000
B. $12,000
C. $15,000
D. $17,000
E. $30,000
F. $31,000
G. $40,000
H. $50,000
I. $75,000
J. $100,000
K. $145,000
L. $150,000

**CPA-04574 Explanation**
**Choice "K" is correct. $145,000.**

| | |
|---|---|
| Sales | $155,000 |
| AR Increase | (10,000) |
| Cash collected | $145,000 |

**CPA-04575 Type1 M/C O,I,F Corr Ans: O PM#54 F 7-99**

131. CPA-04575 PI May 92 #4a 1B Page 3

Following are selected balance sheet accounts of Zach Corp. at December 31, 1991 and 1990, and the increases or decreases in each account from 1990 to 1991. Also presented is selected income statement information for the year ended December 31, 1991, and additional information.

| *Selected balance sheet accounts* | *1991* | *1990* | *Increase (Decrease)* |
|---|---|---|---|
| Assets: | | | |
| Accounts receivable | $ 34,000 | $ 24,000 | $10,000 |
| Property, plant, and equipment | 277,000 | 247,000 | 30,000 |
| Accumulated depreciation | (178,000) | (167,000) | (11,000) |
| Liabilities and stockholders' equity: | | | |
| Bonds payable | 49,000 | 46,000 | 3,000 |
| Dividends payable | 8,000 | 5,000 | 3,000 |
| Common stock, $1 par | 22,000 | 19,000 | 3,000 |
| Additional paid-in capital | 9,000 | 3,000 | 6,000 |


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| | | | |
|---|---|---|---|
| Retained earnings | 104,000 | 91,000 | 13,000 |

*Selected income statement information for the year ended December 31, 1991*

| | |
|---|---|
| Sales revenue | $155,000 |
| Depreciation | 33,000 |
| Gain on sale of equipment | 13,000 |
| Net income | 28,000 |

*Additional information*

- Accounts receivable relate to sales of merchandise.
- During 1991, equipment costing $40,000 was sold for cash.
- During 1991, $20,000 of bonds payable were issued in exchange for property, plant, and equipment. There was no amortization of bond discount or premium.

This question represents an activity that will be reported in Zach's statement of cash flows for the year ended December 31, 1991. Determine the category (Operating activity **[O]**, Investing activity **[I]**, or Financing activity **[F]**) in which the amount should be reported in the statement of cash flows.

Activity to Be Answered

- Cash collections from customers (direct method).

[F] Financing activity.
[I] Investing activity.
[O] Operating activity.

**CPA-04575 Explanation**
**Choice [O] is correct. OPERATING.**

**CPA-04576 Type1 M/C A-L Corr Ans: H PM#55 F 7-99**

132. CPA-04576 PI May 92 #4a 2A Page 3

Following are selected balance sheet accounts of Zach Corp. at December 31, 1991 and 1990, and the increases or decreases in each account from 1990 to 1991. Also presented is selected income statement information for the year ended December 31, 1991, and additional information.

| *Selected balance sheet accounts* | *1991* | *1990* | *Increase (Decrease)* |
|---|---|---|---|
| Assets: | | | |
| Accounts receivable | $ 34,000 | $ 24,000 | $10,000 |
| Property, plant, and equipment | 277,000 | 247,000 | 30,000 |
| Accumulated depreciation | (178,000) | (167,000) | (11,000) |
| Liabilities and stockholders' equity: | | | |
| Bonds payable | 49,000 | 46,000 | 3,000 |
| Dividends payable | 8,000 | 5,000 | 3,000 |
| Common stock, $1 par | 22,000 | 19,000 | 3,000 |
| Additional paid-in capital | 9,000 | 3,000 | 6,000 |
| Retained earnings | 104,000 | 91,000 | 13,000 |

*Selected income statement information for the year ended December 31, 1991*

| | |
|---|---|
| Sales revenue | $155,000 |
| Depreciation | 33,000 |
| Gain on sale of equipment | 13,000 |
| Net income | 28,000 |

*Additional information*

- Accounts receivable relate to sales of merchandise.
- During 1991, equipment costing $40,000 was sold for cash.


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- During 1991, $20,000 of bonds payable were issued in exchange for property, plant, and equipment. There was no amortization of bond discount or premium.

This question represents an activity that will be reported in Zach's statement of cash flows for the year ended December 31, 1991. Determine the amount that should be reported in Zach's 1991 statement of cash flows.

Activity to Be Answered

- Payments for purchases of property, plant, and equipment.

A. $10,000
B. $12,000
C. $15,000
D. $17,000
E. $30,000
F. $31,000
G. $40,000
H. $50,000
I. $75,000
J. $100,000
K. $145,000
L. $150,000

**CPA-04576 Explanation**
**Choice "H" is correct. $50,000.**

| | |
|---|---|
| Change | $ 30,000 |
| Sold | 40,000 |
| Purchases | 70,000 |
| Exchanged for bonds | (20,000) |
| Cash paid | $ 50,000 |

**CPA-04577 Type1 M/C O,I,F Corr Ans: I PM#56 F 7-99**

133. CPA-04577 PI May 92 #4a 2B Page 3

Following are selected balance sheet accounts of Zach Corp. at December 31, 1991 and 1990, and the increases or decreases in each account from 1990 to 1991. Also presented is selected income statement information for the year ended December 31, 1991, and additional information.

| *Selected balance sheet accounts* | *1991* | *1990* | *Increase (Decrease)* |
|---|---|---|---|
| Assets: | | | |
| Accounts receivable | $ 34,000 | $ 24,000 | $10,000 |
| Property, plant, and equipment | 277,000 | 247,000 | 30,000 |
| Accumulated depreciation | (178,000) | (167,000) | (11,000) |
| Liabilities and stockholders' equity: | | | |
| Bonds payable | 49,000 | 46,000 | 3,000 |
| Dividends payable | 8,000 | 5,000 | 3,000 |
| Common stock, $1 par | 22,000 | 19,000 | 3,000 |
| Additional paid-in capital | 9,000 | 3,000 | 6,000 |
| Retained earnings | 104,000 | 91,000 | 13,000 |

| *Selected income statement information for the year ended December 31, 1991* | |
|---|---|
| Sales revenue | $155,000 |
| Depreciation | 33,000 |
| Gain on sale of equipment | 13,000 |
| Net income | 28,000 |


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*Additional information*
- Accounts receivable relate to sales of merchandise.
- During 1991, equipment costing $40,000 was sold for cash.
- During 1991, $20,000 of bonds payable were issued in exchange for property, plant, and equipment. There was no amortization of bond discount or premium.

This question represents an activity that will be reported in Zach's statement of cash flows for the year ended December 31, 1991. Determine the category (Operating activity **[O]**, Investing activity **[I]**, or Financing activity **[F]**) in which the amount should be reported in the statement of cash flows.

Activity to Be Answered

- Payments for purchase of property, plant, and equipment.

[F] Financing activity.
[I] Investing activity.
[O] Operating activity.

**CPA-04577 Explanation**
**Choice [I] is correct. INVESTING.**

**CPA-04578 Type1 M/C A-L Corr Ans: F PM#57 F 7-99**

134. CPA-04578 PI May 92 #4a 3A Page 3

Following are selected balance sheet accounts of Zach Corp. at December 31, 1991 and 1990, and the increases or decreases in each account from 1990 to 1991. Also presented is selected income statement information for the year ended December 31, 1991, and additional information.

| *Selected balance sheet accounts* | *1991* | *1990* | *Increase (Decrease)* |
|---|---|---|---|
| Assets: | | | |
| Accounts receivable | $ 34,000 | $ 24,000 | $10,000 |
| Property, plant, and equipment | 277,000 | 247,000 | 30,000 |
| Accumulated depreciation | (178,000) | (167,000) | (11,000) |
| Liabilities and stockholders' equity: | | | |
| Bonds payable | 49,000 | 46,000 | 3,000 |
| Dividends payable | 8,000 | 5,000 | 3,000 |
| Common stock, $1 par | 22,000 | 19,000 | 3,000 |
| Additional paid-in capital | 9,000 | 3,000 | 6,000 |
| Retained earnings | 104,000 | 91,000 | 13,000 |

| *Selected income statement information for the year ended December 31, 1991* | |
|---|---|
| Sales revenue | $155,000 |
| Depreciation | 33,000 |
| Gain on sale of equipment | 13,000 |
| Net income | 28,000 |

*Additional information*
- Accounts receivable relate to sales of merchandise.
- During 1991, equipment costing $40,000 was sold for cash.
- During 1991, $20,000 of bonds payable were issued in exchange for property, plant, and equipment. There was no amortization of bond discount or premium.

This question represents an activity that will be reported in Zach's statement of cash flows for the year ended December 31, 1991. Determine the amount that should be reported in Zach's 1991 statement of cash flows.

Activity to Be Answered


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- Proceeds from sale of equipment.

A. $10,000
B. $12,000
C. $15,000
D. $17,000
E. $30,000
F. $31,000
G. $40,000
H. $50,000
I. $75,000
J. $100,000
K. $145,000
L. $150,000

**CPA-04578 Explanation**
**Choice "F" is correct. $31,000.**

| | | | | |
|---|---|---|---|---|
| **Dr** | Accumulated depreciation | | 22,000 [1] | |
| **Dr** | Cash | | ? | |
| | **Cr** | Equipment | | 40,000 |
| | **Cr** | Gain on sale | | 13,000 |

| | | |
|---|---|---|
| [1] | Depreciation expense | $33,000 |
| | Increase in Accumulated depreciation | (11,000) |
| | Depreciation on equipment sold | $22,000 |

**CPA-04579 Type1 M/C O,I,F Corr Ans: I PM#58 F 7-99**

135. CPA-04579 PI May 92 #4a 3B Page 3

Following are selected balance sheet accounts of Zach Corp. at December 31, 1991 and 1990, and the increases or decreases in each account from 1990 to 1991. Also presented is selected income statement information for the year ended December 31, 1991, and additional information.

| *Selected balance sheet accounts* | *1991* | *1990* | *Increase (Decrease)* |
|---|---|---|---|
| Assets: | | | |
| Accounts receivable | $ 34,000 | $ 24,000 | $10,000 |
| Property, plant, and equipment | 277,000 | 247,000 | 30,000 |
| Accumulated depreciation | (178,000) | (167,000) | (11,000) |
| Liabilities and stockholders' equity: | | | |
| Bonds payable | 49,000 | 46,000 | 3,000 |
| Dividends payable | 8,000 | 5,000 | 3,000 |
| Common stock, $1 par | 22,000 | 19,000 | 3,000 |
| Additional paid-in capital | 9,000 | 3,000 | 6,000 |
| Retained earnings | 104,000 | 91,000 | 13,000 |

*Selected income statement information for the year ended December 31, 1991*

| | |
|---|---|
| Sales revenue | $155,000 |
| Depreciation | 33,000 |
| Gain on sale of equipment | 13,000 |
| Net income | 28,000 |

*Additional information*

- Accounts receivable relate to sales of merchandise.
- During 1991, equipment costing $40,000 was sold for cash.


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- During 1991, $20,000 of bonds payable were issued in exchange for property, plant, and equipment. There was no amortization of bond discount or premium.

This question represents an activity that will be reported in Zach's statement of cash flows for the year ended December 31, 1991. Determine the category (Operating activity **[O]**, Investing activity **[I]**, or Financing activity **[F]**) in which the amount should be reported in the statement of cash flows.

Activity to Be Answered

- Proceeds from sale of equipment.

[F] Financing activity.
[I] Investing activity.
[O] Operating activity.

**CPA-04579 Explanation**
**Choice [I] is correct. INVESTING.**

**CPA-04580 Type1 M/C A-L Corr Ans: B PM#59 F 7-99**

136. CPA-04580 PI May 92 #4a 4A Page 3

Following are selected balance sheet accounts of Zach Corp. at December 31, 1991 and 1990, and the increases or decreases in each account from 1990 to 1991. Also presented is selected income statement information for the year ended December 31, 1991, and additional information.

| *Selected balance sheet accounts* | *1991* | *1990* | *Increase (Decrease)* |
|---|---|---|---|
| Assets: | | | |
| Accounts receivable | $ 34,000 | $ 24,000 | $10,000 |
| Property, plant, and equipment | 277,000 | 247,000 | 30,000 |
| Accumulated depreciation | (178,000) | (167,000) | (11,000) |
| Liabilities and stockholders' equity: | | | |
| Bonds payable | 49,000 | 46,000 | 3,000 |
| Dividends payable | 8,000 | 5,000 | 3,000 |
| Common stock, $1 par | 22,000 | 19,000 | 3,000 |
| Additional paid-in capital | 9,000 | 3,000 | 6,000 |
| Retained earnings | 104,000 | 91,000 | 13,000 |

*Selected income statement information for the year ended December 31, 1991*

| | |
|---|---|
| Sales revenue | $155,000 |
| Depreciation | 33,000 |
| Gain on sale of equipment | 13,000 |
| Net income | 28,000 |

*Additional information*

- Accounts receivable relate to sales of merchandise.
- During 1991, equipment costing $40,000 was sold for cash.
- During 1991, $20,000 of bonds payable were issued in exchange for property, plant, and equipment. There was no amortization of bond discount or premium.

This question represents an activity that will be reported in Zach's statement of cash flows for the year ended December 31, 1991. Determine the amount that should be reported in Zach's 1991 statement of cash flows.

Activity to Be Answered

- Cash dividends paid.

A. $10,000
B. $12,000
C. $15,000
D. $17,000


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E. $30,000
F. $31,000
G. $40,000
H. $50,000
I. $75,000
J. $100,000
K. $145,000
L. $150,000

**CPA-04580 Explanation**
**Choice "B" is correct. $12,000.**

| | |
|---|---|
| Beg. Retained Earnings | $ 91,000 |
| Add Income | 28,000 |
| | 119,000 |
| Dividends payable | (3,000) |
| Dividends paid | ? |
| End Retained earnings | $104,000 |

**CPA-04581 Type1 M/C O,I,F Corr Ans: F PM#60 F 7-99**

137. CPA-04581 PI May 92 #4a 4B Page 3

Following are selected balance sheet accounts of Zach Corp. at December 31, 1991 and 1990, and the increases or decreases in each account from 1990 to 1991. Also presented is selected income statement information for the year ended December 31, 1991, and additional information.

| *Selected balance sheet accounts* | *1991* | *1990* | *Increase (Decrease)* |
|---|---|---|---|
| Assets: | | | |
| Accounts receivable | $ 34,000 | $ 24,000 | $10,000 |
| Property, plant, and equipment | 277,000 | 247,000 | 30,000 |
| Accumulated depreciation | (178,000) | (167,000) | (11,000) |
| Liabilities and stockholders' equity: | | | |
| Bonds payable | 49,000 | 46,000 | 3,000 |
| Dividends payable | 8,000 | 5,000 | 3,000 |
| Common stock, $1 par | 22,000 | 19,000 | 3,000 |
| Additional paid-in capital | 9,000 | 3,000 | 6,000 |
| Retained earnings | 104,000 | 91,000 | 13,000 |

*Selected income statement information for the year ended December 31, 1991*

| | |
|---|---|
| Sales revenue | $155,000 |
| Depreciation | 33,000 |
| Gain on sale of equipment | 13,000 |
| Net income | 28,000 |

*Additional information*

- Accounts receivable relate to sales of merchandise.
- During 1991, equipment costing $40,000 was sold for cash.
- During 1991, $20,000 of bonds payable were issued in exchange for property, plant, and equipment. There was no amortization of bond discount or premium.

This question represents an activity that will be reported in Zach's statement of cash flows for the year ended December 31, 1991. Determine the category (Operating activity **[O]**, Investing activity **[I]**, or Financing activity **[F]**) in which the amount should be reported in the statement of cash flows.

Activity to Be Answered


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- Cash dividends paid.

[F] Financing activity.
[I] Investing activity.
[O] Operating activity.

**CPA-04581 Explanation**
**Choice [F] is correct. FINANCING.**

**CPA-04582 Type1 M/C A-L Corr Ans: D PM#61 F 7-99**

138. CPA-04582 PI May 92 #4a 5A Page 3

Following are selected balance sheet accounts of Zach Corp. at December 31, 1991 and 1990, and the increases or decreases in each account from 1990 to 1991. Also presented is selected income statement information for the year ended December 31, 1991, and additional information.

| *Selected balance sheet accounts* | *1991* | *1990* | *Increase (Decrease)* |
|---|---|---|---|
| Assets: | | | |
| Accounts receivable | $ 34,000 | $ 24,000 | $10,000 |
| Property, plant, and equipment | 277,000 | 247,000 | 30,000 |
| Accumulated depreciation | (178,000) | (167,000) | (11,000) |
| Liabilities and stockholders' equity: | | | |
| Bonds payable | 49,000 | 46,000 | 3,000 |
| Dividends payable | 8,000 | 5,000 | 3,000 |
| Common stock, $1 par | 22,000 | 19,000 | 3,000 |
| Additional paid-in capital | 9,000 | 3,000 | 6,000 |
| Retained earnings | 104,000 | 91,000 | 13,000 |

| *Selected income statement information for the year ended December 31, 1991* | |
|---|---|
| Sales revenue | $155,000 |
| Depreciation | 33,000 |
| Gain on sale of equipment | 13,000 |
| Net income | 28,000 |

*Additional information*
- Accounts receivable relate to sales of merchandise.
- During 1991, equipment costing $40,000 was sold for cash.
- During 1991, $20,000 of bonds payable were issued in exchange for property, plant, and equipment. There was no amortization of bond discount or premium.

This question represents an activity that will be reported in Zach's statement of cash flows for the year ended December 31, 1991. Determine the amount that should be reported in Zach's 1991 statement of cash flows.

Activity to Be Answered

- Redemption of bonds payable.

A. $10,000
B. $12,000
C. $15,000
D. $17,000
E. $30,000
F. $31,000
G. $40,000
H. $50,000
I. $75,000
J. $100,000


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K. $145,000
L. $150,000

**CPA-04582 Explanation**
**Choice "D" is correct. $17,000.**

| | |
|---|---|
| Beg. Bonds payable | $46,000 |
| Issued | 20,000 |
| | 66,000 |
| Redemption | ? |
| End Bonds payable | $49,000 |

**CPA-01269 Type1 M/C A-D Corr Ans: B PM#62 F 7-99**

139. CPA-01269 FARE R03 #3 Page 55

Kline Co. had the following sales and accounts receivable balances at the end of the current year:

| | |
|---|---|
| Cash sales | $1,000,000 |
| Net credit sales | 3,000,000 |
| Net accounts receivable, 1/1 | 100,000 |
| Net accounts receivable, 12/31 | 400,000 |

What is Kline's average collection period for its accounts receivable?

a. 48.0 days.
b. 30.0 days.
c. 22.5 days.
d. 12.0 days.

**CPA-01269 Explanation**
Choice "b" is correct. To compute the average collection period, we must first calculate accounts receivable turnover.

$$\text{Accts. rec. turnover} = \frac{\text{Net credit sales}}{\text{Average accts rec.}}$$

$$= \frac{3{,}000{,}000}{(100{,}000 + 400{,}000) \div 2}$$

$$= 12$$

$$\text{Average collection period} = \frac{365}{\text{Accts. rec. turnover}}$$

$$= \frac{365}{12}$$

$$= 30$$

**CPA-04583 Type1 M/C O,I,F Corr Ans: F PM#62 F 7-99**

140. CPA-04583 PI May 92 #4a 5B Page 3

Following are selected balance sheet accounts of Zach Corp. at December 31, 1991 and 1990, and the increases or decreases in each account from 1990 to 1991. Also presented is selected income statement information for the year ended December 31, 1991, and additional information.

| *Selected balance sheet accounts* | *1991* | *1990* | *Increase (Decrease)* |
|---|---|---|---|
| Assets: | | | |


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| | | | |
|---|---|---|---|
| Accounts receivable | $ 34,000 | $ 24,000 | $10,000 |
| Property, plant, and equipment | 277,000 | 247,000 | 30,000 |
| Accumulated depreciation | (178,000) | (167,000) | (11,000) |
| Liabilities and stockholders' equity: | | | |
| Bonds payable | 49,000 | 46,000 | 3,000 |
| Dividends payable | 8,000 | 5,000 | 3,000 |
| Common stock, $1 par | 22,000 | 19,000 | 3,000 |
| Additional paid-in capital | 9,000 | 3,000 | 6,000 |
| Retained earnings | 104,000 | 91,000 | 13,000 |

*Selected income statement information for the year ended December 31, 1991*

| | |
|---|---|
| Sales revenue | $155,000 |
| Depreciation | 33,000 |
| Gain on sale of equipment | 13,000 |
| Net income | 28,000 |

*Additional information*

- Accounts receivable relate to sales of merchandise.
- During 1991, equipment costing $40,000 was sold for cash.
- During 1991, $20,000 of bonds payable were issued in exchange for property, plant, and equipment. There was no amortization of bond discount or premium.

This question represents an activity that will be reported in Zach's statement of cash flows for the year ended December 31, 1991. Determine the category (Operating activity **[O]**, Investing activity **[I]**, or Financing activity **[F]**) in which the amount should be reported in the statement of cash flows.

Activity to Be Answered

- Redemption of bonds payable.

[F] Financing activity.
[I] Investing activity.
[O] Operating activity.

**CPA-04583 Explanation**
**Choice [F] is correct. FINANCING.**


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# CPA PassMaster Questions–Financial 8
# Export Date: 10/30/08


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**Governmental Accounting Overview**

**CPA-00893 Type1 M/C A-D Corr Ans: D PM#6 F 8-01**

1. CPA-00893 ARE R96 #4 Page 7

The measurement focus of governmental-type funds is on the determination of:

| | *Current Financial Resources* | *Financial Position* |
|---|---|---|
| a. | Yes | No |
| b. | No | Yes |
| c. | No | No |
| d. | Yes | Yes |

**CPA-00893 Explanation**
Choice "d" is correct. A fund's measurement focus identifies what transactions should be recorded. For governmental funds, the statement of revenues and expenditures should report resources received and consumed during the current period (current financial resources focus). The balance sheet show available resources and current obligations (financial position focus).

**CPA-00894 Type1 M/C A-D Corr Ans: C PM#7 F 8-01**

2. CPA-00894 ARE Nov 95 #57 Page 7

Which of the following fund types of a governmental unit has (have) an economic measurement focus?

| | *General Funds* | *Permanent Funds* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | No |
| d. | No | Yes |

**CPA-00894 Explanation**
Choice "c" is correct. The general fund is a governmental fund. The measurement focus of governmental funds is on the determination of financial position and changes in financial position (sources, uses, and balances of financial resources) rather than on net income determination. The permanent fund is accounted for in the same manner as a governmental fund.

**CPA-00895 Type1 M/C A-D Corr Ans: C PM#8 F 8-01**

3. CPA-00895 ARE Nov 95 #60 Page 6

Fund accounting is used by governmental units with resources that must be:

a. Composed of cash or cash equivalents.
b. Incorporated into combined or combining financial statements.
c. Segregated for the purpose of carrying on specific activities or attaining certain objectives.
d. Segregated physically according to various objectives.

**CPA-00895 Explanation**
Choice "c" is correct. A fund is a fiscal and accounting entity with a self-balancing set of accounts recording cash and other financial resources, together with all related liabilities and residual equities or balances, and changes therein.

**CPA-00896 Type1 M/C A-D Corr Ans: B PM#9 F 8-01**

4. CPA-00896 ARE May 95 #51 Page 7


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For governmental fund types, which item is considered the primary measurement focus?

a. Income determination.
b. Current financial resources.
c. Capital maintenance.
d. Cash flows and balances.

**CPA-00896 Explanation**
Choice "b" is correct. The governmental fund measurement focus is on determination of financial position and changes in financial position (sources, uses, and balances of current financial resources) rather than on net income determination.

Choice "a" is incorrect. Income determination is a focus of proprietary funds.

Choice "c" is incorrect. Capital maintenance is the measurement focus used in proprietary funds.

Choice "d" is incorrect. Measurement of cash flows and balances is a focus of proprietary funds.

**CPA-00897 Type1 M/C A-D Corr Ans: C PM#10 F 8-01**

5. CPA-00897 ARE Nov 94 #1 Page 7

The governmental fund measurement focus is on the determination of:

| | *Income* | *Financial Position* | *Current Financial Resources* |
|---|---|---|---|
| a. | Yes | Yes | Yes |
| b. | No | Yes | No |
| c. | No | Yes | Yes |
| d. | Yes | No | Yes |

**CPA-00897 Explanation**
Choice "c" is correct. A fund's measurement focus identifies what transactions should be recorded. For governmental funds, the statement of revenues and expenditures should report resources received and consumed during the current period (flow of current financial resources focus). The balance sheet should show available resources and current obligations (financial position focus). Note that no income statement is prepared for governmental funds.

**CPA-00898 Type1 M/C A-D Corr Ans: A PM#11 F 8-01**

6. CPA-00898 ARE Nov 94 #3 Page 9

The orientation of accounting and reporting for all proprietary funds of governmental units is:

a. Income determination.
b. Project.
c. Flow of funds.
d. Program.

**CPA-00898 Explanation**
Choice "a" is correct. Accounting and reporting for proprietary funds is similar to accounting and reporting for a business enterprise. Thus, the full accrual basis is used and the measurement focus is on net income and capital maintenance.

Choice "b" is incorrect. Project is not an orientation for proprietary funds.

Choice "c" is incorrect. Flow of funds is not an orientation for proprietary funds.

Choice "d" is incorrect. Program is not an orientation for proprietary funds.


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**CPA-00899 Type1 M/C A-D Corr Ans: A PM#12 F 8-01**

7. CPA-00899 ARE Nov 94 #14 Page 36

A major exception to the general rule of expenditure accrual for governmental funds under the modified accrual basis relates to unmatured:

| | *Principal of General Long-Term Debt* | *Interest on General Long-Term Debt* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |

**CPA-00899 Explanation**
Choice "a" is correct. Under the modified accrual basis of accounting, expenditures are generally recognized when incurred because that is when they become measurable. An exception to this general rule is the treatment of interest and principal payments for long-term debt. Interest and principal on long-term debt are recorded when they become due and payable, not when they accrue.

Choices "b", "c", and "d" are incorrect, per above.

**CPA-00900 Type1 M/C A-D Corr Ans: A PM#13 F 8-01**

8. CPA-00900 ARE May 94 #51 Page 7

The primary emphasis in accounting and reporting for governmental funds is on:

a. Source, use and balance of current financial resources.
b. Income determination.
c. Capital maintenance.
d. Transfers relating to proprietary activities.

**CPA-00900 Explanation**
Choice "a" is correct. The measurement focus prescribed by GASB standards for all governmental funds is the "flow of current financial resources" focus which measures source use and balance of current financial resources.

Choice "b" is incorrect. Income determination (i.e., profit measurement) is not a concern of the governmental funds since there is no profit motive.

Choice "c" is incorrect. Capital maintenance (i.e., preserving capital or assets) is not the primary emphasis of governmental funds, but rather in the general fixed assets account group.

Choice "d" is incorrect. Transfers relating to proprietary activities is not the primary emphasis of governmental funds accounting and reporting.

**CPA-00901 Type1 M/C A-D Corr Ans: C PM#14 F 8-01**

9. CPA-00901 Th Nov 93 #54 Page 8

Which of the following funds of a governmental unit uses the modified accrual basis of accounting?

a. Internal service funds.
b. Enterprise funds.
c. Special revenue funds.
d. Private purpose trust funds.

**CPA-00901 Explanation**
Choice "c" is correct. Special revenue funds are governmental funds, which use the modified accrual basis of accounting.


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Choice "a" is incorrect. Internal service funds are proprietary funds, which use the full accrual basis of accounting.

Choice "b" is incorrect. Enterprise funds are proprietary funds, which use the full accrual basis of accounting.

Choice "d" is incorrect. Private purpose trust funds are fiduciary funds, which use the full accrual basis of accounting.

**CPA-00902 Type1 M/C A-D Corr Ans: A PM#15 F 8-01**

10. CPA-00902 PII May 93 #22 Page 8

The modified accrual basis of accounting should be used for which of the following funds for purposes of fund financial statements?

a. Capital projects fund.
b. Enterprise fund.
c. Pension trust fund.
d. Proprietary fund.

**CPA-00902 Explanation**
Choice "a" is correct. The GRSPP funds use the modified accrual basis of accounting Proprietary funds (SE-enterprise and internal service funds) and fiduciary (PAPI) which include the pension trust fund and other fiduciary funds, use full accrual basis of accounting.

Choice "b" is incorrect. Enterprise funds use full accrual basis of accounting.

Choice "c" is incorrect. Pension trust funds use full accrual basis of accounting.

Choice "d" is incorrect. Proprietary funds including enterprise funds and internal service funds use full accrual basis of accounting.

**Modified Accrual Accounting**

**CPA-00904 Type1 M/C A-D Corr Ans: A PM#1 F 8-02**

11. CPA-00904 ARE R03 #14 Page 18

Chase City imposes a 2% tax on hotel charges. Revenues from this tax will be used to promote tourism in the city. Chase should record this tax as what type of non-exchange transaction?

a. Derived tax revenue.
b. Imposed non-exchange revenue.
c. Government-mandated transaction.
d. Voluntary non-exchange transaction.

**CPA-00904 Explanation**
**Rule:** Derived (non-exchange) tax revenues represent taxes imposed on or derived from exchange transactions such as commercial sales (sales taxes).

Choice "a" is correct. A 2% tax on hotel charges represents a derived non-exchange tax revenue based on commercial sales per rule above.

Choice "b" is incorrect. A 2% tax on hotel charges represents a derived non-exchange tax revenue not an imposed non-exchange tax revenue. Imposed non-exchange revenues represent taxes imposed on non-exchange transactions (such as fines) or wealth (such as property taxes).

Choice "c" is incorrect. A 2% tax on hotel charges represents a derived non-exchange tax revenue not a government-mandated transaction. Government mandated non-exchange transactions represent instances in which a higher level of government (e.g., a state) provides funds and mandates certain activities by another level of government (e.g., a county) such as environmental clean up, etc.


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Choice "d" is incorrect. A 2% tax on hotel charges represents a derived non-exchange tax revenue not a voluntary non-exchange transaction. Voluntary non-exchange transactions represent instances in which the government receives resources and does not provide equal value (e.g., grants agreements).

**CPA-00905 Type1 M/C A-D Corr Ans: B PM#2 F 8-02**

12. CPA-00905 ARE R02 #14 Page 18

Property taxes and fines represent which of the following classes of non-exchange transactions for governmental units?

a Derived tax revenues.
b. Imposed non-exchange revenues.
c. Government-mandated non-exchange transactions.
d. Voluntary non-exchange transactions.

**CPA-00905 Explanation**
Choice "b" is correct. Imposed non-exchange revenues include property taxes and fines.

Choice "a" is incorrect. Derived tax revenues represent a non-exchange transaction that *derives* its revenue from exchange transactions such as sales taxes (on sales) and income taxes (on income).

Choice "c" is incorrect. Government-mandated non-exchange transactions represent non-exchange transactions that compel the collection of revenues for certain activities, such as environmental clean up, etc.

Choice "d" is incorrect. Voluntary non-exchange transactions are non-exchange transactions that effectively represent contributions, such as grants, etc.

**CPA-00906 Type1 M/C A-D Corr Ans: A PM#3 F 8-02**

13. CPA-00906 ARE R02 #19 Page 42

Japes City issued $1,000,000 general obligation bonds at 101 to build a new city hall. As part of the bond issue, the city also paid a $500 underwriter fee and $2,000 in debt issue costs. What amount should Japes City report as other financing sources?

a. $1,010,000
b. $1,008,000
c. $1,007,500
d. $1,000,000

**CPA-00906 Explanation**
Choice "a" is correct. Japes City would account for proceeds from the issuance of general obligation bonds (both face amount and premium) as other financing sources. No debt related transactions are shown on a net basis. Other financing sources are computed as follows:

| | |
|---|---|
| Bond face amount | $1,000,000 |
| Bond premium | 101 |
| **Total proceeds** | **$1,010,000** |

Underwriter's fees of $500 and other debt issues costs of $2,000 would be accounted for as debt service expenditures.

Choice "b" is incorrect. Japes City would not report total proceeds net of other debt issue costs as other financing sources. No debt related transactions are shown on net basis.

Choice "c" is incorrect. Japes City would not report total proceeds net of bond issues costs and other debt issues costs as other financing sources. No debt related transactions are shown on a net basis.

Choice "d" is incorrect. Japes City would not report only the face amount of the issued bonds as other financing sources and exclude bond premium.


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**CPA-00924 Type1 M/C A-D Corr Ans: C PM#6 F 8-02**

14. CPA-00924 ARE R99 #17 Page 27

A county's balances in the general fund included the following:

| | |
|---|---|
| Appropriations | $745,000 |
| Encumbrances | 37,250 |
| Expenditures | 298,000 |
| Vouchers payable | 55,875 |

What is the remaining amount available for use by the county?

a. $353,875
b. $391,125
c. $409,750
d. $447,000

**CPA-00924 Explanation**

Choice "c" is correct. Appropriations is a budgetary account. This account represents the governmental units approved spending (in this case $745,000). Expenditures represent the actual incurring of bills, whether paid in cash or recorded as vouchers payable. Encumbrances are the restrictions of the fund balance for purchase orders. Vouchers payable represent expenditures not yet paid.

| | |
|---|---|
| Appropriations | $745,000 |
| Less: Expenditures | –298,000 |
| Encumbrances | – 37,250 |
| Remaining available appropriations | $409,750 |

Choices "a", "b", and "d" are incorrect per explanation above.

**CPA-00926 Type1 M/C A-D Corr Ans: D PM#7 F 8-02**

15. CPA-00926 ARE R96 #12 Page 20

Which of the following journal entries should a city use to record $250,000 for fire department salaries and wages incurred during the month of May?

| | | |
|---|---|---|
| a. | Salaries and wages expense | $250,000 |
| | Appropriations | $250,000 |
| b. | Salaries and wages expense | $250,000 |
| | Encumbrances | $250,000 |
| c. | Encumbrances | $250,000 |
| | Salaries payable | $250,000 |
| d. | Expenditures-salaries and wages | $250,000 |
| | Salaries payable | $250,000 |

**CPA-00926 Explanation**

Choice "d" is correct. The fire department salaries would be paid out of the general fund, as this is a service of the city. The general fund records the salaries as Expenditures with a credit to salaries payable.

Choice "a" is incorrect. Appropriations is the word for authorized (estimated) resource outflows, including expenditures, used when recording the budget. It does not represent actual expenditures.

Choice "b" is incorrect. Salaries are not usually encumbered, as they are a routine expenditure of the department. In addition, the word "expense" is associated with accrual accounting. The city in its general fund recognizes "expenditures" are the item relates to the financial outflow.


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Choice "c" is incorrect. Salaries are not usually encumbered, as they are a routine expenditure (financial outflow) of the department. Encumbrances represent commitments, not actual amounts payable.

**CPA-00927 Type1 M/C A-D Corr Ans: A PM#8 F 8-02**

16. CPA-00927 ARE Nov 95 #59 Page 16

Which event(s) is(are) supportive of interperiod equity as a financial reporting objective of a governmental unit?

I. A balanced budget is adopted.
II. Residual equity transfers out equals residual equity transfers in.

a. I only.
b. II only.
c. Both I and II.
d. Neither I nor II.

**CPA-00927 Explanation**
Choice "a" is correct. Interperiod equity is a significant part of accountability on behalf of a governmental entity. It helps users assess whether current year revenues are sufficient to pay for the services provided that year and whether future taxpayers will be required to assume burdens for services previously provided. Residual equity transfers is an obsolete term included as a distracter.

Choices "b", "c", and "d" are incorrect per explanation above.

**CPA-00932 Type1 M/C A-D Corr Ans: A PM#9 F 8-02**

17. CPA-00932 ARE Nov 95 #61 Page 16

Vale City legally adopts a cash-basis budget. What basis should be used in Vale's budgetary comparisons?

a. Cash.
b. Modified accrual.
c. Accrual.
d. Modified cash.

**CPA-00932 Explanation**
Choice "a" is correct. When the preparation of the budget is on the cash basis, budgetary comparisons will be prepared on the cash basis. Budgetary comparison schedules should be accompanied by information (either in a separate schedule or in notes to RSI) that reconciles budgetary information to GAAP information.

Choices "b", "c", and "d" are incorrect per explanation above.

**CPA-00944 Type1 M/C A-D Corr Ans: C PM#12 F 8-02**

18. CPA-00944 ARE Nov 95 #72 Page 17

The estimated revenues control account of a governmental unit is debited when:

a. Actual revenues are recorded.
b. Actual revenues are collected.
c. The budget is recorded.
d. The budget is closed at the end of the year.

**CPA-00944 Explanation**
Choice "c" is correct. Estimated revenue control account is part of the budget. The entry to record the budget is:

Estimated revenue control XXX


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Budgetary fund balance XXX

Choice "a" is incorrect. Recording of actual revenues does not impact estimated revenues. Estimated revenues is a budgetary account. Recording actual revenues results in credit to the appropriate actual revenue account.

Choice "b" is incorrect. Collection of actual revenues does not impact estimated revenues. Estimated revenues is a budgetary account. Collection of actual revenues would result in either a credit to the appropriate actual revenue account or a receivable.

Choice "d" is incorrect. Closing the budget at the end of the year is accomplished by reversing the entries that established the budget. Estimated revenues would be credited.

**CPA-00947 Type1 M/C A-D Corr Ans: A PM#13 F 8-02**

19. CPA-00947 ARE May 95 #54 Page 22

The expenditure element "salaries and wages" is an example of which type of classification?

a. Object.
b. Program.
c. Function.
d. Activity.

**CPA-00947 Explanation**

Choice "a" is correct. Wages and salaries is an example of an object classification. This is the most specific classification in the hierarchy and represents the chart of accounts title. Expenditures of governmental resources should be classified by object classes-according to the type of items purchased or services obtained.

Choice "b" is incorrect. Program classification groups activities, operations, or organizational units that are directed to the attainment of specific purposes or objectives.

Choice "c" is incorrect. Function classification groups related activities that are aimed at accomplishing a major service or regulatory responsibility.

Choice "d" is incorrect. Activity classification provides data for calculating expenditures per unit of activity. An activity is a specific and distinguishable line of work performed by an organizational unit.

**CPA-00950 Type1 M/C A-D Corr Ans: D PM#14 F 8-02**

20. CPA-00950 ARE Nov 94 #4 Page 16

On what accounting basis does GASB recommend that governmental fund budgets be prepared?

a. Cash.
b. Modified cash.
c. Accrual.
d. Modified accrual.

**CPA-00950 Explanation**

Choice "d" is correct. Governmental funds use a budget for control and comparison purposes. Since comparisons of budgeted and actual amounts are made, the basis for preparing the budget should be the same as the fund's basis of accounting. The modified accrual basis is used in accounting for governmental funds and should, therefore, be used in preparing governmental fund budgets.

Choices "a", "b", and "c" are incorrect per explanation above.

**CPA-00956 Type1 M/C A-D Corr Ans: D PM#16 F 8-02**

21. CPA-00956 ARE Nov 94 #15 Page 20


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Expenditures of a governmental unit for insurance extending over more than one accounting period:

a. Must be accounted for as expenditures of the period of acquisition.
b. Must be accounted for as expenditures of the periods subsequent to acquisition.
c. Must be allocated between or among accounting periods.
d. May be allocated between or among accounting periods or may be accounted for as expenditures of the period of acquisition.

**CPA-00956 Explanation**
Choice "d" is correct. Expenditures are decreases in net financial resources of governmental funds other than interfund transfers. Expenditures extending over more than one period may be allocated between or among accounting periods.

Choices "a", "b", and "c" are incorrect per explanation above. Absolutes are generally incorrect.

**CPA-00959 Type1 M/C A-D Corr Ans: B PM#17 F 8-02**

22. CPA-00959 ARE Nov 94 #17 Page 18

In which situation(s) should property taxes due to a governmental unit be recorded as deferred revenue?

I. Property taxes receivable are recognized in advance of the year for which they are levied.
II. Property taxes receivable are collected in advance of the year in which they are levied.

a. I only.
b. Both I and II.
c. II only.
d. Neither I nor II.

**CPA-00959 Explanation**
Choice "b" is correct. Revenues are recognized when measurable and available. In the case of property taxes, revenues are recognized in the period in which the taxes are levied. When property taxes receivable are either recognized or collected in advance of the year in which they are levied, deferred revenue is recorded.

| | | | |
|---|---|---|---|
| I. | Property Taxes Receivable | XXX | |
| | Deferred Revenue | | XXX |
| II. | Cash | XXX | |
| | Deferred Revenue | | XXX |

Choices "a", "c", and "d" are incorrect per journal entry explanation above.

**CPA-00961 Type1 M/C A-D Corr Ans: B PM#18 F 8-02**

23. CPA-00961 ARE Nov 94 #18 Page 24

In 1994, New City issued purchase orders and contracts of $850,000 that were chargeable against 1994 budgeted appropriations of $1,000,000. The journal entry to record the issuance of the purchase orders and contracts should include a:

a. Credit to vouchers payable of $1,000,000.
b. Credit to reserve for encumbrances of $850,000.
c. Debit to expenditures of $1,000,000.
d. Debit to appropriations of $850,000.

**CPA-00961 Explanation**
Choice "b" is correct. The issuance of purchase orders or the signing of contracts represents a commitment to expend resources. Such a commitment is recorded as an encumbrance. The entry to record the issuance of the purchase orders and contracts is:

| | | |
|---|---|---|
| Encumbrances | 850,000 | |
| Reserve for encumbrances | | 850,000 |


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Choice "a" is incorrect. Vouchers payable is credited when expenditures are incurred not when purchase orders are issued. Issuance of a purchase order results in an encumbrance.

Choice "c" is incorrect. Expenditures are recorded for the amount incurred when goods are received. The appropriation of funds represents a planned and generally authorized expenditure, not an expenditure itself.

Choice "d" is incorrect. Appropriations are recorded when the budget is formally integrated into the accounting system. New City would have recorded a $1,000,000 appropriation and would not have made any budgetary entry at the time the purchase order is let. Governments record budgets, activity, and encumbrances (BAE) separately and reverse them separately.

**CPA-00966 Type1 M/C A-D Corr Ans: A PM#21 F 8-02**

24. CPA-00966 PII Nov 93 #3 Page 16

For the budgetary year ending December 31, 1993, Maple City's general fund expects the following inflows of resources:

| | |
|---|---|
| Property taxes, licenses, and fines | $9,000,000 |
| Proceeds of debt issue | 5,000,000 |
| Interfund transfers for debt service | 1,000,000 |

In the budgetary entry, what amount should Maple record for estimated revenues?

a. $9,000,000
b. $10,000,000
c. $14,000,000
d. $15,000,000

**CPA-00966 Explanation**
Choice "a" is correct. Only the $9,000,000 property taxes, licenses and fines are classified as Estimated Revenues. The $5,000,000 proceeds of debt issue and the $1,000,000 interfund transfer would be classified as Estimated Other Financing Sources in the budgetary entry.

Choice "b" is incorrect. The $ 1,000,000 interfund transfer would be classified as Estimated Other Financing Sources, not Estimated Revenues.

Choice "c" is incorrect. The $5,000,000 proceeds of debt issue would be classified as Estimated Other Financing Sources, not Estimated Revenues.

Choice "d" is incorrect. Both the $1,000,000 interfund transfer and the $5,000,000 proceeds of debt issue would be classified as Estimated Other Financing Sources, not Estimated Revenues.

**CPA-00968 Type1 M/C A-D Corr Ans: C PM#22 F 8-02**

25. CPA-00968 PII Nov 93 #4 Page 25

During its fiscal year ended June 30, 1993, Cliff City issued purchase orders totaling $5,000,000, which were properly charged to encumbrances at that time. Cliff received goods and related invoices at the encumbered amounts totaling $4,500,000 before year-end. The remaining goods of $500,000 were not received until after year-end. Cliff paid $4,200,000 of the invoices received during the year. What amount of Cliff's encumbrances were outstanding at June 30, 1993?

a. $0
b. $300, 000
c. $500,000
d. $800,000

**CPA-00968 Explanation**
Choice "c" is correct. The encumbrances outstanding at year-end are the $500,000 of remaining goods ordered but not yet received at year end. They would be reflected in the $500,000 balance in the


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Reserve for Encumbrances account if the encumbrances do not lapse at year-end. If they lapse, the amount is disclosed in the notes to the financial statements if the governmental entity intends to honor them. The Encumbrances account would be closed out to Fund Balance at year-end.

Choice "a" is incorrect. While the Encumbrance account would be closed at year-end, the Reserve for encumbrances account would reflect a balance.

Choice "b" is incorrect. The $300,000 not yet paid would be the balance in the Vouchers Payables account, not encumbrances outstanding at year-end.

Choice "d" is incorrect. The $300,000 not yet paid would be the balance in the Vouchers Payables account, but it would *not* affect the encumbrances (i.e., purchase orders) outstanding.

**CPA-00972 Type1 M/C A-D Corr Ans: C PM#24 F 8-02**

26. CPA-00972 PII Nov 93 #7 Page 20

The following information pertains to Spruce City's liability for claims and judgments:

| | |
|---|---|
| Current liability at January 1, 1992 | $100,000 |
| Claims paid during 1992 | 800,000 |
| Current liability at December 31, 1992 | 140,000 |
| Non-current liability at December 31, 1992 | 200,000 |

What amount should Spruce report for 1992 claims and judgments expenditures?

a. $1,040,000
b. $940,000
c. $840,000
d. $800,000

**CPA-00972 Explanation**

Choice "c" is correct. The claims and judgments expenditures would be the sum of the claims paid ($800,000) and the increase in the *current* liability ($40,000), or a total of $840,000. The non-current liability is not an expenditure of the governmental fund for 1992.

Choice "a" is incorrect. The non-current liability is not an expenditure of the governmental fund.

Choice "b" is incorrect. Only the $40,000 *increase* in the current liability should be added to the $800,000 claims paid amount, *not* the entire $140,000 ending current liability balance.

Choice "d" is incorrect. The $40,000 increase in the current liability should be added to the $800,000 claims paid amount.

**CPA-00973 Type1 M/C A-D Corr Ans: C PM#25 F 8-02**

27. CPA-00973 PII Nov 93 #10 Page 18

The following information pertains to property taxes levied by Oak City for the calendar year 1992:

| | |
|---|---|
| Collections during 1992 | $500,000 |
| Expected collections during the first 60 days of 1993 | 100,000 |
| Expected collections during the balance of 1993 | 60,000 |
| Expected collections during January 1994 | 30,000 |
| Estimated to be uncollectible | 10,000 |
| Total levy | $700,000 |

What amount should Oak report for 1992 net property tax revenues in its fund financial statements?

a. $700,000
b. $690,000
c. $600,000
d. $500,000


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**CPA-00973 Explanation**
Choice "c" is correct. The net property tax revenues would include the $500,000 collections during the year plus the $100,000 expected collections within 60 days of year-end, for a total of $600,000. The remaining expected collections of $90,000 ($60,000 + $30,000) would be recorded as deferred revenue under the modified accrual basis of governmental accounting for revenues. The $10,000 estimated to be uncollectible would not be considered since revenues are accounted for net of the estimated uncollectible amount.

Choice "a" is incorrect. The revenues account would include neither the $90,000 expected collections beyond 60 days after year-end nor the $10,000 uncollectible amount.

Choice "b" is incorrect. The revenues account would not include the $90,000 expected collections beyond 60 days after year-end.

Choice "d" is incorrect. The revenues account would include the $100,000 expected collections shortly after year-end (within 60 days).

**CPA-00977 Type1 M/C A-D Corr Ans: B PM#26 F 8-02**

28. CPA-00977 PII Nov 93 #20 Page 25

The following information pertains to Park Township's general fund at December 31, 1992:

| | |
|---|---|
| Total assets, including $200,000 of cash | $1,000,000 |
| Total liabilities | 600,000 |
| Reserved for encumbrances | 100,000 |

Appropriations do not lapse at year-end. At December 31, 1992, what amount should Park report as unreserved fund balance in its general fund balance sheet?

a. $200,000
b. $300,000
c. $400,000
d. $500,000

**CPA-00977 Explanation**
Choice "b" is correct. Total Fund Balance equals total assets of $1,000,000 less total liabilities of $600,000, or $400,000. Since appropriations do not lapse at year-end, the $100,000 Reserved for Encumbrances must be reported as part of the Fund Balance. As a result, the Unreserved Fund Balance is the difference, $400,000 – $100,000, or $300,000.

Choice "a" is incorrect. The $200,000 cash is not used to determine the Unreserved Fund Balance.

Choice "c" is incorrect. The $400,000 is the total Fund Balance. The $100,000 Reserved for Encumbrances is part of this total.

Choice "d" is incorrect. The $100,000 Reserved for Encumbrances is subtracted from the total Fund Balance, not added to it.

**CPA-00978 Type1 M/C A-D Corr Ans: B PM#27 F 8-02**

29. CPA-00978 Th Nov 93 #51 Page 24

The encumbrance account of a governmental unit is debited when:

a. The budget is recorded.
b. A purchase order is approved.
c. Goods are received.
d. A voucher payable is recorded.

**CPA-00978 Explanation**


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Choice "b" is correct. The encumbrances account is debited and Reserve for Encumbrances is credited when a purchase order is approved.

Choice "a" is incorrect. When the budget is recorded, Estimated revenues is debited, Appropriations is credited, and Estimated Change in Fund Balance is credited, if the estimated revenues are greater than the appropriations.

Choice "c" is incorrect. When goods are received, Reserve for Encumbrances is debited and Encumbrances is credited. In addition, Expenditures is debited and Vouchers Payable is credited.

Choice "d" is incorrect. A voucher payable is recorded when goods are received (encumbrance entry is reversed):

| | | | |
|---|---|---|---|
| DR | Expenditures | XXX | |
| CR | Vouchers Payable | | XXX |
| DR | Reserve for Encumbrances | XXX | |
| CR | Encumbrances | | XXX |

**CPA-00979 Type1 M/C A-D Corr Ans: D PM#28 F 8-02**

30. CPA-00979 Th Nov 93 #52 Page 25

A budgetary fund balance reserved for encumbrances in excess of a balance of encumbrances indicates:

a. An excess of vouchers payable over encumbrances.
b. An excess of purchase orders over invoices received.
c. An excess of appropriations over encumbrances.
d. A recording error.

**CPA-00979 Explanation**
Choice "d" is correct. The budgetary fund balance reserved for encumbrances represents a portion of the fund balance that has been segregated for expenditure on vendor performance, usually being goods ordered but not yet received. Remember the entry to record a purchase order:

Dr. Encumbrances
Cr. Fund balance reserved for encumbrances

Likewise, the encumbrance balance represents purchase orders outstanding. For the budgetary fund balance reserved for encumbrance to exceed the encumbrance balance, a recording error must have been made.

Choice "a" is incorrect. Encumbrances represent purchase orders for which the goods ordered are not yet received. Vouchers payable represent the amounts owed and not yet paid for goods received. The relative balances of these accounts have no impact on the balance in the budgetary fund balance reserved for encumbrances.

Choice "b" is incorrect. The budgetary fund balance reserved for encumbrances is a balance sheet account indicating the outstanding purchase orders for goods not yet received. Likewise, the encumbrance balance represents purchase orders outstanding. An excess of purchase orders over invoices received would not explain the difference between these two accounts.

Choice "c" is incorrect. Appropriations are recorded when the budget is adopted and are unrelated to encumbrances.

**CPA-00983 Type1 M/C A-D Corr Ans: D PM#29 F 8-02**

31. CPA-00983 Th Nov 93 #53 Page 18

Which of the following accounts of a governmental unit is credited when taxpayers are billed for property taxes?

a. Appropriations.


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b. Taxes receivable current.
c. Estimated revenues.
d. Revenues.

**CPA-00983 Explanation**
Choice "d" is correct. Revenues are credited and Property Taxes Receivable are debited when taxpayers are billed for property taxes. Note that the revenues are recorded net of estimated uncollectibles.

Choice "a" is incorrect. Appropriations are credited when the budget is recorded at the beginning of the budget year.

Choice "b" is incorrect. Taxes receivable-current are credited when cash is received.

Choice "c" is incorrect. Estimated revenues are credited at fiscal year-end when the estimated revenues and appropriations are closed.

**CPA-00985 Type1 M/C A-D Corr Ans: B PM#30 F 8-02**

32. CPA-00985Th May 93 #52 Page 17

The estimated revenues control account balance of a governmental fund type is eliminated when:

a. The budget is recorded.
b. The budgetary accounts are closed.
c. Appropriations are closed.
d. Property taxes are recorded.

**CPA-00985 Explanation**
Choice "b" is correct. The estimated revenues control account is eliminated when the budgetary accounts are closed.

Choice "a" is incorrect. The estimated revenues control account is created when the budget is recorded.

Choice "c" is incorrect. Appropriations (budgeted expenditures) are a separate control account from the estimated revenues control account.

Choice "d" is incorrect. When property taxes are recorded, the actual revenue account is increased and there is no effect on the estimated revenues control account. Budgetary accounts are altered only when there is an approved change in the budget.

**CPA-00987 Type1 M/C A-D Corr Ans: B PM#31 F 8-02**

33. CPA-00987Th May 93 #53 Page 25

Encumbrances outstanding at year-end in a state's general fund should be reported as a:

a. Liability in the general fund.
b. Fund balance reserve in the general fund.
c. Liability in the general long-term debt account group.
d. Fund balance designation in the general fund.

**CPA-00987 Explanation**
Choice "b" is correct. Encumbrances are commitments for unperformed contracts for goods or services. Encumbrances at year-end do not constitute expenditures or liabilities. Therefore, at year-end encumbrances are closed to fund balance, leaving the reserve for encumbrances intact as a portion of the fund balance not appropriable for expenditure.

Choice "a" is incorrect. Encumbrances are not liabilities. They represent commitments for unperformed contracts for goods or services.

Choice "c" is incorrect. Encumbrances are not debts. They represent commitments for unperformed contracts for goods or services. Also, account groups were eliminated with the implementation of GASB 34.


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Choice "d" is incorrect. Encumbrances are not a fund balance designation; rather, at year-end encumbrances are closed to fund balance, leaving the reserve for encumbrances intact as a portion of the fund balance not appropriable for expenditure.

**CPA-00988 Type1 M/C A-D Corr Ans: A PM#32 F 8-02**

34. CPA-00988Th May 93 #55 Page 13

Which of the following funds of a governmental unit recognizes revenues only in the accounting period in which they become available and measurable in their fund financial statements?

| | *General Fund* | *Enterprise Fund* |
|---|---|---|
| a. | Yes | No |
| b. | No | Yes |
| c. | Yes | Yes |
| d. | No | No |

**CPA-00988 Explanation**
Choice "a" is correct. The general fund uses the modified accrual basis of accounting which recognizes revenues in the accounting period in which they become available and measurable. The enterprise fund uses the full accrual basis of accounting, which recognizes revenues in the accounting period in which they are earned.

**CPA-00990 Type1 M/C A-D Corr Ans: C PM#33 F 8-02**

35. CPA-00990Th May 93 #56 Page 18

A public school district should recognize revenue from property taxes levied for its debt service fund when:

a. Bonds to be retired by the levy are due and payable.
b. Assessed valuations of property subject to the levy are known.
c. Funds from the levy are measurable and available to the district.
d. Proceeds from collection of the levy are deposited in the district's bank account.

**CPA-00990 Explanation**
Choice "c" is correct. Revenue from property taxes is recognized when the revenue is available and measurable.

Choice "a" is incorrect. Revenue from property taxes is recognized prior to the retirement of the bonds.

Choice "b" is incorrect. The funds are not available upon knowing assessed valuations of property.

Choice "d" is incorrect. The revenues are considered available and measurable before the proceeds are collected.

**CPA-04673 Type1 M/C A-D Corr Ans: D PM#35 F 8-02**

36. CPA-04673Released 2005 Page 20

Dayne County's general fund had the following disbursements during the year:

| | |
|---|---|
| Payment of principal on long-term debt | $100,000 |
| Payments to vendors | 500,000 |
| Purchase of a computer | 300,000 |

What amount should Dayne County report as expenditures in its governmental funds statement of revenues, expenditures, and changes in fund balances?

a. $300,000
b. $500,000
c. $800,000


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d. $900,000

**CPA-04673 Explanation**
Choice "d" is correct. Governmental funds use the current financial resources measurement focus. As a result, the governmental fund statement of revenues, expenditures and changes in fund balance will emphasize the financial flow of resources and recognize all of the disbursements described for Dayne County as an expenditure:

| | |
|---|---|
| Current | |
| Expenditures (payments to vendors) | $500,000 |
| Capital Outlay | |
| Computer purchase expenditure | 300,000 |
| Debt Service | |
| Principal payment on long term debt | 100,000 |
| **Total reported expenditures** | **$900,000** |

Choice "a" is incorrect. The total expenditures reported by Dayne County would not be limited to the capital outlay expenditure for computer equipment of $300,000.

Choice "b" is incorrect. The total expenditures reported by Dayne County would not be limited to the vendor payments of $500,000.

Choice "c" is incorrect. The total expenditures reported by Dayne County would not be limited to the total of $800,000 represented by the vendor payments of $500,000 and the capital outlay expenditure for computer equipment of $300,000.

**CPA-05431 Type1 M/C A-D Corr Ans: C PM#36 F 8-02**

37. CPA-05431 Released 2007 Page 25

A county's balances in the general fund included the following:

| | |
|---|---|
| Appropriations | $435,000 |
| Encumbrances | 18,000 |
| Expenditures | 164,000 |
| Vouchers payable | 23,000 |

What is the remaining amount available for use by the county?

a. $230,000
b. $248,000
c. $253,000
d. $271,000

**CPA-05431 Explanation**
Choice "c" is correct. Appropriations is a budgetary account. This account represents the governmental unit's approved spending (in this case $435,000). Expenditures represent the actual incurring of bills, whether paid in cash or recorded as vouchers payable. Encumbrances are restrictions of the fund balance for purchase orders. Vouchers payable represent expenditures not yet paid and are included as a component of the expenditure amount. The amount of appropriations remaining is the difference between the appropriations and the funds encumbered or expended computed as follows:

| | |
|---|---|
| **B**udget: Appropriations | $435,000 |
| **A**ctivity: Expenditures | (164,000) |
| **E**ncumbrances | (18,000) |
| Available appropriations | $253,000 |

Choice "a" is incorrect. The proposed solution reduces available appropriations by encumbrances, expenditures and vouchers payable. Vouchers payable amounts are already included in the expenditure amount.


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Choice "b" is incorrect. The proposed solution reduced available appropriations by expenditures and vouchers payable. Vouchers payable amounts are already included in the expenditure amount. Appropriations must be reduced by amounts committed (encumbered) to determine the amount of available appropriations.

Choice "d" is incorrect. The proposed solution purely reduces the appropriations by expenditures and does not consider encumbered funds.

**CPA-05452 Type1 M/C A-D Corr Ans: D PM#37 F 8-02**

38. CPA-05452 Released 2007 Page 18

Which of the following items is an example of imposed non-exchange revenue for a governmental entity?

a. Personal income taxes.
b. Retail sales tax.
c. Federal grant money.
d. Property taxes.

**CPA-05452 Explanation**
Choice "d" is correct. Imposed non-exchange transactions include taxes imposed on non-exchange transactions (such as fines) or wealth (such as property taxes).

Choice "a" is incorrect. Personal income taxes are derived tax revenues that are imposed upon or derived from exchange transactions (such as income tax on taxpayer income).

Choice "b" is incorrect. Retail sales taxes are derived tax revenues that are imposed upon or derived from exchange transactions (such as sales tax on commercial sales).

Choice "c" is incorrect. Federal grant money could be considered either a grant mandated non-exchange transaction or a voluntary non-exchange transaction depending on the character of the grant. It would not, however, represent imposed non-exchange revenue.

**Governmental Funds**

**CPA-00993 Type1 M/C A-D Corr Ans: C PM#1 F 8-03**

39. CPA-00993 ARE R97 #12 Page 6

Receipts from a special tax levy to retire and pay interest on general obligation bonds should be recorded in which fund?

a. General.
b. Capital projects.
c. Debt service.
d. Special revenue.

**CPA-00993 Explanation**
Choice "c" is correct. The debt service fund services general debt of the governmental entity. As such, the fund accounts for the accumulation of re-sources for, and the payment of, general long-term (1) debt principal and interest.

Choice "a" is incorrect. The general fund accounts for all the financial resources of the governmental entity, except those required to be accounted for in another fund. Resources collected to pay principal and/or interest on general obligation bonds are usually required to be accounted for in another governmental-type fund.

Choice "b" is incorrect. The capital projects fund accounts for the financial resources to be used for the acquisition or construction of major capital facilities not accounted for in proprietary or trust funds. Resources collected to pay principal and/or interest on general obligation bonds are accounted for in another governmental-type fund.


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Choice "d" is incorrect. The special revenue fund accounts for the proceeds of specific revenue sources that are legally restricted to expenditure for specified purposes. Although receipts from a special tax levy would usually be accounted for in a special revenue fund, since the receipts are earmarked for interest payments on general obligation bonds, another governmental-type fund is more appropriate. Resources collected to pay principal and/or interest on general obligation bonds are usually required to be accounted for in another governmental-type fund.

**CPA-00994 Type1 M/C A-D Corr Ans: B PM#2 F 8-03**

40. CPA-00994 ARE Nov 95 #58 Page 46

Capital assets donated to a governmental unit should be recorded:

a. At the donor's carrying amount.
b. At estimated fair value when received.
c. At the lower of the donor's carrying amount or estimated fair value when received.
d. As a memorandum entry only.

**CPA-00994 Explanation**
Choice "b" is correct. Capital assets donated to a governmental unit should be recorded at their estimated fair value at time of acquisition, plus ancillary charges, if any.

Choice "a" is incorrect. Donated capital assets are not recorded at the donor's carrying value.

Choice "c" is incorrect. The donor's carrying value is of no concern to the governmental entity.

Choice "d" is incorrect. Donated capital assets are recorded in the financial records when received; a memorandum entry is not made.

**CPA-00998 Type1 M/C A-D Corr Ans: C PM#5 F 8-03**

41. CPA-00998 ARE Nov 94 #10 Page 46

When a capital lease of a governmental unit represents the acquisition of a general fixed asset, the acquisition should be reflected in fund financial statements as:

a. An expenditure but not as an other financing source.
b. An other financing source but not as an expenditure.
c. Both an expenditure and an other financing source.
d. Neither an expenditure nor an other financing source.

**CPA-00998 Explanation**
Choice "c" is correct. A lease, which represent the acquisition of a general capital asset, should be accounted for in the same manner as a purchase and source of financing. The acquisition should be recorded in the fund acquiring the asset as an expenditure and the financing as an increase in other financing sources. If the fund acquiring the asset is a governmental fund, the asset should be recorded as general capital assets and the lease obligation should be should be recorded in the general long-term liabilities. Both non-current accounts appear in the governmental activities column of the government-wide statement of net assets. The journal entry in the acquiring fund is:

| | | |
|---|---|---|
| Expenditure - Capital lease | XXX | |
| Other financing source - Capital lease | | XXX |

Choices "a", "b", and "d" are incorrect per journal entry explanation above.

**CPA-01001 Type1 M/C A-D Corr Ans: B PM#7 F 8-03**

42. CPA-01001 ARE Nov 94 #13 Page 43

The portion of special assessment debt maturing in 5 years, to be repaid from general resources of the government, should be reported in the:


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a. General fund.
b. Government-wide statement of net assets.
c. Agency fund.
d. Capital projects fund.

**CPA-01001 Explanation**
Choice "b" is correct. When special assessment debt is to be repaid from general resources of the government, the debt should be recorded as general long-term liabilities in the governmental activities column of the government-wide statement of net assets as is any debt that is to be repaid from general resources.

Choice "a" is incorrect. Since the measurement focus of governmental funds is the flow of financial resources, the general fund does not report long-term debt.

Choice "c" is incorrect. The agency fund reports special assessment debt that will be repaid by collections from third parties, not by general resources of the government.

Choice "d" is incorrect. The capital projects fund accounts for resources used in the acquisition and construction of major fixed assets.

**CPA-01005 Type1 M/C A-D Corr Ans: C PM#8 F 8-03**

43. CPA-01005 ARE Nov 94 #20 Page 49

Interfund transfers received by a governmental-type fund should be reported in the Statement of Revenues, Expenditures, and changes in Fund balance as a (an):

a. Addition to contributed capital.
b. Addition to net assets.
c. Other financing source.
d. Reimbursement.

**CPA-01005 Explanation**
Choice "c" is correct. Governmental funds report interfund transfers as other financing sources (uses).

Choice "a" is incorrect. Contributed capital is not recorded in governmental fund financial statements.

Choice "b" is incorrect. Governmental-type funds do not report net assets.

Choice "d" is incorrect. Interfund transfers are non-reciprocal in nature and hence are not reimbursements.

**CPA-01006 Type1 M/C A-D Corr Ans: D PM#9 F 8-03**

44. CPA-01006 PII Nov 93 #6 Page 35

Wood City, which is legally obligated to maintain a debt service fund, issued the following general obligation bonds on July 1, 1992:

| | |
|---|---|
| Term of bonds | 10 years |
| Face amount | $1,000,000 |
| Issue price | 101 |
| Stated interest rate | 6% |

Interest is payable January 1 and July 1. What amount of bond premium should be amortized in Wood's debt service fund for purposes of fund financial reporting for the year ended December 31, 1992?

a. $1,000
b. $500
c. $250
d. $0

**CPA-01006 Explanation**


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Choice "d" is correct. Since the measurement focus is sources and uses of financial resources, bond premium/discount is not amortized in its governmental funds, including the debt service fund. The bond premium/discount is usually recorded in the fund receiving the proceeds. If the premium is to be used for debt service, as is often the case, the premium is considered as Revenue of the debt service fund.

Choice "a" is incorrect. The $1,000 is 1/10th of the $10,000 premium, a full year's amortization. However, there is no premium or discount amortization in governmental funds since the measurement focus is sources and uses of financial resources.

Choice "b" is incorrect. The $500 is a half-year's amortization of the $10,000 premium, based on a 10 year term. There is, however, no premium or discount amortization in governmental funds since the measurement focus is sources and uses of financial resources.

Choice "c" is incorrect. There is no premium or discount amortization in governmental funds since the measurement focus is sources and uses of financial resources.

**CPA-01008 Type1 M/C A-D Corr Ans: C PM#10 F 8-03**

45. CPA-01008 PII Nov 93 #11 Page 41

Financing for the renovation of Fir City's municipal park, begun and completed during 1992, came from the following sources:

| | |
|---|---|
| Grant from state government | $400,000 |
| Proceeds from general obligation bond issue | 500,000 |
| Transfer from Fir's general fund | 100,000 |

In its 1992 capital projects fund operating statement, Fir should report these amounts as:

| | *Revenues* | *Other Financing Sources* |
|---|---|---|
| a. | $1,000,000 | $0 |
| b. | $900,000 | $100,000 |
| c. | $400,000 | $600,000 |
| d. | $0 | $1,000,000 |

**CPA-01008 Explanation**
Choice "c" is correct. The $400,000 state government grant would be considered revenue of the capital projects fund. The $500,000 proceeds from the general obligation bonds and the $100,000 transfer from general fund (total $600,000) would be other financing sources of the capital projects fund.

Choice "a" is incorrect. The $500,000 proceeds from bonds and the $100,000 transfer from general fund would be other financing sources of the capital projects fund, not revenue.

Choice "b" is incorrect. The $500,000 proceeds from bonds would be other financing sources of the capital projects fund, not revenue.

Choice "d" is incorrect. The $400,000 state government grant would be revenue of the capital projects fund, not other financing sources.

**CPA-01010 Type1 M/C A-D Corr Ans: B PM#11 F 8-03**

46. CPA-01010 PII Nov 93 #15 Page 46

In 1993, Palm City acquired, through forfeiture as a result of nonpayment of property taxes, a parcel of land that the city intends to use as a parking lot for general governmental purposes. The total amount of taxes, liens, and other costs incurred by Palm incidental to acquiring ownership and perfecting title was $20,000. The land's fair market value at the forfeiture date was $60,000. What amount should Palm City capitalize relative to its governmental activities?

a. $0
b. $20,000
c. $60,000


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d. $80,000

**CPA-01010 Explanation**
Choice "b" is correct. The property retained by the government becomes a general capital asset in the governmental activities column of the government-wide statement of net assets and is capitalized at the lower of cost ($20,000) or market value ($60,000).

Choice "a" is incorrect. The retained property would be capitalized in the general fixed assets account group, not the general fund. The general fund does not record fixed assets.

Choice "c" is incorrect. The asset would be capitalized at the *lower* of cost ($20,000) or market value ($60,000), not the higher of the two.

Choice "d" is incorrect. The asset would be capitalized at the *lower* of cost ($20,000) or market value ($60,000), not the sum of the two.

**CPA-01012 Type1 M/C A-D Corr Ans: A PM#12 F 8-03**

47. CPA-01012 PII Nov 93 #18 Page 32

The following information pertains to certain monies held by Blair County at December 31, 1992, that are legally restricted to expenditures for specified purposes:

| | |
|---|---|
| Proceeds of short-term notes to be used for advances to private purpose trust funds | $8,000 |
| Proceeds of long-term debt to be used for a major capital project | 90,000 |

What amount of these restricted monies should Blair account for in special revenue funds?

a. $0
b. $8,000
c. $90,000
d. $98,000

**CPA-01012 Explanation**
Choice "a" is correct. Special revenue funds account for the proceeds of specific revenue sources (*other than permanent funds or for major capital projects*) that are legally restricted to expenditures for specific purposes. The $8,000 is for the private purpose trust funds, which would account for it. The $90,000 is for a major capital project, which would be accounted for in a capital projects fund.

Choice "b" is incorrect. The $8,000 is for the private purpose trust funds, which would account for this money.

Choice "c" is incorrect. The $90,000 is accounted for in the capital projects fund.

Choice "d" is incorrect. The $8,000 is accounted for in the private purpose trust funds. The $90,000 is accounted for in the capital projects fund.

**CPA-01013 Type1 M/C A-D Corr Ans: D PM#13 F 8-03**

48. CPA-01013 PII May 93 #34 Page 6

Central County received proceeds from various towns and cities for capital projects financed by Central's long-term debt. A special tax was assessed by each local government, and a portion of the tax was restricted to repay the long-term debt of Central's capital projects. Central should account for the restricted portion of the special tax in which of the following funds?

a. Internal service fund.
b. Enterprise fund.
c. Capital projects fund.
d. Debt service fund.

**CPA-01013 Explanation**


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Choice "d" is correct. The debt service fund accounts for the accumulation of resources for, and the payment of, general long-term liability principal and interest. The restricted portion of the special tax is for the repayment of the long-term debt of Central's capital projects, which would be serviced from the debt service fund. The capital projects fund is a governmental fund for the acquisition or construction of capital assets.

Choice "a" is incorrect. The internal service funds provide goods or services to other departments on a cost-reimbursement basis.

Choice "b" is incorrect. Enterprise funds provide goods or services to the general public similar to a for-profit enterprise.

Choice "c" is incorrect. Capital project funds account for the resources to be used for the acquisition or construction of major capital facilities. Long-term liabilities are not recorded in or serviced from this fund.

**CPA-01017 Type1 M/C A-D Corr Ans: D PM#14 F 8-03**

49. CPA-01017PII May 93 #39 Page 50

Stone Corp. donated investments to Pine City and stipulated that the income from the investments be used to acquire art for the city's museum. Which of the following funds should be used to account for the investments?

a. Endowment fund.
b. Special revenue fund.
c. Private purpose trust fund.
d. Permanent fund.

**CPA-01017 Explanation**
Choice "d" is correct. Permanent funds are used to account for the principal that is restricted from being expended. In this case, the investments must be accounted for in the permanent fund. Investment income can be accounted for in a private purpose trust fund.

Choice "a" is incorrect. Although sometimes called endowment funds, the proper fund name is permanent fund, since this is a municipality.

Choice "b" is incorrect. Special revenue funds account for specific revenues that have been legally restricted to expenditure for specified purposes.

Choice "c" is incorrect. Private purpose trust funds account for the funds, which can be expended according to the donor's restrictions, such as income from investments.

**CPA-01019 Type1 M/C A-D Corr Ans: A PM#15 F 8-03**

50. CPA-01019Th May 93 #51 Page 46

Fixed assets donated to a governmental unit should be recorded:

a. At estimated fair value when received.
b. At the lower of donor's carrying amount or estimated fair value when received.
c. At the donor's carrying amount.
d. As a memorandum entry only.

**CPA-01019 Explanation**
Choice "a" is correct. Donated capital assets to a governmental unit are recorded as if they had been purchased, that is at estimated fair value when received.

Choice "b" is incorrect. The donor's carrying amount is not relevant to the governmental unit receiving the donated assets.

Choice "c" is incorrect. The donor's carrying amount is not relevant to the governmental unit receiving the donated assets.


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Choice "d" is incorrect. Donated capital assets are recorded in the fund that they relate to or in the government activities column of the government-wide statement of net assets. A memorandum entry would not properly record the increase in assets.

**CPA-04665 Type1 M/C A-D Corr Ans: A PM#16 F 8-03**

51. CPA-04665 Released 2005 Page 36

On January 2, City of Walton issued $500,000, 10-year, 7% general obligation bonds. Interest is payable annually, beginning January 2 of the following year. What amount of bond interest is Walton required to report in the statement of revenue, expenditures, and changes in fund balance of its governmental funds at the close of this fiscal year, September 30?

a. $0
b. $17,500
c. $26,250
d. $35,000

**CPA-04665 Explanation**
Choice "a" is correct. The City of Walton would not record any interest expenditures in its current year financial statements. Interest expenditures should be recorded when legally payable per the bond agreement. Interest expenditures should not be accrued between payment dates. Bonds were issued January 2, the balance sheet date is September 30 and the payment date is the following January 2. No interest expenditure would be recognized.

Choice "b" is incorrect. The City of Walton pays interest annually according to the fact pattern. Although it is not unusual for bonds to required payment of interest twice a year, six months of interest expenditures, $17,500, ($500,000 x 7% x 6/12) would not be recorded unless actually paid.

Choice "c" is incorrect. The City of Walton would not accrue interest expenditures. Nine months of interest expenditures suggested by this answer, $26,250, ($500,000 x 7% x 9/12) would not be recorded.

Choice "d" is incorrect. The City of Walton would not record interest expenditures as they are paid. Recognition of a full year of interest, $35,000, ($500,000 x 7%) would not be appropriate.

**CPA-05190 Type1 M/C A-D Corr Ans: B PM#16 F 8-03**

52. CPA-05190 Released 2006 Page 42

A capital projects fund for a new city courthouse recorded a receivable of $300,000 for a state grant and a $450,000 transfer from the general fund. What amount should be reported as revenue by the capital projects fund?

a. $0
b. $300,000
c. $450,000
d. $750,000

**CPA-05190 Explanation**
Choice "b" is correct. The state grant would be reported as revenue in the capital projects fund, and the transfer from the general fund would not (it would be recorded as an "other financing source" and not as revenue). Thus, revenue is $300,000. The receivable associated with this capital project assumes revenues have been earned by either incurring eligible capital outlay expenditures or by satisfaction of other pertinent grant requirements prior to accruing the receivable.

Choice "a" is incorrect. Per the above explanation, the $300,000 state grant is revenue, so this answer cannot be correct.

Choice "c" is incorrect. The $450,000 transfer from the general fund is not revenue. It is classified as an "other financing source."


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Choice "d" is incorrect. The $450,000 transfer from the general fund is not revenue, so this answer, which combines the $300,000 in revenue with the $400,000 transfer, is incorrect.

**Proprietary Funds**

**CPA-01021 Type1 M/C A-D Corr Ans: A PM#1 F 8-04**

53. CPA-01021ARE R02 #13 Page 54

Chase City uses an internal service fund for its central motor pool. The assets and liabilities account balances for this fund that are not eliminated normally should be reported in the government-wide statement of net assets as:

a. Governmental activities.
b. Business-type activities.
c. Fiduciary activities.
d. Note disclosures only.

**CPA-01021 Explanation**
Choice "a" is correct. For purposes of government-wide financial statements, internal service funds are normally reported in the governmental activities column of the government-wide Statement of Net Assets and the Statement of Activities since they are generally established to service the governmental funds.

Choice "b" is incorrect. Internal services funds would not normally be reported in the business-type activities column of the government-wide financial statements even though they are proprietary funds. Usually the enterprise funds are exclusively reported in the business-type activities column since the internal service funds are established to service the governmental funds.

Choice "c" is incorrect. Fiduciary activities are not reported in the government-wide financial statements. Internal service funds are normally reported as governmental activities.

Choice "d" is incorrect. Exclusion of internal service fund activities from government-wide financial statement except for note disclosures is not appropriate. Internal service funds are reported as governmental activities.

**CPA-01023 Type1 M/C A-D Corr Ans: C PM#2 F 8-04**

54. CPA-01023ARE R02 #16 Page 53

Cedar City issues $1,000,000, 6% revenue bonds were issued at par on April 1, to build a new water line for the water enterprise fund. Interest is payable every six months. What amount of interest expense should be reported for the year ended December 31?

a. $0
b. $30,000
c. $45,000
d. $60,000

**CPA-01023 Explanation**
Choice "c" is correct. Interest expense associated with debt in an enterprise fund is accounted for on the accrual basis. Interest expense is computed as the amount of interest paid plus an accrual of any unpaid amount attributable to the accounting period presented. Interest expense for Cedar City would be computed in any number of ways as follows:

Alternative #1

| | |
|---|---|
| Interest paid (4/1 - 9/30: $1,000,000 × 6% × 6/12) | $30,000 |
| Interest accrued (10/1 - 12/31: $30,000 × 3/6) | 15,000 |
| Total interest expense | $45,000 |

Alternative #2


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| | |
|---|---|
| Annual interest ($1,000,000 × 6%) | $60,000 |
| Fraction of year elapsed (4/1 - 12/31) | × 9/12 |
| Total interest expense | $45,000 |

Choice "a" is incorrect. An enterprise fund would report interest expense on its outstanding debt.

Choice "b" is incorrect. An enterprise fund would report interest expense on the accrual basis, not the cash basis. Amounts incurred rather than amounts paid would be reported consistent with commercial accounting.

Choice "d" is incorrect. An enterprise fund would only record the interest expense incurred during the accounting period reported as its annual interest expense, not the full annual amount associated with obligation.

**CPA-01024 Type1 M/C A-D Corr Ans: C PM#3 F 8-04**

55. CPA-01024 ARE Nov 95 #68 Page 56

Polk County's solid waste landfill operation is accounted for in a governmental fund. Polk used available cash to purchase equipment that is included in the estimated current cost of closure and post-closure care of this operation. How would this purchase affect the asset amount in Polk's governmental capital assets and the liability amount in Polk's government-wide financial statements?

| | *Asset Amount* | *Liability Amount* |
|---|---|---|
| a. | Increase | Decrease |
| b. | Increase | No effect |
| c. | No effect | Decrease |
| d. | No effect | No effect |

**CPA-01024 Explanation**
Choice "c" is correct. Equipment, facilities, and services included in the estimated current cost of closure and postclosure care should not be reported as capital assets but should be reported as a reduction of the accrued liability in the general long-term liabilities displayed in the government-wide financial statements when they are acquired.

Choices "a", "b", and "d" are incorrect per explanation above.

**CPA-01027 Type1 M/C A-D Corr Ans: B PM#4 F 8-04**

56. CPA-01027 ARE Nov 95 #69 Page 72

Financial statements for which fund type generally report net assets in their individual fund financial statements?

a. Capital projects.
b. Enterprise.
c. Special revenue.
d. Permanent fund.

**CPA-01027 Explanation**
Choice "b" is correct. An enterprise fund is a proprietary fund, the focus of which is income determination. Therefore, this fund will report net assets as fund equity.

Choice "a" is incorrect. The capital projects fund has a flow of current financial resources as its focus. Fund equity for this fund does not include net assets, but is reported as fund balance.

Choice "c" is incorrect. The special revenue fund has a flow of current financial resources as its focus. Fund equity for this fund does not include net assets, but is reported as fund balance.


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Choice "d" is incorrect. The permanent fund has a flow of current financial resources as its focus. Fund equity for this fund does not include net assets, but is reported as fund balance.

**CPA-01035 Type1 M/C A-D Corr Ans: C PM#7 F 8-04**

57. CPA-01035 ARE Nov 94 #11 Page 72

For which of the following funds do Interfund transfers affect the results of operations in their fund financial statements?

| | *Governmental Funds* | *Proprietary Funds* |
|---|---|---|
| *a*. | No | No |
| b. | No | Yes |
| c. | Yes | Yes |
| d. | Yes | No |

**CPA-01035 Explanation**
Choice "c" is correct. Interfund transfers are recorded as other financing sources (uses) rather than revenues (expenditures) for governmental funds. They are recorded simply as interfund transfers for proprietary funds. Although these transfers are not recorded as revenues or expenditures, they do affect both funds' expendable resources and, therefore, affect the results of operations for both funds.

**CPA-01038 Type1 M/C A-D Corr Ans: B PM#8 F 8-04**

58. CPA-01038 ARE Nov 94 #21 Page 61

The following transactions were among those reported by Corfe City's electric utility enterprise fund for 1993:

| | |
|---|---|
| Capital contributed by subdividers | $ 900,000 |
| Cash received from customer households | 2,700,000 |
| Proceeds from sale of revenue bonds | 4,500,000 |

In the electric utility enterprise fund's statement of cash flows for the year ended December 31, 1993, what amount should be reported as cash flows from capital and related financing activities?

a. $4,500,000
b. $5,400,000
c. $7,200,000
d. $8,100,000

**CPA-01038 Explanation**
Choice "b" is correct. Enterprise funds are required to present a statement of cash flows similar to that of a for-profit entity. The categories of cash flows are: cash flows from operating activities, cash flows from non-capital financing activities, cash flows from capital and related financing activities, and cash flows from investing activities. Cash flows from capital and related financing activities includes contributions from subdividers and proceeds from sale of revenue bonds ($900,000 + $4,500,000 = $5,400,000). Cash received from customer households would be reported as cash flows from operating activities.

Choices "a", "c", and "d" are incorrect per explanation above.

**CPA-01042 Type1 M/C A-D Corr Ans: C PM#10 F 8-04**

59. CPA-01042 ARE May 94 #52 Page 55

For which of the following governmental entities that use proprietary fund accounting should a statement of cash flows be presented?

| *Public Benefit Corporations* | *Governmental Utilities* |
|---|---|


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

**CPA-01042 Explanation**
Choice "c" is correct. A statement of cash flows must be presented for all proprietary funds as part of a set of financial statements. This requirement would apply to both public benefit corporations and governmental utilities.

Choice "a" is incorrect. All governmental entities that use proprietary fund accounting must present a statement of cash flows.

Choice "b" is incorrect. Public benefit corporations that use proprietary fund accounting should present a statement of cash flows.

Choice "d" is incorrect. Governmental utilities that use proprietary fund accounting should present a statement of cash flows.

**CPA-01045 Type1 M/C A-D Corr Ans: D PM#11 F 8-04**

60. CPA-01045 ARE May 94 #55 Page 72

In fund financial statements for governmental units, depreciation expense on assets acquired with capital grants externally restricted for capital acquisitions should be reported in which type of fund?

| | *Governmental Fund* | *Proprietary Fund* |
|---|---|---|
| a. | Yes | No |
| b. | Yes | Yes |
| c. | No | No |
| d. | No | Yes |

**CPA-01045 Explanation**
Choice "d" is correct. Depreciation expense is not recorded in the governmental funds, but is recorded in the proprietary funds.

**CPA-01047 Type1 M/C A-D Corr Ans: B PM#12 F 8-04**

61. CPA-01047 ARE May 94 #56 Page 56

Shared revenues received by an enterprise fund of a local government for operating purposes should be recorded in fund financial statements as:

a. Operating revenues.
b. Non-operating revenues.
c. Other financing sources.
d. Interfund transfers.

**CPA-01047 Explanation**
Choice "b" is correct. Shared revenues are revenues levied by one government but shared on a predetermined basis with another government. Shared revenues received by a proprietary fund should be recorded as non-operating revenue if received for operations or if received for either operations or capital expenditures at the discretion of the recipient governmental unit.

Choice "a" is incorrect. Shared revenues are revenues levied by one government but shared on a predetermined basis with another government. Shared revenues received by proprietary fund types are not classified as operating revenues.

Choice "c" is incorrect. Other financing sources is not a proper classification of enterprise funds.


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Choice "d" is incorrect. Shared revenues are not classified as interfund transfers.

**CPA-01051 Type1 M/C A-D Corr Ans: A PM#13 F 8-04**

62. CPA-01051 PII Nov 93 #12 Page 72

The following equity balances are among those maintained by Cole City:

| | |
|---|---|
| Enterprise funds | $1,000,000 |
| Internal service funds | 400,000 |

Cole's proprietary equity balances amount to:

a. $1,400,000
b. $1,000,000
c. $400,000
d. $0

**CPA-01051 Explanation**
Choice "a" is correct. Both enterprise funds and internal service funds are considered proprietary funds. Their total equity balances amount to $1,400,000 ($1,000,000 + $400,000).

Choice "b" is incorrect. Internal service funds are also proprietary funds.

Choice "c" is incorrect. Enterprise funds are also proprietary funds.

Choice "d" is incorrect. Both enterprise and internal service funds are proprietary funds.

**CPA-01053 Type1 M/C A-D Corr Ans: D PM#14 F 8-04**

63. CPA-01053 PII Nov 93 #13 Page 51

Through an internal service fund, New County operates a centralized data processing center to provide services to New's other governmental units. In 1992, this internal service fund billed New's parks and recreation fund $150,000 for data processing services. What account should New's internal service fund credit to record this $150,000 billing to the parks and recreation fund?

a. Data processing department expenses.
b. Inter-governmental transfers.
c. Interfund exchanges.
d. Operating revenues control.

**CPA-01053 Explanation**
Choice "d" is correct. The $150,000 billing to the parks and recreation fund would be credited to operating revenues control in the internal revenue service fund. The journal entry would be:

| | | |
|---|---|---|
| Due from other funds | 150,000 | |
| Operating revenues control | | 150,000 |

Choice "a" is incorrect. The $150,000 would not reduce data processing department expenses.

Choice "b" is incorrect. The $150,000 is not an *inter-governmental* transfer, but is an *intra*governmental charge for benefits received by the Park and Recreation unit.

Choice "c" is incorrect. Providing services to other departments or funds is recorded as revenue by the internal service fund. Interfund Exchanges is not an appropriate account title.

**CPA-01054 Type1 M/C A-D Corr Ans: D PM#15 F 8-04**

64. CPA-01054 Th Nov 93 #55 (Adapted) Page 54

Which of the following does **not** affect an internal service fund's change in net assets?

a. Depreciation expense on its fixed assets.


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b. Interfund transfers in.
c. Interfund transfers out.
d. Due from other funds.

**CPA-01054 Explanation**
Choice "d" is correct. Due from other funds appears on the balance sheet. They are not a component of changes in net assets.

Choice "a" is incorrect. The internal service fund is a proprietary fund and recognizes depreciation expense.

Choice "b" is incorrect. Interfund transfers in are additions to gross revenues in the internal service fund. Interfund transfers affect the results of operations.

Choice "c" is incorrect. Interfund transfers out are deductions from gross revenues in the internal service fund. Interfund transfers affect the results of operations.

**CPA-01057 Type1 M/C A-D Corr Ans: A PM#16 F 8-04**

65. CPA-01057 PII May 93 #28 Page 55

The town of Hill operates municipal electric and water utilities. In which of the following funds should the operations of the utilities be accounted for?

a. Enterprise fund.
b. Internal service fund.
c. Agency fund.
d. Special revenue fund.

**CPA-01057 Explanation**
Choice "a" is correct. The enterprise fund accounts for a government's for-profit type of operations, which provide goods or services to the general public. Municipal utilities fit this criteria and are therefore recorded in the enterprise fund.

Choice "b" is incorrect. Internal service funds are proprietary funds, which service internal users, that is, one department servicing another within the governmental entity.

Choice "c" is incorrect. Agency funds account for funds held by the governmental entity in an agent capacity.

Choice "d" is incorrect. Special revenue funds are governmental funds, which account for the proceeds of special revenue sources that are legally restricted to expenditure for specified purposes (such as the fuel tax for highways).

**CPA-01060 Type1 M/C A-D Corr Ans: B PM#17 F 8-04**

66. CPA-01060 PII May 93 #32 Page 51

Bay Creek's municipal motor pool maintains all city-owned vehicles and charges the various departments for the cost of rendering those services. In which of the following funds should Bay account for the cost of such maintenance?

a. General fund.
b. Internal service fund.
c. Special revenue fund.
d. Special assessment fund.

**CPA-01060 Explanation**
Choice "b" is correct. The internal service fund accounts for the providing of goods or services by one department to other departments on a cost-reimbursement basis. Municipal motor pools are a good example of internal service funds.


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Choice "a" is incorrect. The general fund accounts for general government services, but not internal services provided by one department for another department.

Choice "c" is incorrect. Special revenue funds account for specific revenues that have been legally restricted to expenditure for specified purposes.

Choice "d" is incorrect. The special assessment fund is not a separate type of fund.

**CPA-01062 Type1 M/C A-D Corr Ans: A PM#18 F 8-04**

67. CPA-01062 Th May 93 #58 (Adapted) Page 61

Which of the following statements is correct concerning a governmental entity's statement of cash flows?

a. Cash flows from capital financing activities are reported separately from cash flows from non-capital financing activities.
b. The statement format is the same as that of a business enterprise's statement of cash flows.
c. Cash flows from operating activities may use the indirect method.
d. The statement format includes columns for the general, governmental, and proprietary fund types.

**CPA-01062 Explanation**

Choice "a" is correct. Capital financing activities are reported separately from non-capital financing activities in a governmental entity's statement of cash flows. Capital financing activities include acquiring and disposing of capital assets and any related debt. Non-capital financing activities include borrowing money for other than capital expenditures, such as tax anticipation notes.

Choice "b" is incorrect. A governmental entity's combined statement of cash flows is not of the same format as that of a business enterprise. It has four classifications: operating, non-capital financing, capital and related financing, and investing activities.

Choice "c" is incorrect. Cash flows from operating activities must be reported using the direct method. A reconciliation is required if the direct method is used.

Choice "d" is incorrect. The cash flow statement of a governmental entity is prepared for proprietary funds.

**CPA-04663 Type1 M/C A-D Corr Ans: C PM#19 F 8-04**

68. CPA-04663 Released 2005 Page 56

On January 2, Basketville City purchased equipment with a useful life of three years to be used by its water and sewer enterprise fund. Which of the following is the correct treatment for the asset?

a. Record the purchase of the equipment as an expenditure.
b. Capitalize; depreciation is optional.
c. Capitalize; depreciation is required.
d. Capitalize; depreciation is **not** permitted.

**CPA-04663 Explanation**

Choice "c" is correct. Enterprise funds record and depreciate their own fixed assets in a manner consistent with the economic resources measurement focus and accrual accounting.

Choice "a" is incorrect. Enterprise funds record and depreciate their own fixed assets. Enterprise funds are proprietary funds and they apply the economic resources measurement focus and use accrual accounting. To record the purchase of capital equipment as an expenditure would be consistent with the current financial resources measurement focus used by governmental funds and would represent an application of the modified accrual basis of accounting.

Choice "b" is incorrect. Enterprise funds record and depreciate their own fixed assets in a manner consistent with the economic resources measurement focus and accrual accounting. Depreciation is not optional.


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Choice "d" is incorrect. Enterprise funds record and depreciate their own fixed assets in a manner consistent with the economic resources measurement focus and accrual accounting. Depreciation is required.

**CPA-04664 Type1 M/C A-D Corr Ans: B PM#20 F 8-04**

69. CPA-04664 Released 2005 Page 13

Sig City used the following funds for financial reporting purposes:

| | |
|---|---|
| General fund | Capital projects fund |
| Internal service fund | Special revenue fund |
| Airport enterprise fund | Debt service fund |
| Pension trust fund | |

How many of Sig's funds use the accrual basis of accounting?

a. Two.
b. Three.
c. Four.
d. Five.

**CPA-04664 Explanation**

Choice "b" is correct. Three of Sig City's reported funds would use the accrual basis of accounting: the Internal Service Fund, the Airport enterprise fund and the Pension trust fund. We remember the basis of accounting used by each of our funds with the GRaSPPSEPAPI mnemonic an apply it to Sig City as follows:

| Governmental | Proprietary | Fiduciary |
|---|---|---|
| **GR**a**SPP** | **SE** | **PAPI** |
| Modified Accrual | **Accrual** | **Accrual** |
| **G**eneral | Internal **S**ervice | **P**ension trust |
| Special **R**evenue | Airport **e**nterprise | |
| **D**ebt service | | |
| Capital **p**rojects | | |

Funds which complete the mnemonic but are not used by Sig City include:

| | |
|---|---|
| **P**ermanent | **A**gency |
| | **P**rivate purpose |
| | **I**nvestment trust |

Choices "a", "c", and "d" are incorrect per above.

**CPA-05430 Type1 M/C A-D Corr Ans: C PM#21 F 8-04**

70. CPA-05430 Released 2007 Page 52

Which of the following funds of a governmental unit records depreciation?

a. Capital projects fund.
b. Debt service fund.
c. Internal service fund.
d. Special revenue fund.

**CPA-05430 Explanation**

Choice "c" is correct. Internal service funds are proprietary funds that use the economic resources measurement focus that includes capitalization of assets and income determination. They used the accrual basis of accounting and recognize depreciation expense.


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Choice "a" is incorrect. Capital projects funds are governmental funds that use the current financial resources measurement focus that excludes capitalization of assets. They use the modified accrual basis of accounting and do not recognize any expenditure for depreciation.

Choice "b" is incorrect. Debt service funds are governmental funds that use the current financial resources measurement focus that excludes capitalization of assets. They use the modified accrual basis of accounting and do not recognize any expenditure for depreciation.

Choice "d" is incorrect. Special revenue funds are governmental funds that use the current financial resources measurement focus that excludes capitalization of assets. They use the modified accrual basis of accounting and do not recognize any expenditure for depreciation.

**Fiduciary Funds**

**CPA-01070 Type1 M/C A-D Corr Ans: C PM#2 F 8-05**

71. CPA-01070 ARE Nov 95 #70 Page 11

Lys City reports a compensated absences liability in its government-wide financial statements. The salary rate used to calculate the liability should normally be the rate in effect:

a. When the unpaid compensated absences were earned.
b. When the compensated absences are to be paid.
c. At the balance sheet date.
d. When the compensated absences were earned or are to be paid, or at the balance sheet date, whichever results in the lowest amount.

**CPA-01070 Explanation**
Choice "c" is correct. Compensated absence liability should be calculated based upon the pay or salary rates in effect at the balance sheet date.

**CPA-01071 Type1 M/C A-D Corr Ans: D PM#3 F 8-05**

72. CPA-01071 ARE Nov 94 #19 Page 62

Which of the following transactions is an expenditure of a governmental unit's general fund?

a. Contribution of enterprise fund capital by the general fund.
b. Transfer from the general fund to a capital projects fund.
c. Operating subsidy transfer from the general fund to an enterprise fund.
d. Routine employer contributions from the general fund to a pension trust fund.

**CPA-01071 Explanation**
Choice "d" is correct. Since the general fund bears the cost of funding the pension plan, routine employer contributions from the general fund to a pension trust fund are expenditures of the general fund.

Choice "a" is incorrect. Contribution of enterprise fund capital by the general fund is an Interfund transfer in the general fund. Interfund transfers to not give rise to revenues and expenditures.

Choice "b" is incorrect. Interfund transfers do not give rise to revenues and expenditures.

Choice "c" is incorrect. Interfund transfers do not give rise to revenues and expenditures.

**CPA-01073 Type1 M/C A-D Corr Ans: C PM#4 F 8-05**

73. CPA-01073 ARE Nov 94 #23 Page 63

Deferred compensation plans, for other than proprietary fund employees, adopted under IRC Sec. 457 should be reported in a (an):

a. Governmental fund.
b. Agency fund.


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c. Pension (and other employee benefits) trust fund.
d. Account group.

**CPA-01073 Explanation**
Choice "c" is correct. IRC SEC 457, deferred compensation plans for other than proprietary fund employees, should be reported in a pension (and other employee benefit) trust fund.

**CPA-01075 Type1 M/C A-D Corr Ans: A PM#5 F 8-05**

74. CPA-01075 ARE Nov 94 #24 Page 68

In which of the following funds should the debt service transactions of a special assessment issue for which the government is **not** obligated in any manner be reported?

a. Agency fund.
b. Trust fund.
c. Internal service fund.
d. General fund.

**CPA-01075 Explanation**
Choice "a" is correct. When the governmental unit is not obligated in any manner for the special assessment debt, it acts as custodian of the resources related to the special assessment. In this case, an agency fund should be used to report the debt service transactions.

**CPA-01077 Type1 M/C A-D Corr Ans: D PM#6 F 8-05**

75. CPA-01077 ARE May 94 #57 Page 67

Taxes collected and held by Franklin County for a separate school district would be accounted for in which fund?

a. Special revenue.
b. Internal service.
c. Trust.
d. Agency.

**CPA-01077 Explanation**
Choice "d" is correct. Agency funds are used to account for assets (such as taxes collected) held by a governmental unit (such as a county) acting as an agent for another governmental unit (such as a school district).

Choice "a" is incorrect. Special revenue funds account for the proceeds of specific revenue sources that are legally restricted or earmarked to expenditures for specified purposes.

Choice "b" is incorrect. Internal service funds account for the financing of goods or services provided by one department to other departments within the governmental unit on a cost reimbursement basis.

Choice "c" is incorrect. Trust funds account for assets held by a governmental unit in a trustee capacity (as opposed to an agent capacity) for others.

**CPA-01080 Type1 M/C A-D Corr Ans: B PM#7 F 8-05**

76. CPA-01080 PII Nov 93 #8 Page 6

Cal City maintains several major fund types. The following were among Cal's cash receipts during 1993:

| | |
|---|---|
| Unrestricted state grant | $1,000,000 |
| Interest on bank accounts held for employees' pension plan | 200,000 |

What amount of these cash receipts should be accounted for in Cal's general fund?

a. $1,200,000


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b. $1,000,000
c. $200,000
d. $0

**CPA-01080 Explanation**
Choice "b" is correct. The $1,000,000 unrestricted state grant would be accounted for in the general fund, which accounts for all financial resources except those required to be accounted for in another fund. If the state grant had been restricted for specified purposes, it would be accounted for in a special revenue fund. The $200,000 interest on bank accounts held for employees' pension plan would be accounted for in the pension trust fund, not the general fund.

Choice "a" is incorrect. The $200,000 interest on bank accounts held for employees' pension plan would be accounted for in the pension trust fund, not the general fund.

Choice "c" is incorrect. The $200,000 interest on the employees' pension plan would be accounted for in the pension trust fund, not the general fund.

Choice "d" is incorrect. The $1,000,000 unrestricted state grant would be accounted for in the general fund.

**CPA-01085 Type1 M/C A-D Corr Ans: A PM#9 F 8-05**

77. CPA-01085 Th Nov 93 #56 Page 68

The debt service transactions of a special assessment bond issue for which the government is **not** obligated in any manner should be reported in the:

a. Agency fund.
b. Enterprise fund.
c. Special revenue fund.
d. Long-term debt account group.

**CPA-01085 Explanation**
Choice "a" is correct. An agency fund is custodial in nature. Transactions for which the governmental unit has no direct responsibility but simply is acting as an agent for a third party are recorded in the agency fund.

Choice "b" is incorrect. The enterprise fund is a proprietary fund and would not record debt service transactions for a special assessment bond issue.

Choice "c" is incorrect. The special revenue fund is a governmental fund in which no debt or debt service transactions are reported.

Choice "d" is incorrect. The general long-term debt account group accounts for unmatured principal of general (not proprietary or trust) debt.

**CPA-05201 Type1 M/C A-D Corr Ans: D PM#10 F 8-05**

78. CPA-05201 Released 2006 Page 72

Which of the following is a required financial statement for an investment trust fund?

a. Statement of revenues, expenditures, and changes in fiduciary net assets.
b. Statement of activities.
c. Statement of revenues, expenses, and changes in fiduciary net assets.
d. Statement of changes in fiduciary net assets.

**CPA-05201 Explanation**
Choice "d" is correct. For an investment trust fund, the required financial statements are a statement of fiduciary net assets (balance sheet) and a statement of changes in fiduciary net assets (income statement). Of the choices available, the statement of changes in fiduciary net assets is required.


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Choice "a" is incorrect. There is no statement of revenues, expenditures, and changes in fiduciary net assets for an investment trust fund. Investment trust funds use the accrual method and not the modified accrual method; thus, there are no expenditures.

Choice "b" is incorrect. There is no statement of activities for an investment trust fund. The closest is the statement of changes in fiduciary net assets.

Choice "c" is incorrect. There is no statement of revenues, expenses, and changes in fiduciary net assets. The closest is the statement of changes in fiduciary net assets.

**CPA-05428 Type1 M/C A-D Corr Ans: C PM#11 F 8-05**

79. CPA-05428 Released 2007 Page 62

Which of the following transactions is an expenditure of a governmental unit's general fund?

a. Contribution of enterprise fund capital by the general fund.
b. Operating subsidy transfer from the general fund to an enterprise fund.
c. Routine employer contributions from the general fund to a pension trust fund.
d. Transfer from the general fund to a capital projects fund.

**CPA-05428 Explanation**
Choice "c" is correct. Routine employer contributions by the general fund to the pension trust fund would be accounted for as an expenditure in the general fund.

Choice "a" is incorrect. The general fund's contribution of capital to the enterprise fund would be classified as a transfer within other financing uses, not as an expenditure.

Choice "b" is incorrect. The general fund's operating subsidy to an enterprise fund would be classified as a transfer within other financing uses, not an expenditure.

Choice "d" is incorrect. A transfer from the general fund to a capital projects fund (or any other fund) would be classified as a transfer within other financing uses, not an expenditure.

**Supplemental Questions**

**CPA-01089 Type1 M/C A-D Corr Ans: D PM#1 F 8-99**

80. CPA-01089 Nov 95 #62 Page 3

What is the basic criterion used to determine the reporting entity for a governmental unit?

a. Special financing arrangement.
b. Geographic boundaries.
c. Scope of public services.
d. Financial accountability.

**CPA-01089 Explanation**
Choice "d" is correct. Financial accountability.

An accountability perspective provides the basis for defining the financial reporting entity.

Choices "a", "b", and "c" are incorrect. Special financing arrangements, geographic boundaries and scope of public services are not the basic criterion used to determine the reporting entity for a governmental unit.

**CPA-01091 Type1 M/C A-D Corr Ans: D PM#2 F 8-99**

81. CPA-01091 Nov 95 #66 Page 55

Tuston Township issued the following bonds during the year ended June 30, 20X5:

Bonds issued for the garbage collection enterprise fund that will service the debt $700,000


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Revenue bonds to be repaid from admission fees collected by the
Township zoo enterprise fund 500,000

What amount of these bonds should be accounted for in Tuston's government-wide financial statement as a liability resulting from governmental activities?

a. $1,200,000
b. $700,000
c. $500,000
d. $0

**CPA-01091 Explanation**
Choice "d" is correct. $0.

Proprietary funds, such as enterprise funds, carry their own debt. Amounts associated with "enterprise fund" debt is statement of net assets.

Choices "a", "b", and "c" are incorrect, per above.

**CPA-01093 Type1 M/C A-D Corr Ans: A PM#3 F 8-99**

82. CPA-01093 Nov 95 #67 Page 6

Frome City signed a 20-year office property lease for its general staff. Frome could terminate the lease at any time after giving one year's notice, but termination is considered a remote possibility. The lease meets the criteria for a capital lease. What is the effect of the lease on the asset amount in Frome's capital assets and the liability amount in Frome's governmental activities column of the government-wide statement of net assets?

| | *Asset amount* | *Liability amount* |
|---|---|---|
| a. | Increase | Increase |
| b. | Increase | No effect |
| c. | No effect | Increase |
| d. | No effect | No effect |

**CPA-01093 Explanation**
**Rule:** Capital leases are treated as if a purchase of fixed assets with related debt for net present value of lease payments.

Choice "a" is correct. Increase, Increase.

The lease liability for a 20 year office property recorded as a capital lease should be reported in the government-wide statement of net assets as an increase in assets and liabilities in the governmental activities column. Capital assets and noncurrent liabilities are not recorded in the governmental funds.

Choices "b", "c", and "d" are incorrect, per rule above.

**CPA-01103 Type1 M/C A-D Corr Ans: B PM#4 F 8-99**

83. CPA-01103 May 93 T #54 Page 20

When equipment was purchased with general fund resources, which of the following accounts would have been increased in the general fund?

a. Due from general fixed asset account group.
b. Expenditures.
c. Appropriations.
d. No entry should be made in the general fund.

**CPA-01103 Explanation**
Choice "b" is correct. Expenditures are increased in the general fund when equipment is purchased.


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Choice "a" is incorrect. "Due from general fixed asset" account is not a general fund account - a far out distractor.

Choice "c" is incorrect. Appropriations are increased when the budget is recorded, not when equipment is purchased.

Choice "d" is incorrect. Expenditures are increased in the general fund when equipment is purchased and received.

**CPA-01106 Type1 M/C A-D Corr Ans: C PM#5 F 8-99**

84. CPA-01106 Nov 92 T #52 Page 17

The appropriations control account of a governmental unit is debited when:

a. Supplies are purchased.
b. Expenditures are recorded.
c. The budgetary accounts are closed.
d. The budget is recorded.

**CPA-01106 Explanation**
Choice "c" is correct. The appropriations control account of a governmental unit is debited when the budgetary accounts are closed at the end of the year.

Budgetary accounts are posted only twice: at the beginning of the year and at the end of the year. The original budget entry is reversed with a debit to appropriations control, a credit to estimated revenues control, and the revenues control, and the difference goes to budgetary fund balance.

Choice "a" is incorrect. Purchase of supplies impacts inventory and vouchers payable.

Choice "b" is incorrect. Recording expenditures impacts real accounts, not budgetary accounts.

Choice "d" is incorrect. Estimated revenues are debited and appropriations control is credited when the budget is recorded at the beginning of the year.

**CPA-01111 Type1 M/C A-D Corr Ans: D PM#6 F 8-99**

85. CPA-01111 Nov 92 T #53 Page 24

The budgetary fund balance reserved for encumbrances account of a governmental-type fund is increased when:

a. The budget is recorded.
b. Appropriations are recorded.
c. Supplies previously ordered are received.
d. A purchase order is approved.

**CPA-01111 Explanation**
Choice "d" is correct. When a "purchase order is approved" the account "budgetary fund balance reserved for encumbrances" of a governmental fund type is increased.

Choices "a" and "b" are incorrect. When appropriations are recorded, or the budget is recorded, the account "budgetary fund balance" is affected.

Choice "c" is incorrect. The receipt of supplies previously ordered will decrease the account "budgetary fund balance reserved for encumbrances."

**CPA-01112 Type1 M/C A-D Corr Ans: D PM#7 F 8-99**

86. CPA-01112 Nov 92 T #55 Page 45

In what fund type should the proceeds from special assessment bonds issued to finance construction of sidewalks in a new subdivision be reported?


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a. Agency fund.
b. Special revenue fund.
c. Enterprise fund.
d. Capital projects fund.

**CPA-01112 Explanation**
Choice "d" is correct. Capital projects fund.

Accounting for special assessments for capital improvements is similar to contractors accounting and is part of capital projects fund or enterprise fund, whichever is appropriate.

General governmental infrastructure financing and expenditure, such as sidewalks, is appropriately classified in a capital projects fund.

Choice "c" is incorrect. Sidewalks in a new subdivision represent infrastructure for general governmental purposes.

Choices "a" and "b" are incorrect, per above.

**CPA-01115 Type1 M/C A-D Corr Ans: C PM#8 F 8-99**

87. CPA-01115 Nov 92 T #58 Page 66

River City has a defined contribution pension plan. How should River report the pension plan in its financial statements?

a. Amortize any transition asset over the estimated number of years of current employees' service.
b. Disclose in the notes to the financial statements the amount of the pension benefit obligation and the net assets available for benefits.
c. Identify in the notes to financial statements the types of employees covered and the employer's and employees' obligations to contribute to the fund.
d. Accrue a liability for benefits earned but not paid to fund participants.

**CPA-01115 Explanation**
**Rule:** Employees should disclose employer and employee obligations to contribute to the plan, a brief statement about the plan, and employee eligibility requirements.

Choice "c" is correct. A governmental defined contribution pension plan should identify in the notes to financial statements the types of employees covered and the employer's and employees' obligations to contribute to the fund.

Choice "a" is incorrect. Far out distractor.

Choice "b" is incorrect. Disclosure of pension benefit obligation and net assets available for benefits pertain to defined benefit plans.

Choice "d" is incorrect. No liability is recorded for benefits earned but not paid to fund participants.

**CPA-01118 Type1 M/C A-D Corr Ans: A PM#9 F 8-99**

88. CPA-01118 Nov 92 T #59 Page 72

Eureka City should issue a statement of cash flows for which of the following funds?

| | *Eureka City Hall* *capital projects fund* | *Eureka Water* *enterprise fund* |
|---|---|---|
| a. | No | Yes |
| b. | No | No |
| c. | Yes | No |
| d. | Yes | Yes |

**CPA-01118 Explanation**


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Choice "a" is correct. No - capital projects fund, Yes - enterprise fund.

A statement of cash flows should be issued for all proprietary funds (enterprise and internal service funds).

Choices "b", "c", and "d" are incorrect. No statement of cash flow is required for governmental fund types such as the "capital projects funds."

**CPA-01119 Type1 M/C A-D Corr Ans: B PM#10 F 8-99**

89. CPA-01119 May 92 T #57 Page 18

Under the modified accrual basis of accounting for a governmental unit, revenues that are measurable should be recognized in the accounting period in which they are:

a. Earned.
b. Available.
c. Budgeted.
d. Collected.

**CPA-01119 Explanation**
Choice "b" is correct. Available.

Under the modified accrual basis of accounting for a governmental unit, revenues should be recognized in the accounting period in which they are measurable and available.

**CPA-01124 Type1 M/C A-D Corr Ans: D PM#11 F 8-99**

90. CPA-01124 May 92 T #58 Page 18

Property taxes levied in fiscal year 20X1 to finance the general fund budget of fiscal year 20X2 should be reported as general fund revenues in fiscal year 20X2:

a. Regardless of the fiscal year in which collected.
b. For the amount collected in fiscal year 20X2 only.
c. For the amount collected before the end of fiscal year 20X2 only.
d. For the amount collected before the end of fiscal year 20X2 or shortly thereafter.

**CPA-01124 Explanation**
Choice "d" is correct. Property taxes levied in fiscal year 20X1 to finance the general fund budget of fiscal year 20X2 should be reported as general fund revenues in fiscal year 20X2 for the amount collected before the end of fiscal year 20X2 or shortly thereafter. The treatment is similar to commercial accounting, but does not record bad debts as revenues, in spite of the fact that potential "property tax bad debts" are more assured of eventual collection because the property is subject to sheriff sales for collection.

**CPA-01127 Type1 M/C A-D Corr Ans: B PM#12 F 8-99**

91. CPA-01127 May 92 II #21 Page 19

Pine City's year end is June 30. Pine levies property taxes in January of each year for the calendar year. One-half of the levy is due in May and one-half is due in October. Property tax revenue is budgeted for the period in which payment is due. The following information pertains to Pine's property taxes for the period from July 1, 20X0, to June 30, 20X1:

| | *Calendar year* | |
|---|---|---|
| | *20X0* | *20X1* |
| Levy | $2,000,000 | $2,400,000 |
| Collected in: | | |
| May | 950,000 | 1,100,000 |


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| | | |
|---|---|---|
| July | 50,000 | 60,000 |
| October | 920,000 | |
| December | 80,000 | |

The $40,000 balance due for the May 20X1 installments was expected to be collected in August 20X1. What amount should Pine recognize for property tax revenue for the year ended June 30, 20X1?

a. $2,160,000
b. $2,200,000
c. $2,360,000
d. $2,400,000

**CPA-01127 Explanation**
Choice "b" is correct. $2,200,000 property tax revenue recognized for fiscal year 6-30-x1

| Calendar yr | Levy | | Payments due in fiscal yr 6-30-X1 | **B** |
|---|---|---|---|---|
| 20X0 | $2,000,000 | × 50% = | 1,000,000 | |
| 20X1 | $2,400,000 | × 50% = | 1,200,000 | |
| | | | 2,200,000 | |

In accordance with the modified accrual basis of accounting, Pine City should recognize $2,200,000 of property tax revenue for the year ended June 30, 20X1. May installments will be collected within 60 days and are therefore deemed to be available and eligible for recognition.

**CPA-01135 Type1 M/C A-D Corr Ans: A PM#13 F 8-99**

92. CPA-01135 May 92 II #24 Page 17

Park City uses encumbrance accounting and formally integrates its budget into the general fund's accounting records. For the year ending July 31, 20X2, the following budget was adopted:

| | |
|---|---|
| Estimated revenues | $30,000,000 |
| Appropriations | 27,000,000 |
| Estimated transfer to debt service fund | 900,000 |

Park should record budgeted appropriations by a:

a. Credit to appropriations control, $27,000,000.
b. Debit to estimated expenditures, $27,000,000.
c. Credit to appropriations control, $27,900,000.
d. Debit to estimated expenditures, $27,900,000.

**CPA-01135 Explanation**
Choice "a" is correct. Park should record budgeted appropriations by a credit to appropriations control of $27,000,000.

| | DR | CR |
|---|---|---|
| Estimated revenues | $30,000,000 | |
| Appropriations control | | 27,000,000 |
| Estimated transfer to debt service fund | | 900,000 |
| Budgetary fund balance | | 2,100,000 |

**CPA-01137 Type1 M/C A-D Corr Ans: C PM#14 F 8-99**

93. CPA-01137 May 92 II #25 Page 20

Park City uses encumbrance accounting and formally integrates its budget into the general fund's accounting records. For the year ending July 31, 20X2, the following budget was adopted:

| | |
|---|---|
| Estimated revenues | $30,000,000 |


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| | |
|---|---|
| Appropriations | 27,000,000 |
| Estimated transfer to debt service fund | 900,000 |

Park incurred salaries and wages of $800,000 for the month of April 20X2. What account should Park debit to record this $800,000?

a. Encumbrances control.
b. Salaries and wages expense control.
c. Expenditures control.
d. Operating funds control.

**CPA-01137 Explanation**
Choice "c" is correct. Expenditures control.

Salaries and wages incurred by Park City general fund should be recorded as a debit to expenditures control.

| | DR | CR |
|---|---|---|
| Expenditures control | 800,000 | |
| Vouchers payable | | 800,000 |

**CPA-01139 Type1 M/C A-D Corr Ans: B PM#15 F 8-99**

94. CPA-01139 May 92 II #27 Page 32

Lake County received the following proceeds that are legally restricted to expenditure for specified purposes:

| | |
|---|---|
| Levies on affected property owners to install sidewalks | $500,000 |
| Gasoline taxes to finance road repairs | 900,000 |

What amount should be accounted for in Lake's special revenue funds?

a. $1,400,000
b. $900,000
c. $500,000
d. $0

**CPA-01139 Explanation**
Choice "b" is correct. $900,000.

The amount to be accounted for in the special revenue fund would include only gasoline taxes to finance road repairs.

The levies (special assessments) on affected property owners to install sidewalks would be accounted for in the capital projects fund.

**CPA-01140 Type1 M/C A-D Corr Ans: C PM#16 F 8-99**

95. CPA-01140 May 92 II #29 Page 72

At December 31, 20X1, the following balances were due from the state government to Clare City's various funds:

| | |
|---|---|
| Capital projects | $300,000 |
| Trust and agency | 100,000 |
| Enterprise | 80,000 |

In Clare's December 31, 20X1, financial statements, what amount should be reported in governmental funds?

a. $100,000
b. $180,000


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c. $300,000
d. $480,000

**CPA-01140 Explanation**
Choice "c" is correct. $300,000.

The amount to be reported in governmental funds (GRASPP) would include only the $300,000 related to capital projects fund (the "P" in GRASPP).

Choice "a" is incorrect. The $100,000 amount related to trust and agency would be reported in fiduciary funds (PAPI).

Choice "b" is incorrect. The $80,000 due to the enterprise fund would be reported in proprietary funds (SE).

Choice "d" is incorrect. Each of the three amounts totaling $480,000 would be reported in a different type of fund.

**CPA-01142 Type1 M/C A-D Corr Ans: C PM#17 F 8-99**

96. CPA-01142 May 92 II #30 Page 61

The following transactions were among those reported by Cliff County's water and sewer enterprise fund for 20X1:

| | |
|---|---|
| Proceeds from sale of revenue bonds | $5,000,000 |
| Cash received from customer households | 3,000,000 |
| Capital contributed by subdividers | 1,000,000 |

In the water and sewer enterprise fund's statement of cash flows for the year ended December 31, 20X1, what amount should be reported as cash flows from capital and related financing activities?

a. $9,000,000
b. $8,000,000
c. $6,000,000
d. $5,000,000

**CPA-01142 Explanation**
Choice "c" is correct. $6,000,000.

The amount to be reported as "cash flows from capital and related financing activities" would include:

| | |
|---|---|
| Proceeds from sale of revenue bonds of | $5,000,000 |
| Capital contributed by subdividers of | $1,000,000 |
| Total | $6,000,000 |

The $3,000,000 of cash received from customer households would be included under "operating activities."

**CPA-01143 Type1 M/C A-D Corr Ans: B PM#18 F 8-99**

97. CPA-01143 May 92 II #31 Page 53

Gem City's internal service fund received $50,000 cash from the general fund to capitalize this fund. This $50,000 should be reported in Gem's internal service fund as a credit to:

a. Revenues.
b. Transfers.
c. Accounts payable.
d. Contributed capital.

**CPA-01143 Explanation**


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Choice "b" is correct. The $50,000 non-reciprocal transfer would be reported in the internal service fund as a credit to "transfers."

**CPA-01147 Type1 M/C A-D Corr Ans: D PM#19 F 8-99**

98. CPA-01147 May 92 II #36 Page 36

Dale City is accumulating financial resources that are legally restricted to payments of general long-term debt principal and interest maturing in future years. At December 31, 20X1, $5,000,000 has been accumulated for principal payments and $300,000 has been accumulated for interest payments. These restricted funds should be accounted for in the:

| | *Debt service fund* | *General fund* |
|---|---|---|
| a. | $0 | $5,300,000 |
| b. | $300,000 | $5,000,000 |
| c. | $5,000,000 | $300,000 |
| d. | $5,300,000 | $0 |

**CPA-01147 Explanation**
Choice "d" is correct. $5,300,000.

The restricted funds of $5,000,000 accumulated for principal payments and $300,000 accumulated for interest payments should both be accounted for in the debt service fund.

**CPA-01149 Type1 M/C A-D Corr Ans: A PM#20 F 8-99**

99. CPA-01149 Nov 91 T #52 Page 16

If a city legally adopts its annual general fund budget on the modified accrual basis of accounting, its estimated revenues should be:

a. Reported on the modified accrual basis of accounting in the general fund budgetary comparison schedule.
b. Converted to the cash basis of accounting and reported in the general fund budgetary comparison schedule.
c. Reported as current assets in the general fund balance sheet.
d. Reported as noncurrent assets in the general fund balance sheet.

**CPA-01149 Explanation**
Choice "a" is correct. If a city legally adopts its annual general fund budget on the modified accrual basis of accounting, its estimated revenues should be reported on the modified accrual basis of accounting in the general fund budgetary comparison schedule. Although the budgetary comparison schedule should appear in the required supplementary information, it may appear in the basic financial statements at the election of the government.

Choices "b", "c", and "d" are incorrect, per above.

**CPA-01152 Type1 M/C A-D Corr Ans: B PM#21 F 8-99**

100. CPA-01152 Nov 91 T #53 Page 25

Gold County received goods that had been approved for purchase but for which payment had **not** yet been made. Should the accounts listed below be increased?

| | *Encumbrances* | *Expenditures* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | No |
| d. | Yes | Yes |


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**CPA-01152 Explanation**
Choice "b" is correct. No - Yes.

When goods are received that had been approved for purchase, the:

Encumbrances account should be decreased (not increased), and the

Expenditures account should be increased (not decreased)

Receipt of goods prior to payment results in an accrual of the expenditure.

**CPA-01154 Type1 M/C A-D Corr Ans: D PM#22 F 8-99**

101. CPA-01154 Nov 91 T #54 Page 72

In which of the following fund types of a city government are revenues and expenditures recognized on the same basis of accounting as the general fund?

a. Fiduciary funds.
b. Internal service.
c. Enterprise.
d. Debt service.

**CPA-01154 Explanation**
Choice "d" is correct. Revenues and expenditures are recognized on the same basis of accounting in the general fund and in the debt service fund. Both of these funds use the modified accrual basis of accounting.

Choices "a", "b", and "c" are incorrect. Fiduciary funds, internal service fund, and the enterprise fund are each required to use the full accrual basis of accounting.

**CPA-01156 Type1 M/C A-D Corr Ans: D PM#23 F 8-99**

102. CPA-01156 Nov 91 T #55 Page 55

An enterprise fund would be used when the governing body requires that:

I. Accounting for the financing of an agency's services to other government departments be on a cost-reimbursement basis.
II. User charges cover the costs of general public services.
III. Net income information be provided for an activity.

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

**CPA-01156 Explanation**
Choice "d" is correct. II and III.

An enterprise fund would be used when:

II. User charges cover the costs of general public services, and
III. Net income information can be provided for an activity.

Not I. Accounting for the financing of an agency's services to other government departments on a cost-reimbursement basis should be accounted for in an internal service fund.

**CPA-01157 Type1 M/C A-D Corr Ans: A PM#24 F 8-99**

103. CPA-01157 May 91 T #51 Page 5


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The primary authoritative body for determining the measurement focus and basis of accounting standards for governmental fund operating statements is the:

a. Governmental Accounting Standards Board (GASB).
b. National Council on Governmental Accounting (NCGA).
c. Government Accounting and Auditing Committee of the AICPA (GAAC).
d. Financial Accounting Standards Board (FASB).

**CPA-01157 Explanation**
Choice "a" is correct. The primary authoritative body for determining the measurement focus and basis of accounting standards for governmental fund operating statements is the governmental accounting standards board (GASB).

Choice "b" is incorrect. The national council on governmental accounting (NCGA) established accounting and financial reporting standards for state and local governments prior to the formation of the governmental accounting standards board.

Choice "c" is incorrect. The governmental accounting and auditing committee of the AICPA (GAAC) disseminates information relating to governmental accounting and auditing matters.

Choice "d" is incorrect. The financial accounting standards board (FASB) exists to establish and improve standards of financial accounting and reporting for the guidance and education of the public which includes issuers, auditors, and users of financial information.

**CPA-01161 Type1 M/C A-D Corr Ans: C PM#25 F 8-99**

104. CPA-01161 May 91 T #53 Page 25

Which of the following amounts are included in a general fund's encumbrance account?

I. Outstanding vouchers payable amounts.
II. Outstanding purchase order amounts.
III. Excess of the amount of a purchase order over the actual expenditure for that order.

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

**CPA-01161 Explanation**
Choice "c" is correct. The amounts in a general fund's encumbrance account include only outstanding purchase order amounts.

Not "I." Outstanding vouchers payable amounts represent actual incurred obligations which are included in "vouchers payable" or "accounts payable."

Not "III." Once an "actual expenditure for that order" has taken place (which means the goods or services have been received), the encumbrance is reversed and the actual expenditure is recorded as vouchers or accounts payable.

**CPA-01163 Type1 M/C A-D Corr Ans: C PM#26 F 8-99**

105. CPA-01163 May 91 T #54 Page 49

Tott City's serial bonds are serviced through a debt service fund with cash provided by the general fund. In a debt service fund's statements, how are cash receipts and cash payments reported?

| | *Cash receipts* | *Cash payments* |
|---|---|---|
| a. | Revenues | Expenditures |
| b. | Revenues | Transfers |
| c. | Transfers | Expenditures |
| d. | Transfers | Transfers |


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**CPA-01163 Explanation**
Choice "c" is correct. When serial bonds are serviced through a debt service fund with cash provided by the general fund, the debt service fund should report cash receipts as "Transfers" (other financing sources) and cash payments as "operating expenditures."

Choices "a", "b", and "d" are incorrect, as per above.

**CPA-01165 Type1 M/C A-D Corr Ans: A PM#27 F 8-99**

106. CPA-01165 Nov 90 T #51 Page 9

Which of the following bases of accounting should a government use for its proprietary funds in measuring financial position and operating results?

| | *Modified accrual basis* | *Accrual basis* |
|---|---|---|
| a. | No | Yes |
| b. | No | No |
| c. | Yes | Yes |
| d. | Yes | No |

**CPA-01165 Explanation**
Choice "a" is correct. No - modified accrual basis. Yes - accrual basis. Proprietary funds (SE) are required to use the accrual basis of accounting - **not** the modified accrual basis which is used by the governmental funds (GRASPP).

**CPA-01166 Type1 M/C A-D Corr Ans: A PM#28 F 8-99**

107. CPA-01166 Nov 90 T #52 Page 20

Which of the following fund types used by a government most likely would have a Fund Balance Reserved for Inventory of Supplies?

a. General.
b. Internal Service.
c. Private Purpose.
d. Capital projects.

**CPA-01166 Explanation**
Choice "a" is correct. The general fund is most likely to have a fund balance reserved for inventory of supplies. General fund will normally have supplies on hand at the end of the period.

Choice "b" is incorrect. The internal service fund is required to follow commercial accounting which does not require the use of a "Fund Balance Reserved for Inventory of Supplies."

Choice "c" is incorrect. Private purpose funds use accrual accounting and would not use fund balance accounts.

Choice "d" is incorrect. Capital projects funds normally charge supplies acquired capital outlay expenditures associated within the construction in progress account.

**CPA-01168 Type1 M/C A-D Corr Ans: A PM#29 F 8-99**

108. CPA-01168 Nov 90 T #54 Page 36

On March 2, 20X0, Finch City issued 10-year general obligation bonds at face amount, with interest payable March 1 and September 1. The proceeds were to be used to finance the construction of a civic center over the period April 1, 20X0, to March 31, 20X1. During the fiscal year ended June 30, 20X0, no resources had been provided to the debt service fund for the payment of principal and interest.


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On June 30, 20X0, Finch's debt service fund should include interest payable on the general obligation bonds for:

a. 0 months.
b. 3 months.
c. 4 months.
d. 6 months.

**CPA-01168 Explanation**
Choice "a" is correct. 0 months. The debt service fund which uses the modified accrual basis of accounting will accrue interest only when it is legally due, not at interim dates. The next (first) interest due date is due September 1, 20X0. This question asks for interest payable displayed in fund financial statements on June 30, 20X0.

**CPA-01169 Type1 M/C A-D Corr Ans: B PM#30 F 8-99**

109. CPA-01169 Nov 90 T #55 Page 41

On March 2, 20X0, Finch City issued 10-year general obligation bonds at face amount, with interest payable March 1 and September 1. The proceeds were to be used to finance the construction of a civic center over the period April 1, 20X0, to March 31, 20X1. During the fiscal year ended June 30, 20X0, no resources had been provided to the debt service fund for the payment of principal and interest.

Proceeds from the general obligation bonds should be recorded in the:

a. General fund.
b. Capital projects fund.
c. General long-term debt account group.
d. Debt service fund.

**CPA-01169 Explanation**
Choice "b" is correct. Capital projects fund.

Proceeds from general obligation bonds which are to be used to finance the construction of a civil center should be recorded in the capital projects fund as "other financing sources-bond issue proceeds."

Choice "a" is incorrect. General fund is not affected by the proceeds from the sale of general obligation bonds used for capital projects.

Choice "c" is incorrect. General long-term debt account group is no longer used. Liabilities associated with governmental activities should be displayed in the governmental activities column of the statement of net assets as a noncurrent liability.

Choice "d" is incorrect. The debt service fund will not be affected until the interest and principal payments are due.

**CPA-01174 Type1 M/C A-D Corr Ans: D PM#31 F 8-99**

110. CPA-01174 Nov 90 T #57 Page 46

On March 2, 20X0, Finch City issued 10-year general obligation bonds at face amount, with interest payable March 1 and September 1. The proceeds were to be used to finance the construction of a civic center over the period April 1, 20X0, to March 31, 20X1. During the fiscal year ended June 30, 20X0, no resources had been provided to the debt service fund for the payment of principal and interest.

On June 30, 20X0, Finch's financial statements should report the construction in progress for the civic center in the:

| | *Capital projects fund* | *Government-wide financial statements* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |


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c. No No
d. No Yes

**CPA-01174 Explanation**
Choice "d" is correct. No, Yes.

At the end of the fiscal year on June 30, 20X0. Finch's government-wide state of net assets should report the construction in progress for the civic center in the governmental activities column. It would not be in the capital projects fund, since each year's capital project activities are closed out at year end. (Prior to year end, construction in process expenditures of the current year would be reported in the capital projects fund.)

**CPA-01175 Type1 M/C A-D Corr Ans: D PM#32 F 8-99**

111. CPA-01175 Nov 90 T #58 Page 55

Which of the following fund types should account for fixed assets in a manner similar to a "for profit" organization?

a. Special revenue fund.
b. Capital projects fund.
c. General fixed assets account group.
d. Enterprise fund.

**CPA-01175 Explanation**
Choice "d" is correct. Enterprise fund should account for fixed assets in a manner similar to a "for profit" organization. Its accounting is similar to accrual basis commercial accounting.

Choice "a" is incorrect. Special revenue fund is used to account for revenues and specific taxes to finance particular activities of government.

Choice "b" is incorrect. Capital projects fund is used to account for the acquisition or construction of major capital assets other than those financed by an enterprise fund.

Choice "c" is incorrect. General fixed assets account group is no longer used.

**CPA-01176 Type1 M/C A-D Corr Ans: A PM#33 F 8-99**

112. CPA-01176 Nov 90 II #41 Page 6

Maple Township issued the following bonds during the year ended June 30, 20X0:

| | |
|---|---|
| Bonds issued for the garbage collection enterprise fund that will service the debt. | $500,000 |
| Revenue bonds to be repaid from admission fees collected by the Township zoo enterprise fund. | 350,000 |

What amount of these bonds should be accounted for in Maple's noncurrent liabilities in the governmental activities column of the government-wide statement of net assets?

a. $0
b. $350,000
c. $500,000
d. $850,000

**CPA-01176 Explanation**
Choice "a" is correct. $0.

None of these bonds should be accounted for in the governmental activities column of the government-wide statement of net assets. Both of the bond issues are related to enterprise funds which are required to service their own debt from revenues they earn. Bonds will both be accounted for in the individual funds and in the government-wide financial statements in the business-type activity column.


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Choices "b", "c", and "d" are incorrect. No amount relative to these transactions would be reported in the context of governmental activities.

**CPA-01177 Type1 M/C A-D Corr Ans: D PM#34 F 8-99**

113. CPA-01177 Nov 90 II #43 Page 55

During 20X0, Spruce City reported the following receipts from self-sustaining activities paid for by users of the services rendered:

| | |
|---|---|
| Operation of water supply plant | $5,000,000 |
| Operation of bus system | 900,000 |

What amount should be accounted for in Spruce's enterprise funds?

a. $0
b. $900,000
c. $5,000,000
d. $5,900,000

**CPA-01177 Explanation**
Choice "d" is correct. $5,900,000.

Because both activities are described as "self-sustaining activities" paid for by users of the services rendered, spruce's enterprise funds should account for receipts from both the bus system and the operation of its water supply plant.

**CPA-01178 Type1 M/C A-D Corr Ans: C PM#35 F 8-99**

114. CPA-01178 Nov 90 II #47 Page 41

Kew City received a $15,000,000 federal grant to finance the construction of a center for rehabilitation of drug addicts. The proceeds of this grant should be accounted for in the:

a. Special revenue funds.
b. General fund.
c. Capital projects funds.
d. Fiduciary funds.

**CPA-01178 Explanation**
Choice "c" is correct. Capital projects funds.

The proceeds of a grant to finance the construction of a center for rehabilitation of drug addicts should be accounted for in the capital projects funds as "revenues."

Choice "a" is incorrect. Special revenue fund is used to account for revenues from specific taxes to finance particular activities of government.

Choice "b" is incorrect. General fund is set up to account for the ordinary operations of a governmental unit.

Choice "d" is incorrect. Fiduciary funds are set up to account for monies donated for specified purposes.

**CPA-01179 Type1 M/C A-D Corr Ans: A PM#36 F 8-99**

115. CPA-01179 Nov 90 II #48 Page 49

Lisa County issued $5,000,000 of general obligation bonds at 101 to finance a capital project. The $50,000 premium was to be used for payment of principal and interest. This transaction should be accounted for in the:

a. Capital projects funds, debt service funds and as noncurrent assets and liabilities in the government-wide financial statements.


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b. Capital projects funds and debt service funds only.
c. Debt service funds and the general long-term debt account group only.
d. Debt service funds only.

**CPA-01179 Explanation**
Choice "a" is correct. The transaction should be accounted for in the:

- Capital projects funds for the proceeds net of premium;
- Debt service funds for the premium; and
- Governmental activities column of the government-wide statement of net assets as noncurrent assets and noncurrent liabilities.

Choice "b" is incorrect. Fund accounting ignores government-wide reporting.

Choice "c" is incorrect. Account groups are no longer used.

Choice "d" is incorrect. Debt proceeds would be recorded in the capital project funds and the resulting debt would appear in the government-wide financial statements.

**CPA-01180 Type1 M/C A-D Corr Ans: B PM#37 F 8-99**

116. CPA-01180 Nov 90 II #49 Page 67

In 20X0, a state government collected income taxes of $8,000,000 for the benefit of one of its cities that imposes an income tax on its residents. The state remitted these collections periodically to the city. The state should account for the $8,000,000 in the:

a. General fund.
b. Agency funds.
c. Internal service funds.
d. Special assessment funds.

**CPA-01180 Explanation**
Choice "b" is correct. Agency funds.

The $8,000,000 collected by a state for the benefit of one of its cities that imposes an income tax on its residents should be accounted for by the state in an agency fund.

The initial recording in the agency fund should be:

| | DR | CR |
|---|---|---|
| Cash | $8,000,000 | |
| Due to other funds - city of X | | $8,000,000 |
| Due to states general fund (if state charged fee for the service) | | |

**CPA-01181 Type1 M/C A-D Corr Ans: A PM#38 F 8-99**

117. CPA-01181 Nov 90 II #50 Page 17

Harbor City's appropriations control account at December 31, 20X1 had a balance of $7,000,000. When the budgetary accounts were closed at year-end, this $7,000,000 appropriations control balance should have:

a. Been debited.
b. Been credited.
c. Remained open.
d. Appeared as a contra account.

**CPA-01181 Explanation**
Choice "a" is correct. Debited.


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When closing the budgetary accounts at year-end, the "appropriations control account" should have been debited $7,000,000 to offset the $7,000,000 credit balance that existed before closing.

| | DR | CR |
|---|---|---|
| Appropriations control | $7,000,000 | |
| Estimated revenues | | $7,000,000 |

**CPA-01182 Type1 M/C A-D Corr Ans: D PM#39 F 8-99**

118. CPA-01182 Nov 90 II #51 Page 18

The following revenues were among those reported by Ariba Township in 20X0:

| | |
|---|---|
| Net rental revenue (after depreciation) from a parking garage owned by Ariba | $ 40,000 |
| Interest earned on investments held for employees' retirement benefits | 100,000 |
| Property taxes | 6,000,000 |

What amount of the foregoing revenues should be accounted for in Ariba's governmental-type funds?

a. $6,140,000
b. $6,100,000
c. $6,040,000
d. $6,000,000

**CPA-01182 Explanation**
Choice "d" is correct. $6,000,000.

The amount of the foregoing revenues that should be accounted for in Ariba's governmental type funds is $6,000,000 for property taxes, which goes into the general fund.

Choices "a", "b", and "c" are incorrect. Net rental revenue (after depreciation) from a parking garage is accounted for in an enterprise fund, which is a "proprietary fund", while interest earned on investments held for employees' retirement benefits should be accounted for in a pension trust fund.

**CPA-01183 Type1 M/C A-D Corr Ans: A PM#40 F 8-99**

119. CPA-01183 Nov 90 II #53 Page 32

The following financial resources were among those received by Seco City during 20X0:

| | |
|---|---|
| For acquisition of major capital facilities | $6,000,000 |
| To create a private purpose trust | 2,000,000 |

With respect to the foregoing resources, what amount should be recorded in special revenue funds?

a. $0
b. $2,000,000
c. $6,000,000
d. $8,000,000

**CPA-01183 Explanation**
Choice "a" is correct. $0.

With respect to the foregoing resources, the amount recorded in the special revenue funds should be $0.

The $6,000,000 for acquisition of major capital facilities should be recorded to the capital projects fund.

The $2,000,000 to create an expendable trust should be recorded in the private purpose trust fund.

**CPA-01184 Type1 M/C A-D Corr Ans: D PM#41 F 8-99**


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120. CPA-01184 Nov 90 II #57 Page 17

When Rolan County adopted its budget for the year ending June 30, 20X0, $20,000,000 was recorded for estimated revenues control. Actual revenues for the year ended June 30, 20X0 amounted to $17,000,000. In closing the budgetary accounts at June 30, 20X0:

a. Revenues control should be debited for $3,000,000.
b. Estimated revenues control should be debited for $3,000,000.
c. Revenues control should be credited for $20,000,000.
d. Estimated revenues control should be credited for $20,000,000.

**CPA-01184 Explanation**
Choice "d" is correct. In closing the budgetary accounts at June 30, 20X0, the estimated revenues control account should be credited for $20,000,000 to offset the $20,000,000 debit balance that existed before closing.

| | DR | CR |
|---|---|---|
| Appropriations control | $20,000,000 | |
| Estimated revenues control | | $20,000,000 |

**CPA-01185 Type1 M/C A-D Corr Ans: A PM#42 F 8-99**

121. CPA-01185 May 90 T #51 Page 51

Todd City formally integrates budgetary accounts into its general fund. Todd uses an internal service fund to account for the operations of its data processing center, which provides services to Todd's other governmental units. During the year ended December 31, 20X0, Todd received a state grant to buy a bus, and an additional grant for bus operation in 20X0. In 20X0, only 90% of the capital grant was used for the bus purchase, but 100% of the operating grant was disbursed. Todd has incurred the following long-term obligations:

- General obligation bonds issued for the water and sewer fund which will service the debt.
- Revenue bonds to be repaid from admission fees collected from users of the municipal recreation center.

These bonds are expected to be paid from enterprise funds, and secured by Todd's full faith, credit, and taxing power as further assurance that the obligations will be paid.

Todd's 20X0 expenditures from the general fund include payments for structural alterations to a firehouse and furniture for the mayor's office.

To record the billing for data processing services provided to Todd's other governmental units, the internal service fund should credit:

a. Operating revenues.
b. Data processing departmental expenses.
c. Intergovernmental transfers.
d. Interfund exchanges.

**CPA-01185 Explanation**
Choice "a" is correct. To record the billing for data processing services provided to other governmental units, the internal service fund should credit operating revenues, just like commercial accounting.

**CPA-01186 Type1 M/C A-D Corr Ans: D PM#43 F 8-99**

122. CPA-01186 May 90 T #52 Page 42

Todd City formally integrates budgetary accounts into its general fund. Todd uses an internal service fund to account for the operations of its data processing center, which provides services to Todd's other governmental units. During the year ended December 31, 20X0, Todd received a state grant to buy a bus, and an additional grant for bus operation in 20X0. In 20X0, only 90% of the capital grant was used


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for the bus purchase, but 100% of the operating grant was disbursed. Todd has incurred the following long-term obligations:

- General obligation bonds issued for the water and sewer fund which will service the debt.
- Revenue bonds to be repaid from admission fees collected from users of the municipal recreation center.

These bonds are expected to be paid from enterprise funds, and secured by Todd's full faith, credit, and taxing power as further assurance that the obligations will be paid.

Todd's 20X0 expenditures from the general fund include payments for structural alterations to a firehouse and furniture for the mayor's office.

In reporting the state grants for the bus purchase and operation, what should Todd include as grant revenues for the year ended December 31, 20X0?

| | *90% of the capital grant* | *100% of the capital grant* | *Operating grant* |
|---|---|---|---|
| a. | Yes | No | No |
| b. | No | Yes | No |
| c. | No | Yes | Yes |
| d. | Yes | No | Yes |

**CPA-01186 Explanation**
Choice "d" is correct. In reporting the state grants for the bus purchase and operation, Todd should include 90% of the capital grant and all of the operating grant. Grant revenues are recognized as revenues in the year in which the monies are used.

**CPA-01187 Type1 M/C A-D Corr Ans: C PM#44 F 8-99**

123. CPA-01187 May 90 T #56 Page 32

Revenues that are legally restricted to expenditures for specified purposes should be accounted for in special revenue funds, including:

a. Accumulation of resources for payment of general long-term debt principal and interest.
b. Pension trust fund revenues.
c. Gasoline taxes to finance road repairs.
d. Proprietary fund revenues.

**CPA-01187 Explanation**
Choice "c" is correct. Revenues that are legally restricted to expenditures for specified purposes, including gasoline taxes to finance road repairs, should be accounted for in the special revenue funds.

Choice "a" is incorrect. Accumulation of resources for payment of general long-term debt principal and interest is usually accounted for in the debt service fund.

Choice "b" is incorrect. Pension trust fund revenues should be accounted for in the pension fund.

Choice "d" is incorrect. Proprietary fund revenues should be accounted for in the appropriate proprietary fund to which they relate (SE).

**CPA-01188 Type1 M/C A-D Corr Ans: B PM#45 F 8-99**

124. CPA-01188 May 90 T #58 Page 25

For state and local governmental units, generally accepted accounting principles require that encumbrances outstanding at year-end be reported as:

a. Expenditures.
b. Reservations of fund balance.
c. Deferred liabilities.
d. Current liabilities.


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**CPA-01188 Explanation**
Choice "b" is correct. For state and local governmental units, generally accepted accounting principles (GAAP) require that encumbrances outstanding at year-end be reported as reservations of fund balance so that funds will be available when the goods and/or services are received.

Choice "a" is incorrect. Outstanding encumbrances at year-end represent orders for goods and services not yet received, where as "expenditures" represent the cost of goods and services already received.

Choices "c" and "d" are incorrect, per above.

**CPA-01189 Type1 M/C A-D Corr Ans: C PM#46 F 8-99**

125. CPA-01189 May 90 II #1 Page 45

Rock County has acquired equipment through a noncancelable lease-purchase agreement dated December 31, 20X0. This agreement requires no down payment and the following minimum lease payments:

| *December 31* | *Principal* | *Interest* | *Total* |
|---|---|---|---|
| 20X1 | $50,000 | $15,000 | $65,000 |
| 20X2 | 50,000 | 10,000 | 60,000 |
| 20X3 | 50,000 | 5,000 | 55,000 |

What account should be debited for $150,000 in the general fund at inception of the lease if the equipment is a governmental capital asset and Rock does not use a capital projects fund?

a. Other financing uses control.
b. Equipment.
c. Expenditures control.
d. Memorandum entry only.

**CPA-01189 Explanation**
Choice "c" is correct. The expenditures control account should be debited in the general fund at the inception of the lease for the principal portion of the lease payments whenever a lease purchase agreement is financed by the general fund.

Choice "a" is incorrect, per above explanation.

Choice "b" is incorrect. The equipment account is not carried in the general fund.

Choice "d" is incorrect, per above explanation.

**CPA-01190 Type1 M/C A-D Corr Ans: A PM#47 F 8-99**

126. CPA-01190 May 90 II #4 Page 45

Rock County has acquired equipment through a noncancelable lease-purchase agreement dated December 31, 20X0. This agreement requires no down payment and the following minimum lease payments:

| *December 31* | *Principal* | *Interest* | *Total* |
|---|---|---|---|
| 20X1 | $50,000 | $15,000 | $65,000 |
| 20X2 | 50,000 | 10,000 | 60,000 |
| 20X3 | 50,000 | 5,000 | 55,000 |

If the lease payments are required to be made from a debt service fund, what account or accounts should be debited in the debt service fund for the December 31, 20X1 lease payment of $65,000?

| | | |
|---|---|---|
| a. | Expenditures control | $65,000 |
| b. | Other financing sources control | $50,000 |
| | Expenditures control | 15,000 |


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| | | | |
|---|---|---|---|
| c. | Amount to be provided for lease payments | $50,000 | |
| | Expenditures control | | 15,000 |
| d. | Expenditures control | $50,000 | |
| | Amount to be provided for lease payments | | 15,000 |

**CPA-01190 Explanation**
Choice "a" is correct. The expenditures control account should be debited in the debt service fund to record the payment of principal ($50,000) and interest ($15,000).

**Rule:** All "expenditures" from (almost) every "operating" fund are debited to an account called "expenditure control."

Journal Entry:

| | | |
|---|---|---|
| Expenditures control | 65,000 | |
| Cash | | 65,000 |

**CPA-01191 Type1 M/C A-D Corr Ans: D PM#48 F 8-99**

127. CPA-01191 May 90 II #5 Page 58

Rock County has acquired equipment through a noncancelable lease-purchase agreement dated December 31, 20X0. This agreement requires no down payment and the following minimum lease payments:

| *December 31* | *Principal* | *Interest* | *Total* |
|---|---|---|---|
| 20X1 | $50,000 | $15,000 | $65,000 |
| 20X2 | 50,000 | 10,000 | 60,000 |
| 20X3 | 50,000 | 5,000 | 55,000 |

If the equipment is used in enterprise fund operations and the lease payments are to be financed with enterprise fund revenues, what account should be debited for $150,000 in the enterprise fund at inception of the lease?

a. Expenses control.
b. Expenditures control.
c. Other financing sources control.
d. Equipment.

**CPA-01191 Explanation**
Choice "d" is correct. Equipment acquired through a "capital lease" arrangement should be accounted for as equipment.

Choices "a" and "b" are incorrect. The lease payments are for a capital item, not an "expense" item.

Choice "c" is incorrect. Lease payments are **not** revenue items, i.e., other financing sources.

**CPA-01192 Type1 M/C A-D Corr Ans: C PM#49 F 8-99**

128. CPA-01192 May 90 II #6 Page 58

Rock County has acquired equipment through a noncancelable lease-purchase agreement dated December 31, 20X0. This agreement requires no down payment and the following minimum lease payments:

| *December 31* | *Principal* | *Interest* | *Total* |
|---|---|---|---|
| 20X1 | $50,000 | $15,000 | $65,000 |
| 20X2 | 50,000 | 10,000 | 60,000 |
| 20X3 | 50,000 | 5,000 | 55,000 |


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If the equipment is used in internal service fund operations and the lease payments are financed with internal service fund revenues, what account or accounts should be debited in the internal service fund for the December 31, 20X1 lease payment of $65,000?

| | | |
|---|---|---|
| a. | Expenditures control | $65,000 |
| b. | Expenses control | $65,000 |
| c. | Capital lease payable | $50,000 |
| | Expenses control | 15,000 |
| d. | Expenditures control | $50,000 |
| | Expenses control | 15,000 |

**CPA-01192 Explanation**
Choice "c" is correct. The equipment (capital) lease payment made one year after acquisition by the internal service fund should be recorded as follows:

| | DR | CR |
|---|---|---|
| Capital lease payable (principal) | 50,000 | |
| Expenses control (interest) | 15,000 | |
| Cash | | 65,000 |

**CPA-01194 Type1 M/C A-D Corr Ans: B PM#50 F 8-99**

129. CPA-01194 May 90 II #8 Page 62

Elm City contributes to and administers a single-employer defined benefit pension plan on behalf of its covered employees. The plan is accounted for in a pension trust fund. Actuarially determined employer contribution requirements and contributions actually made for the past three years, along with the percentage of annual covered payroll, were as follows:

| | *Contribution made* | | *Actuarial requirement* | |
|---|---|---|---|---|
| | *Amount* | *Percent* | *Amount* | *Percent* |
| 20X3 | $11,000 | 26 | $11,000 | 26 |
| 20X2 | 5,000 | 12 | 10,000 | 24 |
| 20X1 | None | None | 8,000 | 20 |

To record the 20X3 pension contribution of $11,000, what debit is required in the governmental-type fund used in connection with employer pension contributions?

a. Other financing uses control.
b. Expenditures control.
c. Expenses control.
d. Due to pension trust fund.

**CPA-01194 Explanation**
Choice "b" is correct. The expenditures control should be debited in the governmental-type fund which made the employer pension contributions.

**CPA-01196 Type1 M/C A-D Corr Ans: C PM#51 F 8-99**

130. CPA-01196 May 90 II #9 Page 66

Elm City was founded in 20X1 and contributes to and administers a single-employer defined benefit pension plan on behalf of its covered employees. The plan is accounted for in a pension trust fund. Actuarially determined employer contribution requirements and contributions actually made for the past three years, along with the percentage of annual covered payroll, were as follows:

| *Contribution made* | | *Actuarial requirement* | |
|---|---|---|---|
| *Amount* | *Percent* | *Amount* | *Percent* |


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| | | | | |
|---|---|---|---|---|
| 20X3 | $11,000 | 26 | $11,000 | 26 |
| 20X2 | 5,000 | 12 | 10,000 | 24 |
| 20X1 | None | None | 8,000 | 20 |

In the required supplementary information to Elm's 20X3 financial statements, employer contributions expressed as percentages of annual covered payroll should be shown to the extent available for a minimum of:

a. 1 year.
b. 2 years.
c. 3 years.
d. 12 years.

**CPA-01196 Explanation**
Choice "c" is correct. In the schedule of employer contributions included in the required supplementary information should display employer contributions expressed as percentages of annual covered payroll to the extent available (for a minimum of 6 years). Although the requirement is to display six years of data as required supplementary information, the city has only been in existence for 3 years.

**CPA-01197 Type1 M/C A-D Corr Ans: D PM#52 F 8-99**

131. CPA-01197 May 90 II #10 Page 45

Grove Township issued $50,000 of bond anticipation notes at face amount in 20X0 and placed the proceeds into its capital projects fund. All legal steps were taken to refinance the notes, but Grove was unable to consummate refinancing. In the capital projects fund, what account should be credited to record the $50,000 proceeds?

a. Other financing sources control.
b. Revenues control.
c. Deferred revenues.
d. Bond anticipation notes payable.

**CPA-01197 Explanation**
Choice "d" is correct. The $50,000 proceeds of bond anticipation notes, when received in the capital projects fund, should be credited to bond anticipation notes payable when the notes could not be refinanced.

Choice "a" is incorrect. "Other financing sources control" would be used for proceeds of bond issues. In this case, the notes were not turned into bonds.

Choice "b" is incorrect. The revenues control account is used to record fees earned by a governmental fund.

Choice "c" is incorrect. Merely a distracter.

**CPA-01202 Type1 M/C A-D Corr Ans: B PM#53 F 8-99**

132. CPA-01202 May 89 II #26 Page 17

A $10,000,000 budgeted excess of revenues over appropriations should be:

a. Debited to budgetary fund balance-unreserved.
b. Credited to budgetary fund balance-unreserved.
c. Debited to estimated excess revenues control.
d. Credited to estimated excess revenues control.

**CPA-01202 Explanation**
Choice "b" is correct. A budgeted excess of revenues over appropriations should be credited to budgetary fund balance unreserved.

| | |
|---|---|
| Estimated revenues (Dr.) | $50,000,000 |


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| | |
|---|---|
| Appropriations (Cr.) | 40,000,000 |
| Budgetary fund balance (Cr.) | $10,000,000 |

Choices "a", "c", and "d" are incorrect per explanation above.

**CPA-01204 Type1 M/C A-D Corr Ans: C PM#54 F 8-99**

133. CPA-01204 May 89 T #51 Page 18

Under the modified accrual basis of accounting for a governmental unit, revenues should be recognized in the accounting period in which they:

a. Are earned and become measurable.
b. Are collected.
c. Become available and measurable.
d. Become available and earned.

**CPA-01204 Explanation**
Choice "c" is correct. Under the "modified accrual basis" of accounting for a governmental unit, revenues should be recognized for the accounting period in which they "become available and measurable."

**CPA-01206 Type1 M/C A-D Corr Ans: D PM#55 F 8-99**

134. CPA-01206 May 89 T #59 Page 72

A local governmental unit could have funds using which of the following accounting bases?

| | *Accrual basis* | *Modified accrual basis* |
|---|---|---|
| a. | No | Yes |
| b. | No | No |
| c. | Yes | No |
| d. | Yes | Yes |

**CPA-01206 Explanation**
Choice "d" is correct. Yes - Yes.

A local governmental unit could have funds using both the "accrual basis" and the "modified accrual basis" of accounting. The governmental funds (GRASPP) are required to use modified accrual, while the proprietary and fiduciary funds (SE PAPI) are required to use the accrual basis.

**CPA-04474 Type1 M/C Y,N Corr Ans: N PM#56 F 8-99**

135. CPA-04474 ARE May 95 PR2 1 Page 3

**EDITOR'S NOTE: Appropriations, as used within the context of the CPA Exam, embrace budgeted expenditures as well as transfers.**

The following information relates to Bel City, whose first fiscal year ended December 31, 20X4. Assume Bel has only the long-term debt specified in the information and only the funds necessitated by the information.

*1. General fund:*

- The following selected information is taken from Bel's 20X4 general fund financial records:

| | *Budget* | *Actual* |
|---|---|---|
| Property taxes | $5,000,000 | $4,700,000 |
| Other revenues | 1,000,000 | 1,050,000 |
| Total revenues | $6,000,000 | $5,750,000 |
| Total expenditures | $5,600,000 | $5,700,000 |
| Property taxes receivable - delinquent | | $ 420,000 |


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| | |
|---|---|
| Less: Allowance for estimated uncollectible taxes - delinquent | 50,000 |
| | $ 370,000 |

- There were no amendments to the budget as originally adopted.
- No property taxes receivable have been written off, and the allowance for uncollectibles balance is unchanged from the initial entry at the time of the original tax levy.
- There were no encumbrances outstanding at December 31, 20X4.

*2. Capital project fund:*

- Finances for Bel's new civic center were provided by a combination of general fund transfers, a state grant, and an issue of general obligation bonds. Any bond premium on issuance is to be used for the repayment of the bonds at their $1,200,000 par value. At December 31, 20X4, the capital project fund for the civic center had the following closing entries:

| | | |
|---|---|---|
| Revenues | $ 800,000 | |
| Other financing sources - bond proceeds | 1,230,000 | |
| Other financing sources - transfers in | 500,000 | |
| Expenditures | | $1,080,000 |
| Other financing uses - transfers out | | 30,000 |
| Unreserved fund balance | | 1,420,000 |

- Also, at December 31, 20X4, capital project fund entries reflected Bel's intention to honor the $1,300,000 purchase orders and commitments outstanding for the center.
- During 20X4, total capital project fund encumbrances exceeded the corresponding expenditures by $42,000. All expenditures were previously encumbered.
- During 20X5, the capital project fund received no revenues and no other financing sources. The civic center building was completed in early 20X5 and the capital project fund was closed by a transfer of $27,000 to the general fund.

*3. Water utility enterprise fund:*

- Bel issued $4,000,000 revenue bonds at par. These bonds, together with a $700,000 transfer from the general fund, were used to acquire a water utility with total assets of $4.7 million. Water utility revenues are expected to be 20% of total assets and are to be the sole source of funds to retire these bonds beginning in year 20X9.

This question relates to Bel's general fund. Indicate if the answer to each item is yes (Y) or no (N).

- Did recording budgetary accounts at the beginning of 20X4 increase the fund balance by $50,000?

N. No
Y. Yes

**CPA-04474 Explanation**
**"No" is the correct answer.** The entry to record the budget for the year is as follows:

| | | |
|---|---|---|
| Fund balance | 800,000 | |
| Estimated revenues | 6,000,000 | |
| Appropriations | | 5,600,000 |
| Estimated other financing uses - Capital projects fund | | 500,000 |
| Estimated capital contributions - Enterprise fund | | 700,000 |

Thus, the fund balance decreases by $800,000. If the transfers to the capital project fund and enterprise fund were planned and approved in advance, they would be included in the budgetary entry.

**CPA-04475 Type1 M/C Y,N Corr Ans: Y PM#57 F 8-99**

136. CPA-04475 ARE May 95 PR2 2 Page 3


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**EDITOR'S NOTE: Appropriations, as used within the context of the CPA Exam, embrace budgeted expenditures as well as transfers.**

The following information relates to Bel City, whose first fiscal year ended December 31, 20X4. Assume Bel has only the long-term debt specified in the information and only the funds necessitated by the information.

*1. General fund:*

- The following selected information is taken from Bel's 20X4 general fund financial records:

| | *Budget* | *Actual* |
|---|---|---|
| Property taxes | $5,000,000 | $4,700,000 |
| Other revenues | 1,000,000 | 1,050,000 |
| Total revenues | $6,000,000 | $5,750,000 |
| Total expenditures | $5,600,000 | $5,700,000 |
| Property taxes receivable - delinquent | | $ 420,000 |
| Less: Allowance for estimated uncollectible taxes - delinquent | | 50,000 |
| | | $ 370,000 |

- There were no amendments to the budget as originally adopted.
- No property taxes receivable have been written off, and the allowance for uncollectibles balance is unchanged from the initial entry at the time of the original tax levy.
- There were no encumbrances outstanding at December 31, 20X4.

*2. Capital project fund:*

- Finances for Bel's new civic center were provided by a combination of general fund transfers, a state grant, and an issue of general obligation bonds. Any bond premium on issuance is to be used for the repayment of the bonds at their $1,200,000 par value. At December 31, 20X4, the capital project fund for the civic center had the following closing entries:

| | | |
|---|---|---|
| Revenues | $ 800,000 | |
| Other financing sources - bond proceeds | 1,230,000 | |
| Other financing sources - transfers in | 500,000 | |
| Expenditures | | $1,080,000 |
| Other financing uses - transfers out | | 30,000 |
| Unreserved fund balance | | 1,420,000 |

- Also, at December 31, 20X4, capital project fund entries reflected Bel's intention to honor the $1,300,000 purchase orders and commitments outstanding for the center.
- During 20X4, total capital project fund encumbrances exceeded the corresponding expenditures by $42,000. All expenditures were previously encumbered.
- During 20X5, the capital project fund received no revenues and no other financing sources. The civic center building was completed in early 20X5 and the capital project fund was closed by a transfer of $27,000 to the general fund.

*3. Water utility enterprise fund:*

- Bel issued $4,000,000 revenue bonds at par. These bonds, together with a $700,000 transfer from the general fund, were used to acquire a water utility with total assets of $4.7 million. Water utility revenues are expected to be 20% of total assets and are to be the sole source of funds to retire these bonds beginning in year 20X9.

This question relates to Bel's general fund. Indicate if the answer to each item is yes (Y) or no (N).

- Should the budgetary accounts for 20X4 include an entry for the expected transfer of funds from the general fund to the capital projects fund?

N. No


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Y. Yes

**CPA-04475 Explanation**
**"Yes" is the correct answer.** The budgetary entry would include a credit of $500,000 to Estimated other financing uses - Capital projects fund.

**CPA-04476 Type1 M/C Y,N Corr Ans: Y PM#58 F 8-99**

137. CPA-04476 ARE May 95 PR2 3 Page 3

**EDITOR'S NOTE: Appropriations, as used within the context of the CPA Exam, embrace budgeted expenditures as well as transfers.**

The following information relates to Bel City, whose first fiscal year ended December 31, 20X4. Assume Bel has only the long-term debt specified in the information and only the funds necessitated by the information.

*1. General fund:*

- The following selected information is taken from Bel's 20X4 general fund financial records:

| | *Budget* | *Actual* |
|---|---|---|
| Property taxes | $5,000,000 | $4,700,000 |
| Other revenues | 1,000,000 | 1,050,000 |
| Total revenues | $6,000,000 | $5,750,000 |
| Total expenditures | $5,600,000 | $5,700,000 |
| Property taxes receivable - delinquent | | $ 420,000 |
| Less: Allowance for estimated uncollectible taxes - delinquent | | 50,000 |
| | | $ 370,000 |

- There were no amendments to the budget as originally adopted.
- No property taxes receivable have been written off, and the allowance for uncollectibles balance is unchanged from the initial entry at the time of the original tax levy.
- There were no encumbrances outstanding at December 31, 20X4.

*2. Capital project fund:*

- Finances for Bel's new civic center were provided by a combination of general fund transfers, a state grant, and an issue of general obligation bonds. Any bond premium on issuance is to be used for the repayment of the bonds at their $1,200,000 par value. At December 31, 20X4, the capital project fund for the civic center had the following closing entries:

| | | |
|---|---|---|
| Revenues | $ 800,000 | |
| Other financing sources - bond proceeds | 1,230,000 | |
| Other financing sources - transfers in | 500,000 | |
| Expenditures | | $1,080,000 |
| Other financing uses - transfers out | | 30,000 |
| Unreserved fund balance | | 1,420,000 |

- Also, at December 31, 20X4, capital project fund entries reflected Bel's intention to honor the $1,300,000 purchase orders and commitments outstanding for the center.
- During 20X4, total capital project fund encumbrances exceeded the corresponding expenditures by $42,000. All expenditures were previously encumbered.
- During 20X5, the capital project fund received no revenues and no other financing sources. The civic center building was completed in early 20X5 and the capital project fund was closed by a transfer of $27,000 to the general fund.

*3. Water utility enterprise fund:*


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- Bel issued $4,000,000 revenue bonds at par. These bonds, together with a $700,000 transfer from the general fund, were used to acquire a water utility with total assets of $4.7 million. Water utility revenues are expected to be 20% of total assets and are to be the sole source of funds to retire these bonds beginning in year 20X9.

This question relates to Bel's general fund. Indicate if the answer to each item is yes (Y) or no (N).

- Should the $700,000 payment from the general fund, which was used to help to establish the water utility fund, be reported as an "other financing use - transfers out"?

N. No
Y. Yes

**CPA-04476 Explanation**
**"Yes" is the correct answer.** When the $700,000 is transferred out, the following journal entry is made:

| | | |
|---|---|---|
| Transfers out | 700,000 | |
| Cash | | 700,000 |

This transfer was used to establish the water fund.

**CPA-04477 Type1 M/C Y,N Corr Ans: N PM#59 F 8-99**

138. CPA-04477 ARE May 95 PR2 4 Page 3

**EDITOR'S NOTE: Appropriations, as used within the context of the CPA Exam, embrace budgeted expenditures as well as transfers.**

The following information relates to Bel City, whose first fiscal year ended December 31, 20X4. Assume Bel has only the long-term debt specified in the information and only the funds necessitated by the information.

*1. General fund:*

- The following selected information is taken from Bel's 20X4 general fund financial records:

| | *Budget* | *Actual* |
|---|---|---|
| Property taxes | $5,000,000 | $4,700,000 |
| Other revenues | 1,000,000 | 1,050,000 |
| Total revenues | $6,000,000 | $5,750,000 |
| Total expenditures | $5,600,000 | $5,700,000 |
| Property taxes receivable - delinquent | | $ 420,000 |
| Less: Allowance for estimated uncollectible taxes - delinquent | | 50,000 |
| | | $ 370,000 |

- There were no amendments to the budget as originally adopted.
- No property taxes receivable have been written off, and the allowance for uncollectibles balance is unchanged from the initial entry at the time of the original tax levy.
- There were no encumbrances outstanding at December 31, 20X4.

*2. Capital project fund:*

- Finances for Bel's new civic center were provided by a combination of general fund transfers, a state grant, and an issue of general obligation bonds. Any bond premium on issuance is to be used for the repayment of the bonds at their $1,200,000 par value. At December 31, 20X4, the capital project fund for the civic center had the following closing entries:

| | | |
|---|---|---|
| Revenues | $ 800,000 | |
| Other financing sources - bond proceeds | 1,230,000 | |
| Other financing sources - transfers in | 500,000 | |
| Expenditures | | $1,080,000 |
| Other financing uses - transfers out | | 30,000 |


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| | |
|---|---|
| Unreserved fund balance | 1,420,000 |

- Also, at December 31, 20X4, capital project fund entries reflected Bel's intention to honor the $1,300,000 purchase orders and commitments outstanding for the center.
- During 20X4, total capital project fund encumbrances exceeded the corresponding expenditures by $42,000. All expenditures were previously encumbered.
- During 20X5, the capital project fund received no revenues and no other financing sources. The civic center building was completed in early 20X5 and the capital project fund was closed by a transfer of $27,000 to the general fund.

*3. Water utility enterprise fund:*

- Bel issued $4,000,000 revenue bonds at par. These bonds, together with a $700,000 transfer from the general fund, were used to acquire a water utility with total assets of $4.7 million. Water utility revenues are expected to be 20% of total assets and are to be the sole source of funds to retire these bonds beginning in year 20X9.

This question relates to Bel's general fund. Indicate if the answer to each item is yes (Y) or no (N).

- Did the general fund receive the $30,000 bond premium from the capital projects fund?

N. No
Y. Yes

**CPA-04477 Explanation**
**"No" is the correct answer.** The fact that the $30,000 was transferred out is evidenced by the closing entry credit to "Other Financing Uses - Operating Transfer Out" in the capital projects fund. However, the premium was transferred to the debt service fund to be used for repayment of the bond principal. The journal entries for each fund are as follows:

| | | |
|---|---|---|
| Capital Projects Fund | | |
| Other financing uses - Transfers out | 30,000 | |
| Cash | | 30,000 |
| Debt Service Fund | | |
| Cash | 30,000 | |
| Other financing sources - Transfer in | | 30,000 |

**CPA-04478 Type1 M/C Y,N Corr Ans: N PM#60 F 8-99**

139. CPA-04478 ARE May 95 PR2 5 Page 3

**EDITOR'S NOTE: Appropriations, as used within the context of the CPA Exam, embrace budgeted expenditures as well as transfers.**

The following information relates to Bel City, whose first fiscal year ended December 31, 20X4. Assume Bel has only the long-term debt specified in the information and only the funds necessitated by the information.

*1. General fund:*

- The following selected information is taken from Bel's 20X4 general fund financial records:

| | *Budget* | *Actual* |
|---|---|---|
| Property taxes | $5,000,000 | $4,700,000 |
| Other revenues | 1,000,000 | 1,050,000 |
| Total revenues | $6,000,000 | $5,750,000 |
| Total expenditures | $5,600,000 | $5,700,000 |

| | |
|---|---|
| Property taxes receivable - delinquent | $ 420,000 |
| Less: Allowance for estimated uncollectible taxes - delinquent | 50,000 |
| | $ 370,000 |

- There were no amendments to the budget as originally adopted.


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- No property taxes receivable have been written off, and the allowance for uncollectibles balance is unchanged from the initial entry at the time of the original tax levy.
- There were no encumbrances outstanding at December 31, 20X4.

*2. Capital project fund:*

- Finances for Bel's new civic center were provided by a combination of general fund transfers, a state grant, and an issue of general obligation bonds. Any bond premium on issuance is to be used for the repayment of the bonds at their $1,200,000 par value. At December 31, 20X4, the capital project fund for the civic center had the following closing entries:

| | | |
|---|---|---|
| Revenues | $ 800,000 | |
| Other financing sources - bond proceeds | 1,230,000 | |
| Other financing sources - transfers in | 500,000 | |
| Expenditures | | $1,080,000 |
| Other financing uses - transfers out | | 30,000 |
| Unreserved fund balance | | 1,420,000 |

- Also, at December 31, 20X4, capital project fund entries reflected Bel's intention to honor the $1,300,000 purchase orders and commitments outstanding for the center.
- During 20X4, total capital project fund encumbrances exceeded the corresponding expenditures by $42,000. All expenditures were previously encumbered.
- During 20X5, the capital project fund received no revenues and no other financing sources. The civic center building was completed in early 20X5 and the capital project fund was closed by a transfer of $27,000 to the general fund.

*3. Water utility enterprise fund:*

- Bel issued $4,000,000 revenue bonds at par. These bonds, together with a $700,000 transfer from the general fund, were used to acquire a water utility with total assets of $4.7 million. Water utility revenues are expected to be 20% of total assets and are to be the sole source of funds to retire these bonds beginning in year 20X9.

This question relates to Bel's general fund. Indicate if the answer to each item is yes (Y) or no (N).

- Should a payment from the general fund for water received for normal civic center operations be reported as an "other financing use - transfers out"?

N. No
Y. Yes

**CPA-04478 Explanation**
**"No" is the correct answer.** Payments received from the general fund for water provided for civic center operations would be treated as an expenditure of the general fund. The journal entry for the general fund would be as follows:

| | | |
|---|---|---|
| Expenditures | XX | |
| Due to water utility enterprise fund | | XX |

**CPA-04480 Type1 M/C Y,N Corr Ans: N PM#61 F 8-99**

140. CPA-04480 ARE May 95 PR2 7 Page 3

**EDITOR'S NOTE: Appropriations, as used within the context of the CPA Exam, embrace budgeted expenditures as well as transfers.**

The following information relates to Bel City, whose first fiscal year ended December 31, 20X4. Assume Bel has only the long-term debt specified in the information and only the funds necessitated by the information.

*1. General fund:*


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- The following selected information is taken from Bel's 20X4 general fund financial records:

| | *Budget* | *Actual* |
|---|---|---|
| Property taxes | $5,000,000 | $4,700,000 |
| Other revenues | 1,000,000 | 1,050,000 |
| Total revenues | $6,000,000 | $5,750,000 |
| Total expenditures | $5,600,000 | $5,700,000 |
| Property taxes receivable - delinquent | | $ 420,000 |
| Less: Allowance for estimated uncollectible taxes - delinquent | | 50,000 |
| | | $ 370,000 |

- There were no amendments to the budget as originally adopted.
- No property taxes receivable have been written off, and the allowance for uncollectibles balance is unchanged from the initial entry at the time of the original tax levy.
- There were no encumbrances outstanding at December 31, 20X4.

*2. Capital project fund:*

- Finances for Bel's new civic center were provided by a combination of general fund transfers, a state grant, and an issue of general obligation bonds. Any bond premium on issuance is to be used for the repayment of the bonds at their $1,200,000 par value. At December 31, 20X4, the capital project fund for the civic center had the following closing entries:

| | | |
|---|---|---|
| Revenues | $ 800,000 | |
| Other financing sources - bond proceeds | 1,230,000 | |
| Other financing sources - transfers in | 500,000 | |
| Expenditures | | $1,080,000 |
| Other financing uses - transfers out | | 30,000 |
| Unreserved fund balance | | 1,420,000 |

- Also, at December 31, 20X4, capital project fund entries reflected Bel's intention to honor the $1,300,000 purchase orders and commitments outstanding for the center.
- During 20X4, total capital project fund encumbrances exceeded the corresponding expenditures by $42,000. All expenditures were previously encumbered.
- During 20X5, the capital project fund received no revenues and no other financing sources. The civic center building was completed in early 20X5 and the capital project fund was closed by a transfer of $27,000 to the general fund.

*3. Water utility enterprise fund:*

- Bel issued $4,000,000 revenue bonds at par. These bonds, together with a $700,000 transfer from the general fund, were used to acquire a water utility with total assets of $4.7 million. Water utility revenues are expected to be 20% of total assets and are to be the sole source of funds to retire these bonds beginning in year 20X9.

This question relates to Bel's general fund. Indicate if the answer to each item is yes (Y) or no (N).

- Would closing budgetary accounts cause the fund balance to increase by $400,000?

N. No
Y. Yes

**CPA-04480 Explanation**
**"No" is the correct answer.** Closing the budgetary accounts would increase the fund balance by $800,000 to its original level. The closing entry is:

| | | |
|---|---|---|
| Appropriations | 5,600,000 | |
| Estimated other financing uses - Capital projects fund | 500,000 | |
| Estimated other financing uses - Enterprise fund | 700,000 | |
| Estimated revenues | | 6,000,000 |


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| | |
|---|---|
| Fund balance | 800,000 |

**CPA-04481 Type1 M/C Y,N Corr Ans: N PM#62 F 8-99**

141. CPA-04481 ARE May 95 PR2 8 Page 3

**EDITOR'S NOTE: Appropriations, as used within the context of the CPA Exam, embrace budgeted expenditures as well as transfers.**

The following information relates to Bel City, whose first fiscal year ended December 31, 20X4. Assume Bel has only the long-term debt specified in the information and only the funds necessitated by the information.

*1. General fund:*

- The following selected information is taken from Bel's 20X4 general fund financial records:

| | *Budget* | *Actual* |
|---|---|---|
| Property taxes | $5,000,000 | $4,700,000 |
| Other revenues | 1,000,000 | 1,050,000 |
| Total revenues | $6,000,000 | $5,750,000 |
| Total expenditures | $5,600,000 | $5,700,000 |
| Property taxes receivable - delinquent | | $ 420,000 |
| Less: Allowance for estimated uncollectible taxes - delinquent | | 50,000 |
| | | $ 370,000 |

- There were no amendments to the budget as originally adopted.
- No property taxes receivable have been written off, and the allowance for uncollectibles balance is unchanged from the initial entry at the time of the original tax levy.
- There were no encumbrances outstanding at December 31, 20X4.

*2. Capital project fund:*

- Finances for Bel's new civic center were provided by a combination of general fund transfers, a state grant, and an issue of general obligation bonds. Any bond premium on issuance is to be used for the repayment of the bonds at their $1,200,000 par value. At December 31, 20X4, the capital project fund for the civic center had the following closing entries:

| | | |
|---|---|---|
| Revenues | $ 800,000 | |
| Other financing sources - bond proceeds | 1,230,000 | |
| Other financing sources - transfers in | 500,000 | |
| Expenditures | | $1,080,000 |
| Other financing uses - transfers out | | 30,000 |
| Unreserved fund balance | | 1,420,000 |

- Also, at December 31, 20X4, capital project fund entries reflected Bel's intention to honor the $1,300,000 purchase orders and commitments outstanding for the center.
- During 20X4, total capital project fund encumbrances exceeded the corresponding expenditures by $42,000. All expenditures were previously encumbered.
- During 20X5, the capital project fund received no revenues and no other financing sources. The civic center building was completed in early 20X5 and the capital project fund was closed by a transfer of $27,000 to the general fund.

*3. Water utility enterprise fund:*

- Bel issued $4,000,000 revenue bonds at par. These bonds, together with a $700,000 transfer from the general fund, were used to acquire a water utility with total assets of $4.7 million. Water utility revenues are expected to be 20% of total assets and are to be the sole source of funds to retire these bonds beginning in year 20X9.


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This question relates to Bel's general fund. Indicate if the answer to each item is yes (Y) or no (N).

- Would the interaction between budgetary and actual amounts cause the fund balance to decrease by $350,000?

N. No
Y. Yes

**CPA-04481 Explanation**
**"No" is the correct answer.** The budgetary entries simply adjusted the fund balance to its planned level, a decrease of $800,000. Closing the actual accounts decreased the fund balance by $1,150,000. The entry to close the accounts is:

| | | |
|---|---|---|
| Fund balance | 1,150,000 | |
| Revenues | 5,750,000 | |
| Expenditures | | 5,700,000 |
| Other financing uses - Enterprise fund | | 700,000 |
| Other financing use - Capital project fund | | 500,000 |

**CPA-04482 Type1 M/C Y,N Corr Ans: N PM#63 F 8-99**

142. CPA-04482 ARE May 95 PR2 9 Page 3

**EDITOR'S NOTE: Appropriations, as used within the context of the CPA Exam, embrace budgeted expenditures as well as transfers.**

The following information relates to Bel City, whose first fiscal year ended December 31, 20X4. Assume Bel has only the long-term debt specified in the information and only the funds necessitated by the information.

*1. General fund:*

- The following selected information is taken from Bel's 20X4 general fund financial records:

| | *Budget* | *Actual* |
|---|---|---|
| Property taxes | $5,000,000 | $4,700,000 |
| Other revenues | 1,000,000 | 1,050,000 |
| Total revenues | $6,000,000 | $5,750,000 |
| Total expenditures | $5,600,000 | $5,700,000 |
| Property taxes receivable - delinquent | | $ 420,000 |
| Less: Allowance for estimated uncollectible taxes - delinquent | | 50,000 |
| | | $ 370,000 |

- There were no amendments to the budget as originally adopted.
- No property taxes receivable have been written off, and the allowance for uncollectibles balance is unchanged from the initial entry at the time of the original tax levy.
- There were no encumbrances outstanding at December 31, 20X4.

*2. Capital project fund:*

- Finances for Bel's new civic center were provided by a combination of general fund transfers, a state grant, and an issue of general obligation bonds. Any bond premium on issuance is to be used for the repayment of the bonds at their $1,200,000 par value. At December 31, 20X4, the capital project fund for the civic center had the following closing entries:

| | | |
|---|---|---|
| Revenues | $ 800,000 | |
| Other financing sources - bond proceeds | 1,230,000 | |
| Other financing sources - transfers in | 500,000 | |
| Expenditures | | $1,080,000 |
| Other financing uses - transfers out | | 30,000 |
| Unreserved fund balance | | 1,420,000 |


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- Also, at December 31, 20X4, capital project fund entries reflected Bel's intention to honor the $1,300,000 purchase orders and commitments outstanding for the center.
- During 20X4, total capital project fund encumbrances exceeded the corresponding expenditures by $42,000. All expenditures were previously encumbered.
- During 20X5, the capital project fund received no revenues and no other financing sources. The civic center building was completed in early 20X5 and the capital project fund was closed by a transfer of $27,000 to the general fund.

*3. Water utility enterprise fund:*

- Bel issued $4,000,000 revenue bonds at par. These bonds, together with a $700,000 transfer from the general fund, were used to acquire a water utility with total assets of $4.7 million. Water utility revenues are expected to be 20% of total assets and are to be the sole source of funds to retire these bonds beginning in year 20X9.

This question relates to Bel's funds other than the general fund. Indicate if the answer to each item is yes (Y) or no (N).

- In the general capital assets, should a credit amount be recorded for 20X4 in "Investment in general fixed assets - capital projects fund"?

N. No
Y. Yes

**CPA-04482 Explanation**
**"No" is the correct answer.** At the end of 20X4, the civic center is not yet complete; however, it must be recorded as Construction in Progress in the General Capital Asset Account and displayed on the government wide statement of net assets. The offsetting credit would be to a liability account in combination with an equity (net asset) account or purely a liability or net asset account. The "equity" account formerly titled "Investment in General Fixed Assets" was used in connection with account groups, a discontinued reporting format prior to the issuance of GASB #34.

**CPA-04483 Type1 M/C Y,N Corr Ans: Y PM#64 F 8-99**

143. CPA-04483 ARE May 95 PR2 10 Page 3

**EDITOR'S NOTE: Appropriations, as used within the context of the CPA Exam, embrace budgeted expenditures as well as transfers.**

The following information relates to Bel City, whose first fiscal year ended December 31, 20X4. Assume Bel has only the long-term debt specified in the information and only the funds necessitated by the information.

*1. General fund:*

- The following selected information is taken from Bel's 20X4 general fund financial records:

| | *Budget* | *Actual* |
|---|---|---|
| Property taxes | $5,000,000 | $4,700,000 |
| Other revenues | 1,000,000 | 1,050,000 |
| Total revenues | $6,000,000 | $5,750,000 |
| Total expenditures | $5,600,000 | $5,700,000 |
| Property taxes receivable - delinquent | | $ 420,000 |
| Less: Allowance for estimated uncollectible taxes - delinquent | | 50,000 |
| | | $ 370,000 |

- There were no amendments to the budget as originally adopted.
- No property taxes receivable have been written off, and the allowance for uncollectibles balance is unchanged from the initial entry at the time of the original tax levy.
- There were no encumbrances outstanding at December 31, 20X4.


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*2. Capital project fund:*

- Finances for Bel's new civic center were provided by a combination of general fund transfers, a state grant, and an issue of general obligation bonds. Any bond premium on issuance is to be used for the repayment of the bonds at their $1,200,000 par value. At December 31, 20X4, the capital project fund for the civic center had the following closing entries:

| | | |
|---|---|---|
| Revenues | $ 800,000 | |
| Other financing sources - bond proceeds | 1,230,000 | |
| Other financing sources - transfers in | 500,000 | |
| Expenditures | | $1,080,000 |
| Other financing uses - transfers out | | 30,000 |
| Unreserved fund balance | | 1,420,000 |

- Also, at December 31, 20X4, capital project fund entries reflected Bel's intention to honor the $1,300,000 purchase orders and commitments outstanding for the center.
- During 20X4, total capital project fund encumbrances exceeded the corresponding expenditures by $42,000. All expenditures were previously encumbered.
- During 20X5, the capital project fund received no revenues and no other financing sources. The civic center building was completed in early 20X5 and the capital project fund was closed by a transfer of $27,000 to the general fund.

*3. Water utility enterprise fund:*

- Bel issued $4,000,000 revenue bonds at par. These bonds, together with a $700,000 transfer from the general fund, were used to acquire a water utility with total assets of $4.7 million. Water utility revenues are expected to be 20% of total assets and are to be the sole source of funds to retire these bonds beginning in year 20X9.

This question relates to Bel's funds other than the general fund. Indicate if the answer to each item is yes (Y) or no (N).

- Relative to its general capital assets, should Bel record depreciation in 20X5 on the civic center?

N. No
Y. Yes

**CPA-04483 Explanation**
**"Yes" is the correct answer.** Depreciation expense is recorded on general capital assets displayed in the accounts summarized **in the expense** columns of the government wide statement of activities.

**CPA-04484 Type1 M/C Y,N Corr Ans: N PM#65 F 8-99**

144. CPA-04484 ARE May 95 PR2 11 Page 3

**EDITOR'S NOTE: Appropriations, as used within the context of the CPA Exam, embrace budgeted expenditures as well as transfers.**

The following information relates to Bel City, whose first fiscal year ended December 31, 20X4. Assume Bel has only the long-term debt specified in the information and only the funds necessitated by the information.

*1. General fund:*

- The following selected information is taken from Bel's 20X4 general fund financial records:

| | *Budget* | *Actual* |
|---|---|---|
| Property taxes | $5,000,000 | $4,700,000 |
| Other revenues | 1,000,000 | 1,050,000 |
| Total revenues | $6,000,000 | $5,750,000 |
| Total expenditures | $5,600,000 | $5,700,000 |


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| | |
|---|---|
| Property taxes receivable - delinquent | $ 420,000 |
| Less: Allowance for estimated uncollectible taxes - delinquent | 50,000 |
| | $ 370,000 |

- There were no amendments to the budget as originally adopted.
- No property taxes receivable have been written off, and the allowance for uncollectibles balance is unchanged from the initial entry at the time of the original tax levy.
- There were no encumbrances outstanding at December 31, 20X4.

*2. Capital project fund:*

- Finances for Bel's new civic center were provided by a combination of general fund transfers, a state grant, and an issue of general obligation bonds. Any bond premium on issuance is to be used for the repayment of the bonds at their $1,200,000 par value. At December 31, 20X4, the capital project fund for the civic center had the following closing entries:

| | | |
|---|---|---|
| Revenues | $ 800,000 | |
| Other financing sources - bond proceeds | 1,230,000 | |
| Other financing sources - transfers in | 500,000 | |
| Expenditures | | $1,080,000 |
| Other financing uses - transfers out | | 30,000 |
| Unreserved fund balance | | 1,420,000 |

- Also, at December 31, 20X4, capital project fund entries reflected Bel's intention to honor the $1,300,000 purchase orders and commitments outstanding for the center.
- During 20X4, total capital project fund encumbrances exceeded the corresponding expenditures by $42,000. All expenditures were previously encumbered.
- During 20X5, the capital project fund received no revenues and no other financing sources. The civic center building was completed in early 20X5 and the capital project fund was closed by a transfer of $27,000 to the general fund.

*3. Water utility enterprise fund:*

- Bel issued $4,000,000 revenue bonds at par. These bonds, together with a $700,000 transfer from the general fund, were used to acquire a water utility with total assets of $4.7 million. Water utility revenues are expected to be 20% of total assets and are to be the sole source of funds to retire these bonds beginning in year 20X9.

This question relates to Bel's funds other than the general fund. Indicate if the answer to each item is yes (Y) or no (N).

- Relative to capital assets displayed in the governmental type activities column, should Bel elect to record depreciation on water utility equipment?

N. No
Y. Yes

**CPA-04484 Explanation**
**"No" is the correct answer.** The water utility equipment is held in an enterprise fund; this is classified as business type activity not governmental activity in the government wide statement of activities.

**CPA-04485 Type1 M/C Y,N Corr Ans: N PM#66 F 8-99**

145. CPA-04485 ARE May 95 PR2 12 Page 3

**EDITOR'S NOTE: Appropriations, as used within the context of the CPA Exam, embrace budgeted expenditures as well as transfers.**


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The following information relates to Bel City, whose first fiscal year ended December 31, 20X4. Assume Bel has only the long-term debt specified in the information and only the funds necessitated by the information.

*1. General fund:*

- The following selected information is taken from Bel's 20X4 general fund financial records:

| | *Budget* | *Actual* |
|---|---|---|
| Property taxes | $5,000,000 | $4,700,000 |
| Other revenues | 1,000,000 | 1,050,000 |
| Total revenues | $6,000,000 | $5,750,000 |
| Total expenditures | $5,600,000 | $5,700,000 |
| Property taxes receivable - delinquent | | $ 420,000 |
| Less: Allowance for estimated uncollectible taxes - delinquent | | 50,000 |
| | | $ 370,000 |

- There were no amendments to the budget as originally adopted.
- No property taxes receivable have been written off, and the allowance for uncollectibles balance is unchanged from the initial entry at the time of the original tax levy.
- There were no encumbrances outstanding at December 31, 20X4.

*2. Capital project fund:*

- Finances for Bel's new civic center were provided by a combination of general fund transfers, a state grant, and an issue of general obligation bonds. Any bond premium on issuance is to be used for the repayment of the bonds at their $1,200,000 par value. At December 31, 20X4, the capital project fund for the civic center had the following closing entries:

| | | |
|---|---|---|
| Revenues | $ 800,000 | |
| Other financing sources - bond proceeds | 1,230,000 | |
| Other financing sources - transfers in | 500,000 | |
| Expenditures | | $1,080,000 |
| Other financing uses - transfers out | | 30,000 |
| Unreserved fund balance | | 1,420,000 |

- Also, at December 31, 20X4, capital project fund entries reflected Bel's intention to honor the $1,300,000 purchase orders and commitments outstanding for the center.
- During 20X4, total capital project fund encumbrances exceeded the corresponding expenditures by $42,000. All expenditures were previously encumbered.
- During 20X5, the capital project fund received no revenues and no other financing sources. The civic center building was completed in early 20X5 and the capital project fund was closed by a transfer of $27,000 to the general fund.

*3. Water utility enterprise fund:*

- Bel issued $4,000,000 revenue bonds at par. These bonds, together with a $700,000 transfer from the general fund, were used to acquire a water utility with total assets of $4.7 million. Water utility revenues are expected to be 20% of total assets and are to be the sole source of funds to retire these bonds beginning in year 20X9.

This question relates to Bel's funds other than the general fund. Indicate if the answer to each item is yes (Y) or no (N).

- Should the capital project fund be included in Bel's government wide financial statements?

N. No
Y. Yes

**CPA-04485 Explanation**


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**"No" is the correct answer.** The government wide financial statements exclude specific fund financial statements and instead summarize government wide financial statements activity as either governmental type or business type.

**CPA-04486 Type1 M/C Y,N Corr Ans: Y PM#67 F 8-99**

146. CPA-04486 ARE May 95 PR2 13 Page 3

**EDITOR'S NOTE: Appropriations, as used within the context of the CPA Exam, embrace budgeted expenditures as well as transfers.**

The following information relates to Bel City, whose first fiscal year ended December 31, 20X4. Assume Bel has only the long-term debt specified in the information and only the funds necessitated by the information.

*1. General fund:*

- The following selected information is taken from Bel's 20X4 general fund financial records:

| | *Budget* | *Actual* |
|---|---|---|
| Property taxes | $5,000,000 | $4,700,000 |
| Other revenues | 1,000,000 | 1,050,000 |
| Total revenues | $6,000,000 | $5,750,000 |
| Total expenditures | $5,600,000 | $5,700,000 |
| Property taxes receivable - delinquent | | $ 420,000 |
| Less: Allowance for estimated uncollectible taxes - delinquent | | 50,000 |
| | | $ 370,000 |

- There were no amendments to the budget as originally adopted.
- No property taxes receivable have been written off, and the allowance for uncollectibles balance is unchanged from the initial entry at the time of the original tax levy.
- There were no encumbrances outstanding at December 31, 20X4.

*2. Capital project fund:*

- Finances for Bel's new civic center were provided by a combination of general fund transfers, a state grant, and an issue of general obligation bonds. Any bond premium on issuance is to be used for the repayment of the bonds at their $1,200,000 par value. At December 31, 20X4, the capital project fund for the civic center had the following closing entries:

| | | |
|---|---|---|
| Revenues | $ 800,000 | |
| Other financing sources - bond proceeds | 1,230,000 | |
| Other financing sources - transfers in | 500,000 | |
| Expenditures | | $1,080,000 |
| Other financing uses - transfers out | | 30,000 |
| Unreserved fund balance | | 1,420,000 |

- Also, at December 31, 20X4, capital project fund entries reflected Bel's intention to honor the $1,300,000 purchase orders and commitments outstanding for the center.
- During 20X4, total capital project fund encumbrances exceeded the corresponding expenditures by $42,000. All expenditures were previously encumbered.
- During 20X5, the capital project fund received no revenues and no other financing sources. The civic center building was completed in early 20X5 and the capital project fund was closed by a transfer of $27,000 to the general fund.

*3. Water utility enterprise fund:*

- Bel issued $4,000,000 revenue bonds at par. These bonds, together with a $700,000 transfer from the general fund, were used to acquire a water utility with total assets of $4.7 million. Water utility


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revenues are expected to be 20% of total assets and are to be the sole source of funds to retire these bonds beginning in year 20X9.

This question relates to Bel's funds other than the general fund. Indicate if the answer to each item is yes (Y) or no (N).

- Should the water utility enterprise fund be included in Bel's fund financial statements as a major fund?

N. No
Y. Yes

**CPA-04486 Explanation**
**"Yes" is the correct answer.** Criteria for a major fund is that the total assets, liabilities, revenues or expense of that individual fund are at least 10% of the account totals for that fund category **and** at least 5% of the account totals for the combined governmental and enterprise funds. As the only enterprise fund, it meets the first criteria. Computed revenues are greater than 5% of all revenue.

**CPA-04487 Type1 M/C Y,N Corr Ans: N PM#68 F 8-99**

147. CPA-04487 ARE May 95 PR2 14 Page 3

**EDITOR'S NOTE: Appropriations, as used within the context of the CPA Exam, embrace budgeted expenditures as well as transfers.**

The following information relates to Bel City, whose first fiscal year ended December 31, 20X4. Assume Bel has only the long-term debt specified in the information and only the funds necessitated by the information.

*1. General fund:*

- The following selected information is taken from Bel's 20X4 general fund financial records:

| | *Budget* | *Actual* |
|---|---|---|
| Property taxes | $5,000,000 | $4,700,000 |
| Other revenues | 1,000,000 | 1,050,000 |
| Total revenues | $6,000,000 | $5,750,000 |
| Total expenditures | $5,600,000 | $5,700,000 |
| Property taxes receivable - delinquent | | $ 420,000 |
| Less: Allowance for estimated uncollectible taxes - delinquent | | 50,000 |
| | | $ 370,000 |

- There were no amendments to the budget as originally adopted.
- No property taxes receivable have been written off, and the allowance for uncollectibles balance is unchanged from the initial entry at the time of the original tax levy.
- There were no encumbrances outstanding at December 31, 20X4.

*2. Capital project fund:*

- Finances for Bel's new civic center were provided by a combination of general fund transfers, a state grant, and an issue of general obligation bonds. Any bond premium on issuance is to be used for the repayment of the bonds at their $1,200,000 par value. At December 31, 20X4, the capital project fund for the civic center had the following closing entries:

| | | |
|---|---|---|
| Revenues | $ 800,000 | |
| Other financing sources - bond proceeds | 1,230,000 | |
| Other financing sources - transfers in | 500,000 | |
| Expenditures | | $1,080,000 |
| Other financing uses - transfers out | | 30,000 |
| Unreserved fund balance | | 1,420,000 |


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- Also, at December 31, 20X4, capital project fund entries reflected Bel's intention to honor the $1,300,000 purchase orders and commitments outstanding for the center.
- During 20X4, total capital project fund encumbrances exceeded the corresponding expenditures by $42,000. All expenditures were previously encumbered.
- During 20X5, the capital project fund received no revenues and no other financing sources. The civic center building was completed in early 20X5 and the capital project fund was closed by a transfer of $27,000 to the general fund.

*3. Water utility enterprise fund:*

- Bel issued $4,000,000 revenue bonds at par. These bonds, together with a $700,000 transfer from the general fund, were used to acquire a water utility with total assets of $4.7 million. Water utility revenues are expected to be 20% of total assets and are to be the sole source of funds to retire these bonds beginning in year 20X9.

This question relates to Bel's funds other than the general fund. Indicate if the answer to each item is yes (Y) or no (N).

- Should Bel report capital and related financing activities for capital project fund transactions in its 20X4 statement of cash flows?

N. No
Y. Yes

**CPA-04487 Explanation**
**"No" is the correct answer.** Governmental funds are not required to prepare a statement of cash flows.

**CPA-04488 Type1 M/C Y,N Corr Ans: N PM#69 F 8-99**

148. CPA-04488 ARE May 95 PR2 15 Page 3

**EDITOR'S NOTE: Appropriations, as used within the context of the CPA Exam, embrace budgeted expenditures as well as transfers.**

The following information relates to Bel City, whose first fiscal year ended December 31, 20X4. Assume Bel has only the long-term debt specified in the information and only the funds necessitated by the information.

*1. General fund:*

- The following selected information is taken from Bel's 20X4 general fund financial records:

| | *Budget* | *Actual* |
|---|---|---|
| Property taxes | $5,000,000 | $4,700,000 |
| Other revenues | 1,000,000 | 1,050,000 |
| Total revenues | $6,000,000 | $5,750,000 |
| Total expenditures | $5,600,000 | $5,700,000 |
| Property taxes receivable - delinquent | | $ 420,000 |
| Less: Allowance for estimated uncollectible taxes - delinquent | | 50,000 |
| | | $ 370,000 |

- There were no amendments to the budget as originally adopted.
- No property taxes receivable have been written off, and the allowance for uncollectibles balance is unchanged from the initial entry at the time of the original tax levy.
- There were no encumbrances outstanding at December 31, 20X4.

*2. Capital project fund:*

- Finances for Bel's new civic center were provided by a combination of general fund transfers, a state grant, and an issue of general obligation bonds. Any bond premium on issuance is to be used


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for the repayment of the bonds at their $1,200,000 par value. At December 31, 20X4, the capital project fund for the civic center had the following closing entries:

| | | |
|---|---|---|
| Revenues | $ 800,000 | |
| Other financing sources - bond proceeds | 1,230,000 | |
| Other financing sources - transfers in | 500,000 | |
| Expenditures | | $1,080,000 |
| Other financing uses - transfers out | | 30,000 |
| Unreserved fund balance | | 1,420,000 |

- Also, at December 31, 20X4, capital project fund entries reflected Bel's intention to honor the $1,300,000 purchase orders and commitments outstanding for the center.
- During 20X4, total capital project fund encumbrances exceeded the corresponding expenditures by $42,000. All expenditures were previously encumbered.
- During 20X5, the capital project fund received no revenues and no other financing sources. The civic center building was completed in early 20X5 and the capital project fund was closed by a transfer of $27,000 to the general fund.

*3. Water utility enterprise fund:*

- Bel issued $4,000,000 revenue bonds at par. These bonds, together with a $700,000 transfer from the general fund, were used to acquire a water utility with total assets of $4.7 million. Water utility revenues are expected to be 20% of total assets and are to be the sole source of funds to retire these bonds beginning in year 20X9.

This question relates to Bel's funds other than the general fund. Indicate if the answer to each item is yes (Y) or no (N).

*Debt Service Fund*

- Should Bel report capital and related financing activities for debt service fund transactions in its 20X4 statement of cash flows?

N. No
Y. Yes

**CPA-04488 Explanation**
**"No" is the correct answer.** Governmental funds are not required to prepare a statement of cash flows.

**CPA-04489 Type1 M/C Y,N Corr Ans: Y PM#70 F 8-99**

149. CPA-04489 ARE May 95 PR2 16 Page 3

**EDITOR'S NOTE: Appropriations, as used within the context of the CPA Exam, embrace budgeted expenditures as well as transfers.**

The following information relates to Bel City, whose first fiscal year ended December 31, 20X4. Assume Bel has only the long-term debt specified in the information and only the funds necessitated by the information.

*1. General fund:*

- The following selected information is taken from Bel's 20X4 general fund financial records:

| | *Budget* | *Actual* |
|---|---|---|
| Property taxes | $5,000,000 | $4,700,000 |
| Other revenues | 1,000,000 | 1,050,000 |
| Total revenues | $6,000,000 | $5,750,000 |
| Total expenditures | $5,600,000 | $5,700,000 |

| | |
|---|---|
| Property taxes receivable - delinquent | $ 420,000 |
| Less: Allowance for estimated uncollectible taxes - delinquent | 50,000 |


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| | |
|---|---|
| | $ 370,000 |

- There were no amendments to the budget as originally adopted.
- No property taxes receivable have been written off, and the allowance for uncollectibles balance is unchanged from the initial entry at the time of the original tax levy.
- There were no encumbrances outstanding at December 31, 20X4.

*2. Capital project fund:*

- Finances for Bel's new civic center were provided by a combination of general fund transfers, a state grant, and an issue of general obligation bonds. Any bond premium on issuance is to be used for the repayment of the bonds at their $1,200,000 par value. At December 31, 20X4, the capital project fund for the civic center had the following closing entries:

| | | |
|---|---|---|
| Revenues | $ 800,000 | |
| Other financing sources - bond proceeds | 1,230,000 | |
| Other financing sources - transfers in | 500,000 | |
| Expenditures | | $1,080,000 |
| Other financing uses - transfers out | | 30,000 |
| Unreserved fund balance | | 1,420,000 |

- Also, at December 31, 20X4, capital project fund entries reflected Bel's intention to honor the $1,300,000 purchase orders and commitments outstanding for the center.
- During 20X4, total capital project fund encumbrances exceeded the corresponding expenditures by $42,000. All expenditures were previously encumbered.
- During 20X5, the capital project fund received no revenues and no other financing sources. The civic center building was completed in early 20X5 and the capital project fund was closed by a transfer of $27,000 to the general fund.

*3. Water utility enterprise fund:*

- Bel issued $4,000,000 revenue bonds at par. These bonds, together with a $700,000 transfer from the general fund, were used to acquire a water utility with total assets of $4.7 million. Water utility revenues are expected to be 20% of total assets and are to be the sole source of funds to retire these bonds beginning in year 20X9.

This question relates to Bel's funds other than the general fund. Indicate if the answer to each item is yes (Y) or no (N).

*Debt Service Fund*

- Should Bel report capital and related financing activities for water utility enterprise fund transactions in its 20X4 statement of cash flows?

N. No
Y. Yes

**CPA-04489 Explanation**
**"Yes" is the correct answer.** Proprietary funds and governmental entities that use proprietary accounting should present a statement of cash flows for each period for which results of operations are reported.

**CPA-04490 Type1 M/C A-G Corr Ans: F PM#71 F 8-99**

150. CPA-04490 ARE May 95 PR2 17 Page 3

**EDITOR'S NOTE: Appropriations, as used within the context of the CPA Exam, embrace budgeted expenditures as well as transfers.**


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The following information relates to Bel City, whose first fiscal year ended December 31, 20X4. Assume Bel has only the long-term debt specified in the information and only the funds necessitated by the information.

*1. General fund:*

- The following selected information is taken from Bel's 20X4 general fund financial records:

| | *Budget* | *Actual* |
|---|---|---|
| Property taxes | $5,000,000 | $4,700,000 |
| Other revenues | 1,000,000 | 1,050,000 |
| Total revenues | $6,000,000 | $5,750,000 |
| Total expenditures | $5,600,000 | $5,700,000 |
| Property taxes receivable - delinquent | | $ 420,000 |
| Less: Allowance for estimated uncollectible taxes - delinquent | | 50,000 |
| | | $ 370,000 |

- There were no amendments to the budget as originally adopted.
- No property taxes receivable have been written off, and the allowance for uncollectibles balance is unchanged from the initial entry at the time of the original tax levy.
- There were no encumbrances outstanding at December 31, 20X4.

*2. Capital project fund:*

- Finances for Bel's new civic center were provided by a combination of general fund transfers, a state grant, and an issue of general obligation bonds. Any bond premium on issuance is to be used for the repayment of the bonds at their $1,200,000 par value. At December 31, 20X4, the capital project fund for the civic center had the following closing entries:

| | | |
|---|---|---|
| Revenues | $ 800,000 | |
| Other financing sources - bond proceeds | 1,230,000 | |
| Other financing sources - transfers in | 500,000 | |
| Expenditures | | $1,080,000 |
| Other financing uses - transfers out | | 30,000 |
| Unreserved fund balance | | 1,420,000 |

- Also, at December 31, 20X4, capital project fund entries reflected Bel's intention to honor the $1,300,000 purchase orders and commitments outstanding for the center.
- During 20X4, total capital project fund encumbrances exceeded the corresponding expenditures by $42,000. All expenditures were previously encumbered.
- During 20X5, the capital project fund received no revenues and no other financing sources. The civic center building was completed in early 20X5 and the capital project fund was closed by a transfer of $27,000 to the general fund.

*3. Water utility enterprise fund:*

- Bel issued $4,000,000 revenue bonds at par. These bonds, together with a $700,000 transfer from the general fund, were used to acquire a water utility with total assets of $4.7 million. Water utility revenues are expected to be 20% of total assets and are to be the sole source of funds to retire these bonds beginning in year 20X9.

This question relates to Bel's general fund. Determine the amount.

- What was the amount recorded in the opening entry for appropriations?

A. $3,000,000
B. $4,000,000
C. $4,500,000
D. $4,750,000
E. $5,000,000
F. $5,600,000


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G. $6,000,000

**CPA-04490 Explanation**
**Choice "F" is correct. $5,600,000.** The journal entry is as follows:

| | | |
|---|---|---|
| Fund Balance | 800,000 | |
| Estimated revenues | 6,000,000 | |
| Appropriations | | 5,600,000 |
| Estimated Other Financing Uses - Capital Projects Fund | | 500,000 |
| Estimated Other Financing Uses - Enterprise Fund | | 700,000 |

**CPA-04491 Type1 M/C A-G Corr Ans: D PM#72 F 8-99**

151. CPA-04491 ARE May 95 PR2 18 Page 3

**EDITOR'S NOTE: Appropriations, as used within the context of the CPA Exam, embrace budgeted expenditures as well as transfers.**

The following information relates to Bel City, whose first fiscal year ended December 31, 20X4. Assume Bel has only the long-term debt specified in the information and only the funds necessitated by the information.

*1. General fund:*

- The following selected information is taken from Bel's 20X4 general fund financial records:

| | *Budget* | *Actual* |
|---|---|---|
| Property taxes | $5,000,000 | $4,700,000 |
| Other revenues | 1,000,000 | 1,050,000 |
| Total revenues | $6,000,000 | $5,750,000 |
| Total expenditures | $5,600,000 | $5,700,000 |
| Property taxes receivable - delinquent | | $ 420,000 |
| Less: Allowance for estimated uncollectible taxes - delinquent | | 50,000 |
| | | $ 370,000 |

- There were no amendments to the budget as originally adopted.
- No property taxes receivable have been written off, and the allowance for uncollectibles balance is unchanged from the initial entry at the time of the original tax levy.
- There were no encumbrances outstanding at December 31, 20X4.

*2. Capital project fund:*

- Finances for Bel's new civic center were provided by a combination of general fund transfers, a state grant, and an issue of general obligation bonds. Any bond premium on issuance is to be used for the repayment of the bonds at their $1,200,000 par value. At December 31, 20X4, the capital project fund for the civic center had the following closing entries:

| | | |
|---|---|---|
| Revenues | $ 800,000 | |
| Other financing sources - bond proceeds | 1,230,000 | |
| Other financing sources - transfers in | 500,000 | |
| Expenditures | | $1,080,000 |
| Other financing uses - transfers out | | 30,000 |
| Unreserved fund balance | | 1,420,000 |

- Also, at December 31, 20X4, capital project fund entries reflected Bel's intention to honor the $1,300,000 purchase orders and commitments outstanding for the center.
- During 20X4, total capital project fund encumbrances exceeded the corresponding expenditures by $42,000. All expenditures were previously encumbered.


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- During 20X5, the capital project fund received no revenues and no other financing sources. The civic center building was completed in early 20X5 and the capital project fund was closed by a transfer of $27,000 to the general fund.

*3. Water utility enterprise fund:*

- Bel issued $4,000,000 revenue bonds at par. These bonds, together with a $700,000 transfer from the general fund, were used to acquire a water utility with total assets of $4.7 million. Water utility revenues are expected to be 20% of total assets and are to be the sole source of funds to retire these bonds beginning in year 20X9.

This question relates to Bel's general fund. Determine the amount.

- What was the total amount debited to property taxes receivable?

A. $3,000,000
B. $4,000,000
C. $4,500,000
D. $4,750,000
E. $5,000,000
F. $5,600,000
G. $6,000,000

**CPA-04491 Explanation**
**Choice "D" is correct. $4,750,000.** This amount may be derived as follows:

| | |
|---|---|
| Actual property tax revenue | $4,700,000 |
| + Allowance for Estimated Uncollectible Taxes | 50,000 |
| TOTAL | $4,750,000 |

The journal entry to record the tax levy is as follows:

| | | |
|---|---|---|
| Property taxes receivable | 4,750,000 | |
| Allowance for Estimated Uncollectible Taxes | | 50,000 |
| Revenues | | 4,700,000 |

Since this was the first fiscal year for Bel and no changes had been made to the allowance account, the receivable can be derived in the above-stated manner.

**CPA-04492 Type1 M/C A-I Corr Ans: E PM#73 F 8-99**

152. CPA-04492 ARE May 95 PR2 19 Page 3

**EDITOR'S NOTE: Appropriations, as used within the context of the CPA Exam, embrace budgeted expenditures as well as transfers.**

The following information relates to Bel City, whose first fiscal year ended December 31, 20X4. Assume Bel has only the long-term debt specified in the information and only the funds necessitated by the information.

*1. General fund:*

- The following selected information is taken from Bel's 20X4 general fund financial records:

| | *Budget* | *Actual* |
|---|---|---|
| Property taxes | $5,000,000 | $4,700,000 |
| Other revenues | 1,000,000 | 1,050,000 |
| Total revenues | $6,000,000 | $5,750,000 |
| Total expenditures | $5,600,000 | $5,700,000 |
| Property taxes receivable - delinquent | | $ 420,000 |
| Less: Allowance for estimated uncollectible taxes - delinquent | | 50,000 |
| | | $ 370,000 |


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- There were no amendments to the budget as originally adopted.
- No property taxes receivable have been written off, and the allowance for uncollectibles balance is unchanged from the initial entry at the time of the original tax levy.
- There were no encumbrances outstanding at December 31, 20X4.

*2. Capital project fund:*

- Finances for Bel's new civic center were provided by a combination of general fund transfers, a state grant, and an issue of general obligation bonds. Any bond premium on issuance is to be used for the repayment of the bonds at their $1,200,000 par value. At December 31, 20X4, the capital project fund for the civic center had the following closing entries:

| | | |
|---|---|---|
| Revenues | $ 800,000 | |
| Other financing sources - bond proceeds | 1,230,000 | |
| Other financing sources - transfers in | 500,000 | |
| Expenditures | | $1,080,000 |
| Other financing uses - transfers out | | 30,000 |
| Unreserved fund balance | | 1,420,000 |

- Also, at December 31, 20X4, capital project fund entries reflected Bel's intention to honor the $1,300,000 purchase orders and commitments outstanding for the center.
- During 20X4, total capital project fund encumbrances exceeded the corresponding expenditures by $42,000. All expenditures were previously encumbered.
- During 20X5, the capital project fund received no revenues and no other financing sources. The civic center building was completed in early 20X5 and the capital project fund was closed by a transfer of $27,000 to the general fund.

*3. Water utility enterprise fund:*

- Bel issued $4,000,000 revenue bonds at par. These bonds, together with a $700,000 transfer from the general fund, were used to acquire a water utility with total assets of $4.7 million. Water utility revenues are expected to be 20% of total assets and are to be the sole source of funds to retire these bonds beginning in year 20X9.

This question relates to Bel's funds other than the general fund. Determine the amount.

- In the government wide financial statements, what amount should be reported for long-term liabilities in the governmental activities column at December 31, 20X4?

A. $120,000
B. $450,000
C. $800,000
D. $1,000,000
E. $1,200,000
F. $2,000,000
G. $2,422,000
H. $2,473,000
I. $2,565,000

**CPA-04492 Explanation**
**Choice "E" is correct. $1,200,000.** Bonds are reported in the general long-term liability account at their par value in the government wide statement of net assets.

**CPA-04493 Type1 M/C A-I Corr Ans: H PM#74 F 8-99**

153. CPA-04493 ARE May 95 PR2 20 Page 3

**EDITOR'S NOTE: Appropriations, as used within the context of the CPA Exam, embrace budgeted expenditures as well as transfers.**


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The following information relates to Bel City, whose first fiscal year ended December 31, 20X4. Assume Bel has only the long-term debt specified in the information and only the funds necessitated by the information.

*1. General fund:*

- The following selected information is taken from Bel's 20X4 general fund financial records:

| | *Budget* | *Actual* |
|---|---|---|
| Property taxes | $5,000,000 | $4,700,000 |
| Other revenues | 1,000,000 | 1,050,000 |
| Total revenues | $6,000,000 | $5,750,000 |
| Total expenditures | $5,600,000 | $5,700,000 |
| Property taxes receivable - delinquent | | $ 420,000 |
| Less: Allowance for estimated uncollectible taxes - delinquent | | 50,000 |
| | | $ 370,000 |

- There were no amendments to the budget as originally adopted.
- No property taxes receivable have been written off, and the allowance for uncollectibles balance is unchanged from the initial entry at the time of the original tax levy.
- There were no encumbrances outstanding at December 31, 20X4.

*2. Capital project fund:*

- Finances for Bel's new civic center were provided by a combination of general fund transfers, a state grant, and an issue of general obligation bonds. Any bond premium on issuance is to be used for the repayment of the bonds at their $1,200,000 par value. At December 31, 20X4, the capital project fund for the civic center had the following closing entries:

| | | |
|---|---|---|
| Revenues | $ 800,000 | |
| Other financing sources - bond proceeds | 1,230,000 | |
| Other financing sources - transfers in | 500,000 | |
| Expenditures | | $1,080,000 |
| Other financing uses - transfers out | | 30,000 |
| Unreserved fund balance | | 1,420,000 |

- Also, at December 31, 20X4, capital project fund entries reflected Bel's intention to honor the $1,300,000 purchase orders and commitments outstanding for the center.
- During 20X4, total capital project fund encumbrances exceeded the corresponding expenditures by $42,000. All expenditures were previously encumbered.
- During 20X5, the capital project fund received no revenues and no other financing sources. The civic center building was completed in early 20X5 and the capital project fund was closed by a transfer of $27,000 to the general fund.

*3. Water utility enterprise fund:*

- Bel issued $4,000,000 revenue bonds at par. These bonds, together with a $700,000 transfer from the general fund, were used to acquire a water utility with total assets of $4.7 million. Water utility revenues are expected to be 20% of total assets and are to be the sole source of funds to retire these bonds beginning in year 20X9.

This question relates to Bel's funds other than the general fund. Determine the amount.

- What was the completed cost of the civic center?

A. $120,000
B. $450,000
C. $800,000
D. $1,000,000
E. $1,200,000
F. $2,000,000


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G. $2,422,000
H. $2,473,000
I. $2,565,000

**CPA-04493 Explanation**
**Choice "H" is correct. $2,473,000.** The capital projects fund expends or transfers all funds flowing into it. Therefore, the difference between total inflows and transfers will equal the cost of the center:

| | |
|---|---|
| Inflows: | |
| Grant Revenue | $ 800,000 |
| Bond Proceeds | 1,230,000 |
| General Fund Transfer | 500,000 |
| Total | 2,530,000 |
| Transfer of Premium to General Fund | (30,000) |
| Transfer to Close Fund | (27,000) |
| Cost of Center | $2,473,000 |

**CPA-04494 Type1 M/C A-I Corr Ans: C PM#75 F 8-99**

154. CPA-04494 ARE May 95 PR2 21 Page 3

**EDITOR'S NOTE: Appropriations, as used within the context of the CPA Exam, embrace budgeted expenditures as well as transfers.**

The following information relates to Bel City, whose first fiscal year ended December 31, 20X4. Assume Bel has only the long-term debt specified in the information and only the funds necessitated by the information.

*1. General fund:*

- The following selected information is taken from Bel's 20X4 general fund financial records:

| | *Budget* | *Actual* |
|---|---|---|
| Property taxes | $5,000,000 | $4,700,000 |
| Other revenues | 1,000,000 | 1,050,000 |
| Total revenues | $6,000,000 | $5,750,000 |
| Total expenditures | $5,600,000 | $5,700,000 |
| Property taxes receivable - delinquent | | $ 420,000 |
| Less: Allowance for estimated uncollectible taxes - delinquent | | 50,000 |
| | | $ 370,000 |

- There were no amendments to the budget as originally adopted.
- No property taxes receivable have been written off, and the allowance for uncollectibles balance is unchanged from the initial entry at the time of the original tax levy.
- There were no encumbrances outstanding at December 31, 20X4.

*2. Capital project fund:*

- Finances for Bel's new civic center were provided by a combination of general fund transfers, a state grant, and an issue of general obligation bonds. Any bond premium on issuance is to be used for the repayment of the bonds at their $1,200,000 par value. At December 31, 20X4, the capital project fund for the civic center had the following closing entries:

| | | |
|---|---|---|
| Revenues | $ 800,000 | |
| Other financing sources - bond proceeds | 1,230,000 | |
| Other financing sources - transfers in | 500,000 | |
| Expenditures | | $1,080,000 |
| Other financing uses - transfers out | | 30,000 |
| Unreserved fund balance | | 1,420,000 |


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- Also, at December 31, 20X4, capital project fund entries reflected Bel's intention to honor the $1,300,000 purchase orders and commitments outstanding for the center.
- During 20X4, total capital project fund encumbrances exceeded the corresponding expenditures by $42,000. All expenditures were previously encumbered.
- During 20X5, the capital project fund received no revenues and no other financing sources. The civic center building was completed in early 20X5 and the capital project fund was closed by a transfer of $27,000 to the general fund.

*3. Water utility enterprise fund:*

- Bel issued $4,000,000 revenue bonds at par. These bonds, together with a $700,000 transfer from the general fund, were used to acquire a water utility with total assets of $4.7 million. Water utility revenues are expected to be 20% of total assets and are to be the sole source of funds to retire these bonds beginning in year 20X9.

This question relates to Bel's funds other than the general fund. Determine the amount.

- How much was the state capital grant for the civic center?

A. $120,000
B. $450,000
C. $800,000
D. $1,000,000
E. $1,200,000
F. $2,000,000
G. $2,422,000
H. $2,473,000
I. $2,565,000

**CPA-04494 Explanation**
**Choice "C" is correct. $800,000.** The state grant is reflected in the revenues of $800,000 shown in the closing entry.

**CPA-04495 Type1 M/C A-I Corr Ans: G PM#76 F 8-99**

155. CPA-04495 ARE May 95 PR2 22 Page 3

**EDITOR'S NOTE: Appropriations, as used within the context of the CPA Exam, embrace budgeted expenditures as well as transfers.**

The following information relates to Bel City, whose first fiscal year ended December 31, 20X4. Assume Bel has only the long-term debt specified in the information and only the funds necessitated by the information.

*1. General fund:*

- The following selected information is taken from Bel's 20X4 general fund financial records:

| | *Budget* | *Actual* |
|---|---|---|
| Property taxes | $5,000,000 | $4,700,000 |
| Other revenues | 1,000,000 | 1,050,000 |
| Total revenues | $6,000,000 | $5,750,000 |
| Total expenditures | $5,600,000 | $5,700,000 |
| Property taxes receivable - delinquent | | $ 420,000 |
| Less: Allowance for estimated uncollectible taxes - delinquent | | 50,000 |
| | | $ 370,000 |

- There were no amendments to the budget as originally adopted.
- No property taxes receivable have been written off, and the allowance for uncollectibles balance is unchanged from the initial entry at the time of the original tax levy.


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- There were no encumbrances outstanding at December 31, 20X4.

*2. Capital project fund:*

- Finances for Bel's new civic center were provided by a combination of general fund transfers, a state grant, and an issue of general obligation bonds. Any bond premium on issuance is to be used for the repayment of the bonds at their $1,200,000 par value. At December 31, 20X4, the capital project fund for the civic center had the following closing entries:

| | | |
|---|---|---|
| Revenues | $ 800,000 | |
| Other financing sources - bond proceeds | 1,230,000 | |
| Other financing sources - transfers in | 500,000 | |
| Expenditures | | $1,080,000 |
| Other financing uses - transfers out | | 30,000 |
| Unreserved fund balance | | 1,420,000 |

- Also, at December 31, 20X4, capital project fund entries reflected Bel's intention to honor the $1,300,000 purchase orders and commitments outstanding for the center.
- During 20X4, total capital project fund encumbrances exceeded the corresponding expenditures by $42,000. All expenditures were previously encumbered.
- During 20X5, the capital project fund received no revenues and no other financing sources. The civic center building was completed in early 20X5 and the capital project fund was closed by a transfer of $27,000 to the general fund.

*3. Water utility enterprise fund:*

- Bel issued $4,000,000 revenue bonds at par. These bonds, together with a $700,000 transfer from the general fund, were used to acquire a water utility with total assets of $4.7 million. Water utility revenues are expected to be 20% of total assets and are to be the sole source of funds to retire these bonds beginning in year 20X9.

This question relates to Bel's funds other than the general fund. Determine the amount.

- In the capital project fund, what was the amount of the total encumbrances recorded during 20X4?

A. $120,000
B. $450,000
C. $800,000
D. $1,000,000
E. $1,200,000
F. $2,000,000
G. $2,422,000
H. $2,473,000
I. $2,565,000

**CPA-04495 Explanation**
**Choice "G" is correct. $2,422,000.** This may be derived as follows:

| | |
|---|---|
| Expenditures | $1,080,000 |
| Excess of encumbrances over expenditures | 42,000 |
| Encumbrances as of December 31, 20X4 | 1,300,000 |
| Total | $2,422,000 |

**CPA-04496 Type1 M/C A-I Corr Ans: A PM#77 F 8-99**

156. CPA-04496 ARE May 95 PR2 23 Page 3

**EDITOR'S NOTE: Appropriations, as used within the context of the CPA Exam, embrace budgeted expenditures as well as transfers.**


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The following information relates to Bel City, whose first fiscal year ended December 31, 20X4. Assume Bel has only the long-term debt specified in the information and only the funds necessitated by the information.

*1. General fund:*

- The following selected information is taken from Bel's 20X4 general fund financial records:

| | *Budget* | *Actual* |
|---|---|---|
| Property taxes | $5,000,000 | $4,700,000 |
| Other revenues | 1,000,000 | 1,050,000 |
| Total revenues | $6,000,000 | $5,750,000 |
| Total expenditures | $5,600,000 | $5,700,000 |
| Property taxes receivable - delinquent | | $ 420,000 |
| Less: Allowance for estimated uncollectible taxes - delinquent | | 50,000 |
| | | $ 370,000 |

- There were no amendments to the budget as originally adopted.
- No property taxes receivable have been written off, and the allowance for uncollectibles balance is unchanged from the initial entry at the time of the original tax levy.
- There were no encumbrances outstanding at December 31, 20X4.

*2. Capital project fund:*

- Finances for Bel's new civic center were provided by a combination of general fund transfers, a state grant, and an issue of general obligation bonds. Any bond premium on issuance is to be used for the repayment of the bonds at their $1,200,000 par value. At December 31, 20X4, the capital project fund for the civic center had the following closing entries:

| | | |
|---|---|---|
| Revenues | $ 800,000 | |
| Other financing sources - bond proceeds | 1,230,000 | |
| Other financing sources - transfers in | 500,000 | |
| Expenditures | | $1,080,000 |
| Other financing uses - transfers out | | 30,000 |
| Unreserved fund balance | | 1,420,000 |

- Also, at December 31, 20X4, capital project fund entries reflected Bel's intention to honor the $1,300,000 purchase orders and commitments outstanding for the center.
- During 20X4, total capital project fund encumbrances exceeded the corresponding expenditures by $42,000. All expenditures were previously encumbered.
- During 20X5, the capital project fund received no revenues and no other financing sources. The civic center building was completed in early 20X5 and the capital project fund was closed by a transfer of $27,000 to the general fund.

*3. Water utility enterprise fund:*

- Bel issued $4,000,000 revenue bonds at par. These bonds, together with a $700,000 transfer from the general fund, were used to acquire a water utility with total assets of $4.7 million. Water utility revenues are expected to be 20% of total assets and are to be the sole source of funds to retire these bonds beginning in year 20X9.

This question relates to Bel's funds other than the general fund. Determine the amount.

- In the capital project fund, what was the unreserved fund balance reported at December 31, 20X4?

A. $120,000
B. $450,000
C. $800,000
D. $1,000,000
E. $1,200,000
F. $2,000,000


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G. $2,422,000
H. $2,473,000
I. $2,565,000

**CPA-04496 Explanation**
**Choice "A" is correct. $120,000.** The unreserved fund balance is the $1,420,000 shown in the closing entry less the $1,300,000 reserved for the outstanding purchase orders and commitments.

*Note*: The year-end encumbrances and corresponding reserve for encumbrances should have been shown in the closing entry. The fact pattern indicates that the fund balance has been encumbered for $1,300,000.

**CPA-04497 Type1 M/C A-C Corr Ans: A PM#78 F 8-99**

157. CPA-04497 ARE May 96 PR2 1 Page 3

The following selected information is taken from Shar City's general fund statement of revenues, expenditures, and changes in fund balance for the year ended December 31, 20X5:

The following selected information is taken from Shar City's general fund statement of revenues, expenditures, and changes in fund balance for the year ended December 31, 20X5:

| | |
|---|---|
| Revenues | |
| Property taxes - 20X5 | $ 825,000 |
| Expenditures - 20X5 | $1,349,000 |
| Expenditures - 20X4 | 56,000 |
| Expenditures | |
| Current services | |
| Public safety | 428,000 |
| Capital outlay (police vehicles) | 100,000 |
| Debt service | 74,000 |
| Expenditures | $1,405,000 |
| Excess of revenues over expenditures | $ 153,000 |
| Other financing uses | (125,000) |
| Excess of revenues over expenditures and other financing uses | $ 28,000 |
| Decrease in reserve for encumbrances during 20X5 | 15,000 |
| Capital contributions to other funds | (190,000) |
| Decrease in unreserved fund balance during 20X5 | $ (147,000) |
| Unreserved fund balance January 1, 20X5 | 304,000 |
| Unreserved fund balance December 31, 20X5 | $ 157,000 |

The following selected information is taken from Shar's December 31, 20X5, general fund balance sheet:

| | |
|---|---|
| Property taxes receivable - delinquent - 20X5 | $ 34,000 |
| Allowance for estimated uncollectible taxes-delinquent | 20,000 |
| Vouchers payable | $ 89,000 |
| Fund balance - | |
| reserved for encumbrances - 20X5 | 43,000 |
| reserved for supplies inventory | 38,000 |
| unreserved | 157,000 |

**Additional Information:**

- Debt service was for bonds used to finance a library building and included interest of $22,000.
- $8,000 of 20X5 property taxes receivable were written off; otherwise the allowance for uncollectible taxes balance is unchanged from the initial entry at the time of the original tax levy at the beginning of the year.


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- Shar reported supplies inventory of $21,000 at December 31, 20X4.

**Additional Information:**

- Debt service was for bonds used to finance a library building and included interest of $22,000.
- $8,000 of 20X5 property taxes receivable were written off; otherwise the allowance for uncollectible taxes balance is unchanged from the initial entry at the time of the original tax levy at the beginning of the year.
- Shar reported supplies inventory of $21,000 at December 31, 20X4.

For this question indicate the type of classification used by Shar according to the item's classification:

- Expenditures - current services.

A. Character.
B. Function.
C. Object.

**CPA-04497 Explanation**
**Choice "A" is correct**. Classification of expenditures by character refers to the fiscal year that will benefit from the expenditure. Current services is such a character, benefiting the current period.

**CPA-04498 Type1 M/C A-C Corr Ans: A PM#79 F 8-99**

158. CPA-04498 ARE May 96 PR2 2 Page 3

The following selected information is taken from Shar City's general fund statement of revenues, expenditures, and changes in fund balance for the year ended December 31, 20X5:

| | |
|---|---|
| Revenues | |
| Property taxes - 20X5 | $ 825,000 |
| Expenditures - 20X5 | $1,349,000 |
| Expenditures - 20X4 | 56,000 |
| Expenditures | |
| Current services | |
| Public safety | 428,000 |
| Capital outlay (police vehicles) | 100,000 |
| Debt service | 74,000 |
| Expenditures | $1,405,000 |
| Excess of revenues over expenditures | $ 153,000 |
| Other financing uses | (125,000) |
| Excess of revenues over expenditures and other financing uses | $ 28,000 |
| Decrease in reserve for encumbrances during 20X5 | 15,000 |
| Capital contributions to other funds | (190,000) |
| Decrease in unreserved fund balance during 20X5 | $ (147,000) |
| Unreserved fund balance January 1, 20X5 | 304,000 |
| Unreserved fund balance December 31, 20X5 | $ 157,000 |

The following selected information is taken from Shar's December 31, 20X5, general fund balance sheet:

| | |
|---|---|
| Property taxes receivable - delinquent - 20X5 | $ 34,000 |
| Allowance for estimated uncollectible taxes-delinquent | 20,000 |
| Vouchers payable | $ 89,000 |
| Fund balance - | |
| reserved for encumbrances - 20X5 | 43,000 |
| reserved for supplies inventory | 38,000 |
| unreserved | 157,000 |


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**Additional Information:**

- Debt service was for bonds used to finance a library building and included interest of $22,000.
- $8,000 of 20X5 property taxes receivable were written off; otherwise the allowance for uncollectible taxes balance is unchanged from the initial entry at the time of the original tax levy at the beginning of the year.
- Shar reported supplies inventory of $21,000 at December 31, 20X4.

For this question indicate the type of classification used by Shar according to the item's classification:

- Expenditures - capital outlay.

A. Character.
B. Function.
C. Object.

**CPA-04498 Explanation**
**Choice "A" is correct.** Classification of expenditures by character refers to the fiscal year that will benefit from the expenditure. Capital outlay is such a character, benefiting current and future periods.

**CPA-04499 Type1 M/C A-C Corr Ans: B PM#80 F 8-99**

159. CPA-04499 ARE May 96 PR2 3 Page 3

The following selected information is taken from Shar City's general fund statement of revenues, expenditures, and changes in fund balance for the year ended December 31, 20X5:

| | |
|---|---|
| Revenues | |
| Property taxes - 20X5 | $ 825,000 |
| Expenditures - 20X5 | $1,349,000 |
| Expenditures - 20X4 | 56,000 |
| Expenditures | |
| Current services | |
| Public safety | 428,000 |
| Capital outlay (police vehicles) | 100,000 |
| Debt service | 74,000 |
| Expenditures | $1,405,000 |
| Excess of revenues over expenditures | $ 153,000 |
| Other financing uses | (125,000) |
| Excess of revenues over expenditures and other financing uses | $ 28,000 |
| Decrease in reserve for encumbrances during 20X5 | 15,000 |
| Capital contributions to other funds | (190,000) |
| Decrease in unreserved fund balance during 20X5 | $ (147,000) |
| Unreserved fund balance January 1, 20X5 | 304,000 |
| Unreserved fund balance December 31, 20X5 | $ 157,000 |

The following selected information is taken from Shar's December 31, 20X5, general fund balance sheet:

| | |
|---|---|
| Property taxes receivable - delinquent - 20X5 | $ 34,000 |
| Allowance for estimated uncollectible taxes-delinquent | 20,000 |
| Vouchers payable | $ 89,000 |
| Fund balance - | |
| reserved for encumbrances - 20X5 | 43,000 |
| reserved for supplies inventory | 38,000 |
| unreserved | 157,000 |

**Additional Information:**


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- Debt service was for bonds used to finance a library building and included interest of $22,000.
- $8,000 of 20X5 property taxes receivable were written off; otherwise the allowance for uncollectible taxes balance is unchanged from the initial entry at the time of the original tax levy at the beginning of the year.
- Shar reported supplies inventory of $21,000 at December 31, 20X4.

For this question indicate the type of classification used by Shar according to the item's classification:

- Expenditures - health.

A. Character.
B. Function.
C. Object.

**CPA-04499 Explanation**
**Choice "B" is correct.** Classification of expenditures by function refers to the major services of the governmental unit. Health is a major service area.

**CPA-04500 Type1 M/C A-C Corr Ans: B PM#81 F 8-99**

160. CPA-04500 ARE May 96 PR2 4 Page 3

The following selected information is taken from Shar City's general fund statement of revenues, expenditures, and changes in fund balance for the year ended December 31, 20X5:

| | |
|---|---|
| Revenues | |
| Property taxes - 20X5 | $ 825,000 |
| Expenditures - 20X5 | $1,349,000 |
| Expenditures - 20X4 | 56,000 |
| Expenditures | |
| Current services | |
| Public safety | 428,000 |
| Capital outlay (police vehicles) | 100,000 |
| Debt service | 74,000 |
| Expenditures | $1,405,000 |
| Excess of revenues over expenditures | $ 153,000 |
| Other financing uses | (125,000) |
| Excess of revenues over expenditures and other financing uses | $ 28,000 |
| Decrease in reserve for encumbrances during 20X5 | 15,000 |
| Capital contributions to other funds | (190,000) |
| Decrease in unreserved fund balance during 20X5 | $ (147,000) |
| Unreserved fund balance January 1, 20X5 | 304,000 |
| Unreserved fund balance December 31, 20X5 | $ 157,000 |

The following selected information is taken from Shar's December 31, 20X5, general fund balance sheet:

| | |
|---|---|
| Property taxes receivable - delinquent - 20X5 | $ 34,000 |
| Allowance for estimated uncollectible taxes-delinquent | 20,000 |
| Vouchers payable | $ 89,000 |
| Fund balance - | |
| reserved for encumbrances - 20X5 | 43,000 |
| reserved for supplies inventory | 38,000 |
| unreserved | 157,000 |

**Additional Information:**

- Debt service was for bonds used to finance a library building and included interest of $22,000.


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- $8,000 of 20X5 property taxes receivable were written off; otherwise the allowance for uncollectible taxes balance is unchanged from the initial entry at the time of the original tax levy at the beginning of the year.
- Shar reported supplies inventory of $21,000 at December 31, 20X4. Inventory accounts are adjusted once per year.

What recording method did Shar use for its general fund supplies inventory?

A. Consumption.
B. Purchase.
C. Perpetual inventory.

**CPA-04500 Explanation**
**Choice "B" is correct.** Shar uses the purchases method of recording supplies. Supplies are recorded as an expenditure when purchased, then at year-end an adjustment is made for supplies on hand:

| | | |
|---|---|---|
| Supplies Inventory | XXX | |
| Reserved for supplies inventory | | XXX |

**CPA-04501 Type1 M/C A-C Corr Ans: B PM#82 F 8-99**

161. CPA-04501 ARE May 96 PR2 5 Page 3

The following selected information is taken from Shar City's general fund statement of revenues, expenditures, and changes in fund balance for the year ended December 31, 20X5:

| | |
|---|---|
| Revenues | |
| Property taxes - 20X5 | $ 825,000 |
| Expenditures - 20X5 | $1,349,000 |
| Expenditures - 20X4 | 56,000 |
| Expenditures | |
| Current services | |
| Public safety | 428,000 |
| Capital outlay (police vehicles) | 100,000 |
| Debt service | 74,000 |
| Expenditures | $1,405,000 |
| Excess of revenues over expenditures | $ 153,000 |
| Other financing uses | (125,000) |
| Excess of revenues over expenditures and other financing uses | $ 28,000 |
| Decrease in reserve for encumbrances during 20X5 | 15,000 |
| Capital contributions to other funds | (190,000) |
| Decrease in unreserved fund balance during 20X5 | $ (147,000) |
| Unreserved fund balance January 1, 20X5 | 304,000 |
| Unreserved fund balance December 31, 20X5 | $ 157,000 |

The following selected information is taken from Shar's December 31, 20X5, general fund balance sheet:

| | |
|---|---|
| Property taxes receivable - delinquent - 20X5 | $ 34,000 |
| Allowance for estimated uncollectible taxes-delinquent | 20,000 |
| Vouchers payable | $ 89,000 |
| Fund balance - | |
| reserved for encumbrances - 20X5 | 43,000 |
| reserved for supplies inventory | 38,000 |
| unreserved | 157,000 |

**Additional Information:**

- Debt service was for bonds used to finance a library building and included interest of $22,000.


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- $8,000 of 20X5 property taxes receivable were written off; otherwise the allowance for uncollectible taxes balance is unchanged from the initial entry at the time of the original tax levy at the beginning of the year.
- Shar reported supplies inventory of $21,000 at December 31, 20X4.

How should fund equity be reported in Shar's electric utility enterprise fund?

A. A single amount described as net assets.
B. Separately for various classifications of net assets.
C. Separately for amount due to general fund and retained income.

**CPA-04501 Explanation**
**Choice "B" is correct.** Fund equity for an enterprise fund consists of net assets classified as unrestricted, restricted or invested in capital assets net of related liabilities.

**CPA-04502 Type1 M/C A-C Corr Ans: A PM#83 F 8-99**

162. CPA-04502 ARE May 96 PR2 6 Page 3

The following selected information is taken from Shar City's general fund statement of revenues, expenditures, and changes in fund balance for the year ended December 31, 20X5:

| | |
|---|---|
| Revenues | |
| Property taxes - 20X5 | $ 825,000 |
| Expenditures - 20X5 | $1,349,000 |
| Expenditures - 20X4 | 56,000 |
| Expenditures | |
| Current services | |
| Public safety | 428,000 |
| Capital outlay (police vehicles) | 100,000 |
| Debt service | 74,000 |
| Expenditures | $1,405,000 |
| Excess of revenues over expenditures | $ 153,000 |
| Other financing uses | (125,000) |
| Excess of revenues over expenditures and other financing uses | $ 28,000 |
| Decrease in reserve for encumbrances during 20X5 | 15,000 |
| Capital contributions to other funds | (190,000) |
| Decrease in unreserved fund balance during 20X5 | $ (147,000) |
| Unreserved fund balance January 1, 20X5 | 304,000 |
| Unreserved fund balance December 31, 20X5 | $ 157,000 |

The following selected information is taken from Shar's December 31, 20X5, general fund balance sheet:

| | |
|---|---|
| Property taxes receivable - delinquent - 20X5 | $ 34,000 |
| Allowance for estimated uncollectible taxes-delinquent | 20,000 |
| Vouchers payable | $ 89,000 |
| Fund balance - | |
| reserved for encumbrances - 20X5 | 43,000 |
| reserved for supplies inventory | 38,000 |
| unreserved | 157,000 |

**Additional Information:**

- Debt service was for bonds used to finance a library building and included interest of $22,000.
- $8,000 of 20X5 property taxes receivable were written off; otherwise the allowance for uncollectible taxes balance is unchanged from the initial entry at the time of the original tax levy at the beginning of the year.


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- Shar reported supplies inventory of $21,000 at December 31, 20X4.

Shar's electric utility enterprise fund borrowed $1,000,000 subject to Shar's general guarantee. Where should the liability be reported?

A. The electric utility enterprise fund.
B. The general long-term debt account group.
C. Both the electric utility enterprise fund and the general long-term liabilities in the governmental activities column of the government wide financial statements.

**CPA-04502 Explanation**
**Choice "A" is correct.** A liability of an enterprise fund is recognized within that fund. It would be reported on the balance sheet of the enterprise as a current and/or long-term liability.

**CPA-04503 Type1 M/C A-E Corr Ans: A PM#84 F 8-99**

163. CPA-04503 ARE May 96 PR2 7 Page 3

The following selected information is taken from Shar City's general fund statement of revenues, expenditures, and changes in fund balance for the year ended December 31, 20X5:

| | |
|---|---|
| Revenues | |
| Property taxes - 20X5 | $ 825,000 |
| Expenditures - 20X5 | $1,349,000 |
| Expenditures - 20X4 | 56,000 |
| Expenditures | |
| Current services | |
| Public safety | 428,000 |
| Capital outlay (police vehicles) | 100,000 |
| Debt service | 74,000 |
| Expenditures | $1,405,000 |
| Excess of revenues over expenditures | $ 153,000 |
| Other financing uses | (125,000) |
| Excess of revenues over expenditures and other financing uses | $ 28,000 |
| Decrease in reserve for encumbrances during 20X5 | 15,000 |
| Capital contributions to other funds | (190,000) |
| Decrease in unreserved fund balance during 20X5 | $ (147,000) |
| Unreserved fund balance January 1, 20X5 | 304,000 |
| Unreserved fund balance December 31, 20X5 | $ 157,000 |

The following selected information is taken from Shar's December 31, 20X5, general fund balance sheet:

| | |
|---|---|
| Property taxes receivable - delinquent - 20X5 | $ 34,000 |
| Allowance for estimated uncollectible taxes-delinquent | 20,000 |
| Vouchers payable | $ 89,000 |
| Fund balance - | |
| reserved for encumbrances - 20X5 | 43,000 |
| reserved for supplies inventory | 38,000 |
| unreserved | 157,000 |

**Additional Information:**

- Debt service was for bonds used to finance a library building and included interest of $22,000.
- $8,000 of 20X5 property taxes receivable were written off; otherwise the allowance for uncollectible taxes balance is unchanged from the initial entry at the time of the original tax levy at the beginning of the year.
- Shar reported supplies inventory of $21,000 at December 31, 20X4.


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Indicate the part of Shar's general fund statement of revenues, expenditures, and changes in fund balance affected by the transaction.

- An unrestricted state grant is received.

A. Revenues.
B. Expenditures.
C. Other financing sources and uses.
D. Residual equity transfers.
E. Statement of revenues, expenditures, and changes in fund balance is not affected.

**CPA-04503 Explanation**
**Choice "A" is correct.** An unrestricted state grant is reported as a revenue in the general fund's statement of revenue, expenditures, and changes in fund balance.

**CPA-04504 Type1 M/C A-E Corr Ans: E PM#85 F 8-99**

164. CPA-04504 ARE May 96 PR2 8 Page 3

The following selected information is taken from Shar City's general fund statement of revenues, expenditures, and changes in fund balance for the year ended December 31, 20X5:

| | |
|---|---|
| Revenues | |
| Property taxes - 20X5 | $ 825,000 |
| Expenditures - 20X5 | $ 1,349,000 |
| Expenditures - 20X4 | 56,000 |
| Expenditures | |
| Current services | |
| Public safety | 428,000 |
| Capital outlay (police vehicles) | 100,000 |
| Debt service | 74,000 |
| Expenditures | $ 1,405,000 |
| Excess of revenues over expenditures | $ 153,000 |
| Other financing uses | (125,000) |
| Excess of revenues over expenditures and other financing uses | $ 28,000 |
| Decrease in reserve for encumbrances during 20X5 | 15,000 |
| Capital contributions to other funds | (190,000) |
| Decrease in unreserved fund balance during 20X5 | $ (147,000) |
| Unreserved fund balance January 1, 20X5 | 304,000 |
| Unreserved fund balance December 31, 20X5 | $ 157,000 |

The following selected information is taken from Shar's December 31, 20X5, general fund balance sheet:

| | |
|---|---|
| Property taxes receivable - delinquent - 20X5 | $ 34,000 |
| Allowance for estimated uncollectible taxes-delinquent | 20,000 |
| Vouchers payable | $ 89,000 |
| Fund balance - | |
| reserved for encumbrances - 20X5 | 43,000 |
| reserved for supplies inventory | 38,000 |
| unreserved | 157,000 |

**Additional Information:**

- Debt service was for bonds used to finance a library building and included interest of $22,000.


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- $8,000 of 20X5 property taxes receivable were written off; otherwise the allowance for uncollectible taxes balance is unchanged from the initial entry at the time of the original tax levy at the beginning of the year.
- Shar reported supplies inventory of $21,000 at December 31, 20X4.

Indicate the part of Shar's general fund statement of revenues, expenditures, and changes in fund balance affected by the transaction.

- The general fund paid pension fund contributions that were recoverable from an internal service fund.

A. Revenues.
B. Expenditures.
C. Other financing sources and uses.
D. Residual equity transfers.
E. Statement of revenues, expenditures, and changes in fund balance is not affected.

**CPA-04504 Explanation**
**Choice "E" is correct.** If the general fund paid expenditures on behalf of another fund, it simply would be reported on the general fund's balance sheet as a "due from." It would not affect the general fund's statement of revenue, expenditures, and changes in fund balance.

**CPA-04505 Type1 M/C A-E Corr Ans: B PM#86 F 8-99**

165. CPA-04505 ARE May 96 PR2 9 Page 3

The following selected information is taken from Shar City's general fund statement of revenues, expenditures, and changes in fund balance for the year ended December 31, 20X5:

| | |
|---|---|
| Revenues | |
| Property taxes - 20X5 | $ 825,000 |
| Expenditures - 20X5 | $1,349,000 |
| Expenditures - 20X4 | 56,000 |
| Expenditures | |
| Current services | |
| Public safety | 428,000 |
| Capital outlay (police vehicles) | 100,000 |
| Debt service | 74,000 |
| Expenditures | $1,405,000 |
| Excess of revenues over expenditures | $ 153,000 |
| Other financing uses | (125,000) |
| Excess of revenues over expenditures and other financing uses | $ 28,000 |
| Decrease in reserve for encumbrances during 20X5 | 15,000 |
| Capital contributions to other funds | (190,000) |
| Decrease in unreserved fund balance during 20X5 | $ (147,000) |
| Unreserved fund balance January 1, 20X5 | 304,000 |
| Unreserved fund balance December 31, 20X5 | $ 157,000 |

The following selected information is taken from Shar's December 31, 20X5, general fund balance sheet:

| | |
|---|---|
| Property taxes receivable - delinquent - 20X5 | $ 34,000 |
| Allowance for estimated uncollectible taxes-delinquent | 20,000 |
| Vouchers payable | $ 89,000 |
| Fund balance - | |
| reserved for encumbrances - 20X5 | 43,000 |
| reserved for supplies inventory | 38,000 |
| unreserved | 157,000 |


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**Additional Information:**

- Debt service was for bonds used to finance a library building and included interest of $22,000.
- $8,000 of 20X5 property taxes receivable were written off; otherwise the allowance for uncollectible taxes balance is unchanged from the initial entry at the time of the original tax levy at the beginning of the year.
- Shar reported supplies inventory of $21,000 at December 31, 20X4.

Indicate the part of Shar's general fund statement of revenues, expenditures, and changes in fund balance affected by the transaction.

- The general fund paid $60,000 for electricity supplied by Shar's electric utility enterprise fund.

A. Revenues.
B. Expenditures.
C. Other financing sources and uses.
D. Residual equity transfers.
E. Statement of revenues, expenditures, and changes in fund balance is not affected.

**CPA-04505 Explanation**
**Choice "B" is correct.** An expenditure for electricity, even though to an enterprise fund, is reported as an expenditure in the general fund's statement of revenue, expenditures, and changes in fund balance.

**CPA-04506 Type1 M/C A-E Corr Ans: C PM#87 F 8-99**

166. CPA-04506 ARE May 96 PR2 10 Page 3

The following selected information is taken from Shar City's general fund statement of revenues, expenditures, and changes in fund balance for the year ended December 31, 20X5:

| | |
|---|---|
| Revenues | |
| Property taxes - 20X5 | $ 825,000 |
| Expenditures - 20X5 | $1,349,000 |
| Expenditures - 20X4 | 56,000 |
| Expenditures | |
| Current services | |
| Public safety | 428,000 |
| Capital outlay (police vehicles) | 100,000 |
| Debt service | 74,000 |
| Expenditures | $1,405,000 |
| Excess of revenues over expenditures | $ 153,000 |
| Other financing uses | (125,000) |
| Excess of revenues over expenditures and other financing uses | $ 28,000 |
| Decrease in reserve for encumbrances during 20X5 | 15,000 |
| Capital contributions to other funds | (190,000) |
| Decrease in unreserved fund balance during 20X5 | $ (147,000) |
| Unreserved fund balance January 1, 20X5 | 304,000 |
| Unreserved fund balance December 31, 20X5 | $ 157,000 |

The following selected information is taken from Shar's December 31, 20X5, general fund balance sheet:

| | |
|---|---|
| Property taxes receivable - delinquent - 20X5 | $ 34,000 |
| Allowance for estimated uncollectible taxes-delinquent | 20,000 |
| Vouchers payable | $ 89,000 |
| Fund balance - | |
| reserved for encumbrances - 20X5 | 43,000 |


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| | |
|---|---|
| reserved for supplies inventory | 38,000 |
| unreserved | 157,000 |

**Additional Information:**

- Debt service was for bonds used to finance a library building and included interest of $22,000.
- $8,000 of 20X5 property taxes receivable were written off; otherwise the allowance for uncollectible taxes balance is unchanged from the initial entry at the time of the original tax levy at the beginning of the year.
- Shar reported supplies inventory of $21,000 at December 31, 20X4.

Indicate the part of Shar's general fund statement of revenues, expenditures, and changes in fund balance affected by the transaction.

- General fund resources were used to subsidize Shar's swimming pool enterprise fund.

A. Revenues.
B. Expenditures.
C. Other financing sources and uses.
D. Residual equity transfers.
E. Statement of revenues, expenditures, and changes in fund balance is not affected.

**CPA-04506 Explanation**
**Choice "C" is correct.** Operating subsidy transfers from the general fund to a proprietary fund are called transfers. A transfer from the general fund to another fund is reported as other financing sources in the general fund's statement of revenue, expenditures, and changes in fund balance and as a transfer in the enterprise's statement of revenues and expenses, and changes in net assets. Note that this is not a loan but a transfer.

**CPA-04507 Type1 M/C A-E Corr Ans: E PM#88 F 8-99**

167. CPA-04507 ARE May 96 PR2 11 Page 3

The following selected information is taken from Shar City's general fund statement of revenues, expenditures, and changes in fund balance for the year ended December 31, 20X5:

| | |
|---|---|
| Revenues | |
| Property taxes - 20X5 | $ 825,000 |
| Expenditures - 20X5 | $1,349,000 |
| Expenditures - 20X4 | 56,000 |
| Expenditures | |
| Current services | |
| Public safety | 428,000 |
| Capital outlay (police vehicles) | 100,000 |
| Debt service | 74,000 |
| Expenditures | $1,405,000 |
| Excess of revenues over expenditures | $ 153,000 |
| Other financing uses | (125,000) |
| Excess of revenues over expenditures and other financing uses | $ 28,000 |
| Decrease in reserve for encumbrances during 20X5 | 15,000 |
| Capital contributions to other funds | (190,000) |
| Decrease in unreserved fund balance during 20X5 | $ (147,000) |
| Unreserved fund balance January 1, 20X5 | 304,000 |
| Unreserved fund balance December 31, 20X5 | $ 157,000 |

The following selected information is taken from Shar's December 31, 20X5, general fund balance sheet:

| | |
|---|---|
| Property taxes receivable - delinquent - 20X5 | $ 34,000 |


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| | |
|---|---|
| Allowance for estimated uncollectible taxes-delinquent | 20,000 |
| Vouchers payable | $ 89,000 |
| Fund balance - | |
| reserved for encumbrances - 20X5 | 43,000 |
| reserved for supplies inventory | 38,000 |
| unreserved | 157,000 |

**Additional Information:**

- Debt service was for bonds used to finance a library building and included interest of $22,000.
- $8,000 of 20X5 property taxes receivable were written off; otherwise the allowance for uncollectible taxes balance is unchanged from the initial entry at the time of the original tax levy at the beginning of the year.
- Shar reported supplies inventory of $21,000 at December 31, 20X4.

Indicate the part of Shar's general fund statement of revenues, expenditures, and changes in fund balance affected by the transaction.

- $90,000 of general fund resources were loaned to an internal service fund.

A. Revenues.
B. Expenditures.
C. Other financing sources and uses.
D. Residual equity transfers.
E. Statement of revenues, expenditures, and changes in fund balance is not affected.

**CPA-04507 Explanation**
**Choice "E" is correct.** If the general fund loaned resources to another fund, it simply would be reported on the general fund's balance sheet as a "due from." It would not affect the general fund's statement of revenue, expenditures, and changes in fund balance.

**CPA-04508 Type1 M/C A-E Corr Ans: C PM#89 F 8-99**

168. CPA-04508 ARE May 96 PR2 12 Page 3

The following selected information is taken from Shar City's general fund statement of revenues, expenditures, and changes in fund balance for the year ended December 31, 20X5:

| | |
|---|---|
| Revenues | |
| Property taxes - 20X5 | $ 825,000 |
| Expenditures - 20X5 | $1,349,000 |
| Expenditures - 20X4 | 56,000 |
| Expenditures | |
| Current services | |
| Public safety | 428,000 |
| Capital outlay (police vehicles) | 100,000 |
| Debt service | 74,000 |
| Expenditures | $1,405,000 |
| Excess of revenues over expenditures | $ 153,000 |
| Other financing uses | (125,000) |
| Excess of revenues over expenditures and other financing uses | $ 28,000 |
| Decrease in reserve for encumbrances during 20X5 | 15,000 |
| Capital contributions to other funds | (190,000) |
| Decrease in unreserved fund balance during 20X5 | $ (147,000) |
| Unreserved fund balance January 1, 20X5 | 304,000 |
| Unreserved fund balance December 31, 20X5 | $ 157,000 |


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The following selected information is taken from Shar's December 31, 20X5, general fund balance sheet:

| | |
|---|---|
| Property taxes receivable - delinquent - 20X5 | $ 34,000 |
| Allowance for estimated uncollectible taxes-delinquent | 20,000 |
| Vouchers payable | $ 89,000 |
| Fund balance - | |
| reserved for encumbrances - 20X5 | 43,000 |
| reserved for supplies inventory | 38,000 |
| unreserved | 157,000 |

**Additional Information:**

- Debt service was for bonds used to finance a library building and included interest of $22,000.
- $8,000 of 20X5 property taxes receivable were written off; otherwise the allowance for uncollectible taxes balance is unchanged from the initial entry at the time of the original tax levy at the beginning of the year.
- Shar reported supplies inventory of $21,000 at December 31, 20X4.

Indicate the part of Shar's general fund statement of revenues, expenditures, and changes in fund balance affected by the transaction.

- A motor pool internal service fund was established by a transfer of $80,000 from the general fund. This amount will not be repaid unless the motor pool is disbanded.

A. Revenues.
B. Expenditures.
C. Other financing sources and uses.
D. Residual equity transfers.
E. Statement of revenues, expenditures, and changes in fund balance is not affected.

**CPA-04508 Explanation**
**Choice "C" is correct.** This transfer is a nonrecurring or nonroutine transfer of equity between funds. Transfers are classified as "Other Financing Sources and Uses" regardless of whether they are recurring or nonrecurring. Prior to issuance of GASB #34, transfers between funds were identified by type. Nonrecurring transfers of equity would have been classified as a residual equity transfer. The term residual equity transfer is no longer recognized in the professional literature.

**CPA-04509 Type1 M/C A-E Corr Ans: B PM#90 F 8-99**

169. CPA-04509 ARE May 96 PR2 13 Page 3

The following selected information is taken from Shar City's general fund statement of revenues, expenditures, and changes in fund balance for the year ended December 31, 20X5:

| | |
|---|---|
| Revenues | |
| Property taxes - 20X5 | $ 825,000 |
| Expenditures - 20X5 | $1,349,000 |
| Expenditures - 20X4 | 56,000 |
| Expenditures | |
| Current services | |
| Public safety | 428,000 |
| Capital outlay (police vehicles) | 100,000 |
| Debt service | 74,000 |
| Expenditures | $1,405,000 |
| Excess of revenues over expenditures | $ 153,000 |
| Other financing uses | (125,000) |


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| | |
|---|---|
| Excess of revenues over expenditures and other financing uses | $ 28,000 |
| Decrease in reserve for encumbrances during 20X5 | 15,000 |
| Capital contributions to other funds | (190,000) |
| Decrease in unreserved fund balance during 20X5 | $ (147,000) |
| Unreserved fund balance January 1, 20X5 | 304,000 |
| Unreserved fund balance December 31, 20X5 | $ 157,000 |

The following selected information is taken from Shar's December 31, 20X5, general fund balance sheet:

| | |
|---|---|
| Property taxes receivable - delinquent - 20X5 | $ 34,000 |
| Allowance for estimated uncollectible taxes-delinquent | 20,000 |
| Vouchers payable | $ 89,000 |
| Fund balance - | |
| reserved for encumbrances - 20X5 | 43,000 |
| reserved for supplies inventory | 38,000 |
| unreserved | 157,000 |

**Additional Information:**

- Debt service was for bonds used to finance a library building and included interest of $22,000.
- $8,000 of 20X5 property taxes receivable were written off; otherwise the allowance for uncollectible taxes balance is unchanged from the initial entry at the time of the original tax levy at the beginning of the year.
- Shar reported supplies inventory of $21,000 at December 31, 20X4.

Indicate the part of Shar's general fund statement of revenues, expenditures, and changes in fund balance affected by the transaction.

- General fund resources were used to pay amounts due on an operating lease.

A. Revenues.
B. Expenditures.
C. Other financing sources and uses.
D. Residual equity transfers.
E. Statement of revenues, expenditures, and changes in fund balance is not affected.

**CPA-04509 Explanation**
**Choice "B" is correct.** Operating lease payments are reported as expenditures in the general fund's statement of revenue, expenditures, and changes in fund balance.

**CPA-04510 Type1 M/C A-L Corr Ans: D PM#91 F 8-99**

170. CPA-04510 ARE May 96 PR2 14 Page 3

The following selected information is taken from Shar City's general fund statement of revenues, expenditures, and changes in fund balance for the year ended December 31, 20X5:

| | |
|---|---|
| Revenues | |
| Property taxes - 20X5 | $ 825,000 |
| Expenditures - 20X5 | $ 1,349,000 |
| Expenditures - 20X4 | 56,000 |
| Expenditures | |
| Current services | |
| Public safety | 428,000 |
| Capital outlay (police vehicles) | 100,000 |
| Debt service | 74,000 |
| Expenditures | $ 1,405,000 |


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| | |
|---|---|
| Excess of revenues over expenditures | $ 153,000 |
| Other financing uses | (125,000) |
| Excess of revenues over expenditures and other financing uses | $ 28,000 |
| Decrease in reserve for encumbrances during 20X5 | 15,000 |
| Capital contributions to other funds | (190,000) |
| Decrease in unreserved fund balance during 20X5 | $ (147,000) |
| Unreserved fund balance January 1, 20X5 | 304,000 |
| Unreserved fund balance December 31, 20X5 | $ 157,000 |

The following selected information is taken from Shar's December 31, 20X5, general fund balance sheet:

| | |
|---|---|
| Property taxes receivable - delinquent - 20X5 | $ 34,000 |
| Allowance for estimated uncollectible taxes-delinquent | 20,000 |
| Vouchers payable | $ 89,000 |
| Fund balance - | |
| reserved for encumbrances - 20X5 | 43,000 |
| reserved for supplies inventory | 38,000 |
| unreserved | 157,000 |

**Additional Information:**

- Debt service was for bonds used to finance a library building and included interest of $22,000.
- $8,000 of 20X5 property taxes receivable were written off; otherwise the allowance for uncollectible taxes balance is unchanged from the initial entry at the time of the original tax levy at the beginning of the year.
- Shar reported supplies inventory of $21,000 at December 31, 20X4.

For this item, calculate the numeric amount.

What was the reserved fund balance of the 20X4 general fund?

A. $25,000
B. $52,000
C. $75,000
D. $79,000
E. $89,000
F. $100,000
G. $250,000
H. $500,000
I. $800,000
J. $811,000
K. $1,000,000
L. $1,392,000

**CPA-04510 Explanation**
**Choice "D" is correct. $79,000.** The reserved fund balance in the general fund in 20X4 relates to reserves established for encumbrances and inventories.

Reserves for inventories for 20X4 are equal to the amount of inventory assets at the end of 20X4, an amount given as $21,000.

Encumbrances for 20X4 are not given. The problem gives data for 20X5 encumbrances and the changes in year-end encumbrance balances from 20X4 through 20X5 as part of the computation of unreserved fund balances at the end of 20X5. Candidates are required to squeeze the 20X4 ending balance in encumbrances by using the **BASE** mnemonic. The ending balance for 20X4 encumbrances is, by definition, the beginning balance for 20X5 encumbrances. The beginning balance, "**B**", is unknown. The additions and subtractions, "**A**" and "**S**", are given at $15,000. The ending balance, "**E**" is given at $43,000.


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Candidates must squeeze the beginning balance by adding the ending balance for 20X5 to the net reduction in encumbrances for the 20X5 fiscal year to arrive at the beginning balance for 20X4.

Reserved fund balance at December 31, 20X4 is computed as follows:

| | | |
|---|---|---|
| Reserved for ending inventories (20X4) | | $21,000 |
| "**B**"eginning balance of encumbrances | $58,000 | 58,000 |
| "**A**"dditions to encumbrances | | |
| "**S**"ubtractions from encumbrances | 15,000 | |
| "**E**"nding balance of encumbrances (20X5) | $43,000 | |
| **Reserved fund balances at 12/31/X4** | | **$79,000** |

**CPA-04511 Type1 M/C A-L Corr Ans: J PM#92 F 8-99**

171. CPA-04511 ARE May 96 PR2 15 Page 3

The following selected information is taken from Shar City's general fund statement of revenues, expenditures, and changes in fund balance for the year ended December 31, 20X5:

| | |
|---|---|
| Revenues | |
| Property taxes - 20X5 | $ 825,000 |
| Expenditures - 20X5 | $ 1,349,000 |
| Expenditures - 20X4 | 56,000 |
| Expenditures | |
| Current services | |
| Public safety | 428,000 |
| Capital outlay (police vehicles) | 100,000 |
| Debt service | 74,000 |
| Expenditures | $ 1,405,000 |
| Excess of revenues over expenditures | $ 153,000 |
| Other financing uses | (125,000) |
| Excess of revenues over expenditures and other financing uses | $ 28,000 |
| Decrease in reserve for encumbrances during 20X5 | 15,000 |
| Capital contributions to other funds | (190,000) |
| Decrease in unreserved fund balance during 20X5 | $ (147,000) |
| Unreserved fund balance January 1, 20X5 | 304,000 |
| Unreserved fund balance December 31, 20X5 | $ 157,000 |

The following selected information is taken from Shar's December 31, 20X5, general fund balance sheet:

| | |
|---|---|
| Property taxes receivable - delinquent - 20X5 | $ 34,000 |
| Allowance for estimated uncollectible taxes-delinquent | 20,000 |
| Vouchers payable | $ 89,000 |
| Fund balance - | |
| reserved for encumbrances - 20X5 | 43,000 |
| reserved for supplies inventory | 38,000 |
| unreserved | 157,000 |

**Additional Information:**

- Debt service was for bonds used to finance a library building and included interest of $22,000.
- $8,000 of 20X5 property taxes receivable were written off; otherwise the allowance for uncollectible taxes balance is unchanged from the initial entry at the time of the original tax levy at the beginning of the year.


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- Shar reported supplies inventory of $21,000 at December 31, 20X4.

For this item, calculate the numeric amount.

What amount was collected from 20X5 tax assessments?

A. $25,000
B. $52,000
C. $75,000
D. $79,000
E. $89,000
F. $100,000
G. $250,000
H. $500,000
I. $800,000
J. $811,000
K. $1,000,000
L. $1,392,000

**CPA-04511 Explanation**
**Choice "J" is correct. $811,000.** The amount collected from 20X5 tax assessments is calculated as:

| | |
|---|---|
| Revenues, property taxes - 20X5 | $825,000 |
| Allowance for estimated uncollectible taxes - delinquent | 20,000 |
| Property taxes receivable - delinquent | (34,000) |
| 20X5 tax assessments collected | $811,000 |

Remember that property tax revenue is recorded at net, receivables less allowance.

**CPA-04512 Type1 M/C A-L Corr Ans: E PM#93 F 8-99**

172. CPA-04512 ARE May 96 PR2 16 Page 3

The following selected information is taken from Shar City's general fund statement of revenues, expenditures, and changes in fund balance for the year ended December 31, 20X5:

| | |
|---|---|
| Revenues | |
| Property taxes - 20X5 | $ 825,000 |
| Expenditures - 20X5 | $ 1,349,000 |
| Expenditures - 20X4 | 56,000 |
| Expenditures | |
| Current services | |
| Public safety | 428,000 |
| Capital outlay (police vehicles) | 100,000 |
| Debt service | 74,000 |
| Expenditures | $ 1,405,000 |
| Excess of revenues over expenditures | $ 153,000 |
| Other financing uses | (125,000) |
| Excess of revenues over expenditures and other financing uses | $ 28,000 |
| Decrease in reserve for encumbrances during 20X5 | 15,000 |
| Capital contributions to other funds | (190,000) |
| Decrease in unreserved fund balance during 20X5 | $ (147,000) |
| Unreserved fund balance January 1, 20X5 | 304,000 |
| Unreserved fund balance December 31, 20X5 | $ 157,000 |

The following selected information is taken from Shar's December 31, 20X5, general fund balance sheet:

| | |
|---|---|
| Property taxes receivable - delinquent - 20X5 | $ 34,000 |
| Allowance for estimated uncollectible taxes-delinquent | 20,000 |


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| | |
|---|---|
| Vouchers payable | $ 89,000 |
| Fund balance - | |
| reserved for encumbrances - 20X5 | 43,000 |
| reserved for supplies inventory | 38,000 |
| unreserved | 157,000 |

**Additional Information:**

- Debt service was for bonds used to finance a library building and included interest of $22,000.
- $8,000 of 20X5 property taxes receivable were written off; otherwise the allowance for uncollectible taxes balance is unchanged from the initial entry at the time of the original tax levy at the beginning of the year.
- Shar reported supplies inventory of $21,000 at December 31, 20X4.

For this item, calculate the numeric amount.

What amount is Shar's liability to general fund vendors and contractors at December 31, 20X5?

A. $25,000
B. $52,000
C. $75,000
D. $79,000
E. $89,000
F. $100,000
G. $250,000
H. $500,000
I. $800,000
J. $811,000
K. $1,000,000
L. $1,392,000

**CPA-04512 Explanation**
**Choice "E" is correct. $89,000.** Shar's liability to general fund vendors and contractors at December 31, 20X5, is the balance in the vouchers payable account as of that date, $89,000.

**CPA-04513 Type1 M/C A-L Corr Ans: F PM#94 F 8-99**

173. CPA-04513 ARE May 96 PR2 17 Page 3

The following selected information is taken from Shar City's general fund statement of revenues, expenditures, and changes in fund balance for the year ended December 31, 20X5:

| | |
|---|---|
| Revenues | |
| Property taxes - 20X5 | $ 825,000 |
| Expenditures - 20X5 | $ 1,349,000 |
| Expenditures - 20X4 | 56,000 |
| Expenditures | |
| Current services | |
| Public safety | 428,000 |
| Capital outlay (police vehicles) | 100,000 |
| Debt service | 74,000 |
| Expenditures | $ 1,405,000 |
| Excess of revenues over expenditures | $ 153,000 |
| Other financing uses | (125,000) |
| Excess of revenues over expenditures and other financing uses | $ 28,000 |
| Decrease in reserve for encumbrances during 20X5 | 15,000 |


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| | |
|---|---|
| Capital contributions to other funds | (190,000) |
| Decrease in unreserved fund balance during 20X5 | $ (147,000) |
| Unreserved fund balance January 1, 20X5 | 304,000 |
| Unreserved fund balance December 31, 20X5 | $ 157,000 |

The following selected information is taken from Shar's December 31, 20X5, general fund balance sheet:

| | |
|---|---|
| Property taxes receivable - delinquent - 20X5 | $ 34,000 |
| Allowance for estimated uncollectible taxes-delinquent | 20,000 |
| Vouchers payable | $ 89,000 |
| Fund balance - | |
| reserved for encumbrances - 20X5 | 43,000 |
| reserved for supplies inventory | 38,000 |
| unreserved | 157,000 |

**Additional Information:**

- Debt service was for bonds used to finance a library building and included interest of $22,000.
- $8,000 of 20X5 property taxes receivable were written off; otherwise the allowance for uncollectible taxes balance is unchanged from the initial entry at the time of the original tax levy at the beginning of the year.
- Shar reported supplies inventory of $21,000 at December 31, 20X4.

For this item, calculate the numeric amount.

What amount should be included in the capital assets reported under governmental activities column in the government wide statement of net assets for the cost of assets acquired in 20X5 through the general fund?

A. $25,000
B. $52,000
C. $75,000
D. $79,000
E. $89,000
F. $100,000
G. $250,000
H. $500,000
I. $800,000
J. $811,000
K. $1,000,000
L. $1,392,000

**CPA-04513 Explanation**
**Choice "F" is correct. $100,000.** The capital outlay for 20X5 included the amount reported in the statement of revenues, expenditures, and changes in fund balance statement as capital outlay, police vehicles, $100,000. General capital assets are, in turn, capitalized and displayed on the general capital asset line in the governmental activities column of the government wide statement of net assets.

**CPA-04514 Type1 M/C A-L Corr Ans: B PM#95 F 8-99**

174. CPA-04514 ARE May 96 PR2 18 Page 3

The following selected information is taken from Shar City's general fund statement of revenues, expenditures, and changes in fund balance for the year ended December 31, 20X5:

| | |
|---|---|
| Revenues | |
| Property taxes - 20X5 | $ 825,000 |
| Expenditures - 20X5 | $1,349,000 |
| Expenditures - 20X4 | 56,000 |


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| | |
|---|---|
| Expenditures | |
| Current services | |
| Public safety | 428,000 |
| Capital outlay (police vehicles) | 100,000 |
| Debt service | 74,000 |
| Expenditures | $1,405,000 |
| Excess of revenues over expenditures | $ 153,000 |
| Other financing uses | (125,000) |
| Excess of revenues over expenditures and other financing uses | $ 28,000 |
| Decrease in reserve for encumbrances during 20X5 | 15,000 |
| Capital contributions to other funds | (190,000) |
| Decrease in unreserved fund balance during 20X5 | $ (147,000) |
| Unreserved fund balance January 1, 20X5 | 304,000 |
| Unreserved fund balance December 31, 20X5 | $ 157,000 |

The following selected information is taken from Shar's December 31, 20X5, general fund balance sheet:

| | |
|---|---|
| Property taxes receivable - delinquent - 20X5 | $ 34,000 |
| Allowance for estimated uncollectible taxes-delinquent | 20,000 |
| Vouchers payable | $ 89,000 |
| Fund balance - | |
| reserved for encumbrances - 20X5 | 43,000 |
| reserved for supplies inventory | 38,000 |
| unreserved | 157,000 |

**Additional Information:**

- Debt service was for bonds used to finance a library building and included interest of $22,000.
- $8,000 of 20X5 property taxes receivable were written off; otherwise the allowance for uncollectible taxes balance is unchanged from the initial entry at the time of the original tax levy at the beginning of the year.
- Shar reported supplies inventory of $21,000 at December 31, 20X4.

For this item, calculate the numeric amount.

What amount arising from 20X5 transactions decreased liabilities reported in the general long-term liabilities reported under the governmental activities column in the government wide statement of net assets?

A. $25,000
B. $52,000
C. $75,000
D. $79,000
E. $89,000
F. $100,000
G. $250,000
H. $500,000
I. $800,000
J. $811,000
K. $1,000,000
L. $1,392,000

**CPA-04514 Explanation**
**Choice "B" is correct. $52,000.** The decrease in general long-term liabilities would be the principal payments on the bonds. The total payment from the debt service fund was $74,000, of which $22,000 was interest. The remainder ($52,000) was a reduction in the principal of the bonds outstanding.


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**CPA-04515 Type1 M/C A-L Corr Ans: L PM#96 F 8-99**

175. CPA-04515 ARE May 96 PR2 19 Page 3

The following selected information is taken from Shar City's general fund statement of revenues, expenditures, and changes in fund balance for the year ended December 31, 20X5:

| | |
|---|---|
| Revenues | |
| Property taxes - 20X5 | $ 825,000 |
| Expenditures - 20X5 | $1,349,000 |
| Expenditures - 20X4 | 56,000 |
| Expenditures | |
| Current services | |
| Public safety | 428,000 |
| Capital outlay (police vehicles) | 100,000 |
| Debt service | 74,000 |
| Expenditures | $1,405,000 |
| Excess of revenues over expenditures | $ 153,000 |
| Other financing uses | (125,000) |
| Excess of revenues over expenditures and other financing uses | $ 28,000 |
| Decrease in reserve for encumbrances during 20X5 | 15,000 |
| Capital contributions to other funds | (190,000) |
| Decrease in unreserved fund balance during 20X5 | $ (147,000) |
| Unreserved fund balance January 1, 20X5 | 304,000 |
| Unreserved fund balance December 31, 20X5 | $ 157,000 |

The following selected information is taken from Shar's December 31, 20X5, general fund balance sheet:

| | |
|---|---|
| Property taxes receivable - delinquent - 20X5 | $ 34,000 |
| Allowance for estimated uncollectible taxes-delinquent | 20,000 |
| Vouchers payable | $ 89,000 |
| Fund balance - | |
| reserved for encumbrances - 20X5 | 43,000 |
| reserved for supplies inventory | 38,000 |
| unreserved | 157,000 |

**Additional Information:**

- Debt service was for bonds used to finance a library building and included interest of $22,000.
- $8,000 of 20X5 property taxes receivable were written off; otherwise the allowance for uncollectible taxes balance is unchanged from the initial entry at the time of the original tax levy at the beginning of the year.
- Shar reported supplies inventory of $21,000 at December 31, 20X4.

For this item, calculate the numeric amount.

If Shar elects to include budgetary comparisons as part of its fund financial statements, what amount of total actual expenditures should Shar report in its 20X5 general fund statement of revenues, expenditures, and changes in fund balance - budget and actual?

A. $25,000
B. $52,000
C. $75,000
D. $79,000
E. $89,000
F. $100,000
G. $250,000
H. $500,000


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I. $800,000
J. $811,000
K. $1,000,000
L. $1,392,000

**CPA-04515 Explanation**
**Choice "L" is correct. $1,392,000.** The total expenditures used in 20X5 for budgetary comparisons would include only those expenditures that relate to 20X5 appropriations. Candidates are required to squeeze the 20X5 expenditure data that relates to 20X5 appropriations from the change in unreserved fund balance, an amount that includes expenditure and encumbrance data from multiple periods.

Candidates should use the **BASE** mnemonic to label their computation sheet to ensure consideration of all relevant transactions and squeeze the required number, 20X5 expenditures that relate to the 20X5 budget.

| | | |
|---|---|---|
| "**B**"eginning unreserved fund balance | | $ 304,000 |
| "**A**"dditions | | |
| Revenues (20X5) | | |
| GAAP basis expenditures | $1,405,000 | |
| Excess of revenues over expenditures | 153,000 | |
| Total 20X5 revenues | | 1,558,000 |
| Reserves related to 20X4 encumbrances and related to 20X4 budget (added to unreserved fund balance) | | |
| Ending encumbrances (20X5) | $ 43,000 | |
| Decrease in encumbrance (20X5) | 15,000 | |
| Encumbrances at 12/31/X4 | 58,000 | |
| 20X4 Expenditures included in 20X5 GAAP expenditures | 56,000 | |
| Amounts included in 20X5 reserves that relate to the 20X4 budget year | | 2,000 |
| "**S**"ubtractions | | |
| Other financing uses | | (125,000) |
| Capital contributions | | (190,000) |
| Subtotal: Unreserved fund balance before consideration of 20X5 expenditures | | 1,549,000 |
| **Expenditures (20X5)** | | **(1,392,000) SQZ** |
| "**E**"nding unreserved fund balance | | $ 157,000 |

Don't get caught into thinking that that 20X5 actual expenditures represent 20X5 expenditures plus the reserve for encumbrance balance in 20X5. Encumbrances represent commitments related to unperformed contracts for goods or services. Encumbrances outstanding at year-end represent the estimated amount of expenditures at year-end if the unperformed contracts are completed, not actual expenditures.

Changes in reserves for inventory are not relevant to the computation. Increases to reserves balance increases to assets. Expenditures represent appropriate current year charges.

**CPA-04516 Type1 M/C A-O Corr Ans: E PM#97 F 8-99**

176. CPA-04516 ARE 96 OOAF #3 1 Page 3

The following events affected the financial statements of Jey City during 20X5:

Budgetary activities:

- Total general fund estimated revenues $8,000,000
- Total general fund budgeted expenditures 7,500,000


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- Planned construction of a courthouse improvement expected to cost $1,500,000, and to be financed in the following manner: $250,000 from the general fund, $450,000 from state entitlements, and $800,000 from the proceeds of 20-year, 8% bonds dated and expected to be issued at par on June 30, 20X5. Interest on the bonds is payable annually on July 1, together with one-twentieth of the bond principal from general fund revenues of the payment period.
- A budgeted general fund payment of $180,000 to subsidize operations of a solid waste landfill enterprise fund.

Actual results included the following:

- Jey recorded property tax revenues of $5,000,000 and a related allowance for uncollectibles-current of $60,000. On December 31, 20X5, the remaining $56,000 balance of the allowance for uncollectibles-current was closed, and an adjusted allowance for uncollectibles-delinquent was recorded equal to the property tax receivables balance of $38,000.
- A police car with an original cost of $25,000 was sold for $7,000.
- Office equipment to be used by the city's fire department was acquired through a capital lease. The lease required 10 equal annual payments of $10,000, beginning with the July 1, 20X5, acquisition date. Using a 6% discount rate, the 10 payments had a present value of $78,000 at the acquisition date.
- The courthouse was improved and financed as budgeted except for a $27,000 cost overrun that was paid for by the general fund. Jey plans to transfer cash to the debt service fund during 20X6 to service the interest and principal payments called for in the bonds.
- Information related to the solid waste landfill at December 31, 20X5:

| | |
|---|---|
| Capacity | 1,000,000 cubic yards |
| Usage prior to 20X5 | 500,000 cubic yards |
| Usage in 20X5 | 40,000 cubic yards |
| Estimated total life | 20 years |
| Closure costs incurred to date | $300,000 |
| Estimated future costs of closure and post-closure care | 1,700,000 |
| Expense for closure and post-closure care recognized prior to 20X5 | 973,000 |

Jey does not record depreciation for nonproprietary fund-type assets.

Determine the amount based solely on the above information.

What was the net effect of the budgetary activities on the general fund balance at January 1, 20X5?

A. 0
B. 5,000
C. 10,000
D. 50,000
E. 70,000
F. 107,000
G. 200,000
H. 430,000
I. 450,000
J. 500,000
K. 780,000
L. 868,000
M. 1,000,000
N. 1,580,000
O. 5,018,000

**CPA-04516 Explanation**
**Choice "E" is correct. 70,000.** The net effect of the budgetary activities increased fund balance by $70,000:


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| | |
|---|---|
| Estimated revenues | $8,000,000 |
| Appropriations | (7,500,000) |
| Transfer out to capital projects fund | (250,000) |
| Transfer out to enterprise fund | (180,000) |
| Increase in fund balance | $ 70,000 |

**CPA-04517 Type1 M/C A-O Corr Ans: H PM#98 F 8-99**

177. CPA-04517 ARE 96 OOAF #3 2 Page 3

The following events affected the financial statements of Jey City during 20X5:

Budgetary activities:

- Total general fund estimated revenues $8,000,000
- Total general fund budgeted expenditures 7,500,000
- Planned construction of a courthouse improvement expected to cost $1,500,000, and to be financed in the following manner: $250,000 from the general fund, $450,000 from state entitlements, and $800,000 from the proceeds of 20-year, 8% bonds dated and expected to be issued at par on June 30, 20X5. Interest on the bonds is payable annually on July 1, together with one-twentieth of the bond principal from general fund revenues of the payment period.
- A budgeted general fund payment of $180,000 to subsidize operations of a solid waste landfill enterprise fund.

Actual results included the following:

- Jey recorded property tax revenues of $5,000,000 and a related allowance for uncollectibles-current of $60,000. On December 31, 20X5, the remaining $56,000 balance of the allowance for uncollectibles-current was closed, and an adjusted allowance for uncollectibles-delinquent was recorded equal to the property tax receivables balance of $38,000.
- A police car with an original cost of $25,000 was sold for $7,000.
- Office equipment to be used by the city's fire department was acquired through a capital lease. The lease required 10 equal annual payments of $10,000, beginning with the July 1, 20X5, acquisition date. Using a 6% discount rate, the 10 payments had a present value of $78,000 at the acquisition date.
- The courthouse was improved and financed as budgeted except for a $27,000 cost overrun that was paid for by the general fund. Jey plans to transfer cash to the debt service fund during 20X6 to service the interest and principal payments called for in the bonds.
- Information related to the solid waste landfill at December 31, 20X5:

| | |
|---|---|
| Capacity | 1,000,000 cubic yards |
| Usage prior to 20X5 | 500,000 cubic yards |
| Usage in 20X5 | 40,000 cubic yards |
| Estimated total life | 20 years |
| Closure costs incurred to date | $300,000 |
| Estimated future costs of closure and post-closure care | 1,700,000 |
| Expense for closure and post-closure care recognized prior to 20X5 | 973,000 |

Jey does not record depreciation for nonproprietary fund-type assets.

Determine the amount based solely on the above information.

What was the total amount of transfers out included in the general fund's budgetary accounts at January 1, 20X5?

A. 0
B. 5,000
C. 10,000


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D. 50,000
E. 70,000
F. 107,000
G. 200,000
H. 430,000
I. 450,000
J. 500,000
K. 780,000
L. 868,000
M. 1,000,000
N. 1,580,000
O. 5,018,000

**CPA-04517 Explanation**
**Choice "H" is correct. 430,000.** There were two transfers: One to the capital projects fund ($250,000) and one to the enterprise fund ($180,000).

**CPA-04518 Type1 M/C A-O Corr Ans: A PM#99 F 8-99**

178. CPA-04518 ARE 96 OOAF #3 3 Page 3

The following events affected the financial statements of Jey City during 20X5:

Budgetary activities:

- Total general fund estimated revenues $8,000,000
- Total general fund budgeted expenditures 7,500,000
- Planned construction of a courthouse improvement expected to cost $1,500,000, and to be financed in the following manner: $250,000 from the general fund, $450,000 from state entitlements, and $800,000 from the proceeds of 20-year, 8% bonds dated and expected to be issued at par on June 30, 20X5. Interest on the bonds is payable annually on July 1, together with one-twentieth of the bond principal from general fund revenues of the payment period.
- A budgeted general fund payment of $180,000 to subsidize operations of a solid waste landfill enterprise fund.

Actual results included the following:

- Jey recorded property tax revenues of $5,000,000 and a related allowance for uncollectibles-current of $60,000. On December 31, 20X5, the remaining $56,000 balance of the allowance for uncollectibles-current was closed, and an adjusted allowance for uncollectibles-delinquent was recorded equal to the property tax receivables balance of $38,000.
- A police car with an original cost of $25,000 was sold for $7,000.
- Office equipment to be used by the city's fire department was acquired through a capital lease. The lease required 10 equal annual payments of $10,000, beginning with the July 1, 20X5, acquisition date. Using a 6% discount rate, the 10 payments had a present value of $78,000 at the acquisition date.
- The courthouse was improved and financed as budgeted except for a $27,000 cost overrun that was paid for by the general fund. Jey plans to transfer cash to the debt service fund during 20X6 to service the interest and principal payments called for in the bonds.
- Information related to the solid waste landfill at December 31, 20X5:

| | |
|---|---|
| Capacity | 1,000,000 cubic yards |
| Usage prior to 20X5 | 500,000 cubic yards |
| Usage in 20X5 | 40,000 cubic yards |
| Estimated total life | 20 years |
| Closure costs incurred to date | $300,000 |
| Estimated future costs of closure and post-closure care | 1,700,000 |


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Expense for closure and post-closure care recognized prior to 20X5 973,000

Jey does not record depreciation for nonproprietary fund-type assets.

Determine the amount based solely on the above information.

What amount of interest payable related to the 20-year bonds should be reported by the general fund at December 31, 20X5?

A. 0
B. 5,000
C. 10,000
D. 50,000
E. 70,000
F. 107,000
G. 200,000
H. 430,000
I. 450,000
J. 500,000
K. 780,000
L. 868,000
M. 1,000,000
N. 1,580,000
O. 5,018,000

**CPA-04518 Explanation**
**Choice "A" is correct. 0.** Interest payable is not accrued in the general fund. Interest is recorded when it is due.

**CPA-04519 Type1 M/C A-O Corr Ans: C PM#100 F 8-99**

179. CPA-04519 ARE 96 OOAF #3 4 Page 3

The following events affected the financial statements of Jey City during 20X5:

Budgetary activities:

- Total general fund estimated revenues $8,000,000
- Total general fund budgeted expenditures 7,500,000
- Planned construction of a courthouse improvement expected to cost $1,500,000, and to be financed in the following manner: $250,000 from the general fund, $450,000 from state entitlements, and $800,000 from the proceeds of 20-year, 8% bonds dated and expected to be issued at par on June 30, 20X5. Interest on the bonds is payable annually on July 1, together with one-twentieth of the bond principal from general fund revenues of the payment period.
- A budgeted general fund payment of $180,000 to subsidize operations of a solid waste landfill enterprise fund.

Actual results included the following:

- Jey recorded property tax revenues of $5,000,000 and a related allowance for uncollectibles-current of $60,000. On December 31, 20X5, the remaining $56,000 balance of the allowance for uncollectibles-current was closed, and an adjusted allowance for uncollectibles-delinquent was recorded equal to the property tax receivables balance of $38,000.
- A police car with an original cost of $25,000 was sold for $7,000.
- Office equipment to be used by the city's fire department was acquired through a capital lease. The lease required 10 equal annual payments of $10,000, beginning with the July 1, 20X5, acquisition date. Using a 6% discount rate, the 10 payments had a present value of $78,000 at the acquisition date.


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- The courthouse was improved and financed as budgeted except for a $27,000 cost overrun that was paid for by the general fund. Jey plans to transfer cash to the debt service fund during 20X6 to service the interest and principal payments called for in the bonds.
- Information related to the solid waste landfill at December 31, 20X5:

| | |
|---|---|
| Capacity | 1,000,000 cubic yards |
| Usage prior to 20X5 | 500,000 cubic yards |
| Usage in 20X5 | 40,000 cubic yards |
| Estimated total life | 20 years |
| Closure costs incurred to date | $300,000 |
| Estimated future costs of closure and post-closure care | 1,700,000 |
| Expense for closure and post-closure care recognized prior to 20X5 | 973,000 |

Jey does not record depreciation for nonproprietary fund-type assets.

Determine the amount based solely on the above information.

What lease payment amount should be included in 20X5 general fund expenditures?

A. 0
B. 5,000
C. 10,000
D. 50,000
E. 70,000
F. 107,000
G. 200,000
H. 430,000
I. 450,000
J. 500,000
K. 780,000
L. 868,000
M. 1,000,000
N. 1,580,000
O. 5,018,000

**CPA-04519 Explanation**
**Choice "C" is correct. 10,000.** The general fund uses the financial resources measurement focus. Thus, the expenditure for the capital lease payment due July 1, 20X5, would be recorded in total, $10,000.

**CPA-04520 Type1 M/C A-O Corr Ans: O PM#101 F 8-99**

180. CPA-04520 ARE 96 OOAF #3 5 Page 3

The following events affected the financial statements of Jey City during 20X5:

Budgetary activities:

- Total general fund estimated revenues $8,000,000
- Total general fund budgeted expenditures 7,500,000
- Planned construction of a courthouse improvement expected to cost $1,500,000, and to be financed in the following manner: $250,000 from the general fund, $450,000 from state entitlements, and $800,000 from the proceeds of 20-year, 8% bonds dated and expected to be issued at par on June 30, 20X5. Interest on the bonds is payable annually on July 1, together with one-twentieth of the bond principal from general fund revenues of the payment period.
- A budgeted general fund payment of $180,000 to subsidize operations of a solid waste landfill enterprise fund.

Actual results included the following:


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- Jey recorded property tax revenues of $5,000,000 and a related allowance for uncollectibles-current of $60,000. On December 31, 20X5, the remaining $56,000 balance of the allowance for uncollectibles-current was closed, and an adjusted allowance for uncollectibles-delinquent was recorded equal to the property tax receivables balance of $38,000.
- A police car with an original cost of $25,000 was sold for $7,000.
- Office equipment to be used by the city's fire department was acquired through a capital lease. The lease required 10 equal annual payments of $10,000, beginning with the July 1, 20X5, acquisition date. Using a 6% discount rate, the 10 payments had a present value of $78,000 at the acquisition date.
- The courthouse was improved and financed as budgeted except for a $27,000 cost overrun that was paid for by the general fund. Jey plans to transfer cash to the debt service fund during 20X6 to service the interest and principal payments called for in the bonds.
- Information related to the solid waste landfill at December 31, 20X5:

| | |
|---|---|
| Capacity | 1,000,000 cubic yards |
| Usage prior to 20X5 | 500,000 cubic yards |
| Usage in 20X5 | 40,000 cubic yards |
| Estimated total life | 20 years |
| Closure costs incurred to date | $300,000 |
| Estimated future costs of closure and post-closure care | 1,700,000 |
| Expense for closure and post-closure care recognized prior to 20X5 | 973,000 |

Jey does not record depreciation for nonproprietary fund-type assets.

Determine the amount based solely on the above information.

What amount was collected from 20X5 property taxes in 20X5?

A. 0
B. 5,000
C. 10,000
D. 50,000
E. 70,000
F. 107,000
G. 200,000
H. 430,000
I. 450,000
J. 500,000
K. 780,000
L. 868,000
M. 1,000,000
N. 1,580,000
O. 5,018,000

**CPA-04520 Explanation**
**Choice "O" is correct. 5,018,000.** The amount of property taxes levied was $5,060,000, the sum of the revenue and allowance amounts. Of this amount, $4,000 was written off against the allowance and there is a receivable balance of $38,000: $5,060,000 - $4,000 - $38,000 = $5,018,000.

**CPA-04521 Type1 M/C A-O Corr Ans: I PM#102 F 8-99**

181. CPA-04521 ARE 96 OOAF #3 6 Page 3

The following events affected the financial statements of Jey City during 20X5:

Budgetary activities:

- Total general fund estimated revenues $8,000,000


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- Total general fund budgeted expenditures 7,500,000
- Planned construction of a courthouse improvement expected to cost $1,500,000, and to be financed in the following manner: $250,000 from the general fund, $450,000 from state entitlements, and $800,000 from the proceeds of 20-year, 8% bonds dated and expected to be issued at par on June 30, 20X5. Interest on the bonds is payable annually on July 1, together with one-twentieth of the bond principal from general fund revenues of the payment period.
- A budgeted general fund payment of $180,000 to subsidize operations of a solid waste landfill enterprise fund.

Actual results included the following:

- Jey recorded property tax revenues of $5,000,000 and a related allowance for uncollectibles-current of $60,000. On December 31, 20X5, the remaining $56,000 balance of the allowance for uncollectibles-current was closed, and an adjusted allowance for uncollectibles-delinquent was recorded equal to the property tax receivables balance of $38,000.
- A police car with an original cost of $25,000 was sold for $7,000.
- Office equipment to be used by the city's fire department was acquired through a capital lease. The lease required 10 equal annual payments of $10,000, beginning with the July 1, 20X5, acquisition date. Using a 6% discount rate, the 10 payments had a present value of $78,000 at the acquisition date.
- The courthouse was improved and financed as budgeted except for a $27,000 cost overrun that was paid for by the general fund. Jey plans to transfer cash to the debt service fund during 20X6 to service the interest and principal payments called for in the bonds.
- Information related to the solid waste landfill at December 31, 20X5:

| | |
|---|---|
| Capacity | 1,000,000 cubic yards |
| Usage prior to 20X5 | 500,000 cubic yards |
| Usage in 20X5 | 40,000 cubic yards |
| Estimated total life | 20 years |
| Closure costs incurred to date | $300,000 |
| Estimated future costs of closure and post-closure care | 1,700,000 |
| Expense for closure and post-closure care recognized prior to 20X5 | 973,000 |

Jey does not record depreciation for nonproprietary fund-type assets.

Determine the amount based solely on the above information.

What was the total amount of the capital project fund's 20X5 revenues?

A. 0
B. 5,000
C. 10,000
D. 50,000
E. 70,000
F. 107,000
G. 200,000
H. 430,000
I. 450,000
J. 500,000
K. 780,000
L. 868,000
M. 1,000,000
N. 1,580,000
O. 5,018,000

**CPA-04521 Explanation**


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**Choice" I" is correct. 450,000.** The only revenue to the capital project fund was the state entitlements totaling $450,000. The transfers from the general fund and the bond proceeds are "Other financing sources."

**CPA-04522 Type1 M/C A-O Corr Ans: L PM#103 F 8-99**

182. CPA-04522 ARE 96 OOAF #3 7 Page 3

The following events affected the financial statements of Jey City during 20X5:

Budgetary activities:

- Total general fund estimated revenues $8,000,000
- Total general fund budgeted expenditures 7,500,000
- Planned construction of a courthouse improvement expected to cost $1,500,000, and to be financed in the following manner: $250,000 from the general fund, $450,000 from state entitlements, and $800,000 from the proceeds of 20-year, 8% bonds dated and expected to be issued at par on June 30, 20X5. Interest on the bonds is payable annually on July 1, together with one-twentieth of the bond principal from general fund revenues of the payment period.
- A budgeted general fund payment of $180,000 to subsidize operations of a solid waste landfill enterprise fund.

Actual results included the following:

- Jey recorded property tax revenues of $5,000,000 and a related allowance for uncollectibles-current of $60,000. On December 31, 20X5, the remaining $56,000 balance of the allowance for uncollectibles-current was closed, and an adjusted allowance for uncollectibles-delinquent was recorded equal to the property tax receivables balance of $38,000.
- A police car with an original cost of $25,000 was sold for $7,000.
- Office equipment to be used by the city's fire department was acquired through a capital lease. The lease required 10 equal annual payments of $10,000, beginning with the July 1, 20X5, acquisition date. Using a 6% discount rate, the 10 payments had a present value of $78,000 at the acquisition date.
- The courthouse was improved and financed as budgeted except for a $27,000 cost overrun that was paid for by the general fund. Jey plans to transfer cash to the debt service fund during 20X6 to service the interest and principal payments called for in the bonds.
- Information related to the solid waste landfill at December 31, 20X5:

| | |
|---|---|
| Capacity | 1,000,000 cubic yards |
| Usage prior to 20X5 | 500,000 cubic yards |
| Usage in 20X5 | 40,000 cubic yards |
| Estimated total life | 20 years |
| Closure costs incurred to date | $300,000 |
| Estimated future costs of closure and post-closure care | 1,700,000 |
| Expense for closure and post-closure care recognized prior to 20X5 | 973,000 |

Jey does not record depreciation for nonproprietary fund-type assets.

Determine the amount based solely on the above information.

What amount should be reported as liabilities in the general long-term liabilities line item under the governmental activities column of the government wide statement of net assets at December 31, 20X5?

A. 0
B. 5,000
C. 10,000
D. 50,000
E. 70,000


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F. 107,000
G. 200,000
H. 430,000
I. 450,000
J. 500,000
K. 780,000
L. 868,000
M. 1,000,000
N. 1,580,000
O. 5,018,000

**CPA-04522 Explanation**
**Choice "L" is correct. 868,000.** The general long-term liabilities displayed on the government wide statement of net assets would include the liability on the bonds ($800,000) and the liability on the capital lease ($78,000 less $10,000 payment), or $868,000.

**CPA-04523 Type1 M/C A-O Corr Ans: N PM#104 F 8-99**

183. CPA-04523 ARE 96 OOAF #3 8 Page 3

The following events affected the financial statements of Jey City during 20X5:

Budgetary activities:

- Total general fund estimated revenues $8,000,000
- Total general fund budgeted expenditures 7,500,000
- Planned construction of a courthouse improvement expected to cost $1,500,000, and to be financed in the following manner: $250,000 from the general fund, $450,000 from state entitlements, and $800,000 from the proceeds of 20-year, 8% bonds dated and expected to be issued at par on June 30, 20X5. Interest on the bonds is payable annually on July 1, together with one-twentieth of the bond principal from general fund revenues of the payment period.
- A budgeted general fund payment of $180,000 to subsidize operations of a solid waste landfill enterprise fund.

Actual results included the following:

- Jey recorded property tax revenues of $5,000,000 and a related allowance for uncollectibles-current of $60,000. On December 31, 20X5, the remaining $56,000 balance of the allowance for uncollectibles-current was closed, and an adjusted allowance for uncollectibles-delinquent was recorded equal to the property tax receivables balance of $38,000.
- A police car with an original cost of $25,000 was sold for $7,000.
- Office equipment to be used by the city's fire department was acquired through a capital lease. The lease required 10 equal annual payments of $10,000, beginning with the July 1, 20X5, acquisition date. Using a 6% discount rate, the 10 payments had a present value of $78,000 at the acquisition date.
- The courthouse was improved and financed as budgeted except for a $27,000 cost overrun that was paid for by the general fund. Jey plans to transfer cash to the debt service fund during 20X6 to service the interest and principal payments called for in the bonds.
- Information related to the solid waste landfill at December 31, 20X5:

| | |
|---|---|
| Capacity | 1,000,000 cubic yards |
| Usage prior to 20X5 | 500,000 cubic yards |
| Usage in 20X5 | 40,000 cubic yards |
| Estimated total life | 20 years |
| Closure costs incurred to date | $300,000 |
| Estimated future costs of closure and post-closure care | 1,700,000 |
| Expense for closure and post-closure care recognized prior to 20X5 | 973,000 |


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Jey does not record depreciation for nonproprietary fund-type assets.

Determine the amount based solely on the above information.

What net increase in capital assets should be recorded for reporting in the capital assets line item in the governmental activities column in the government wide statement of net assets at December 31, 20X5?

A. 0
B. 5,000
C. 10,000
D. 50,000
E. 70,000
F. 107,000
G. 200,000
H. 430,000
I. 450,000
J. 500,000
K. 780,000
L. 868,000
M. 1,000,000
N. 1,580,000
O. 5,018,000

**CPA-04523 Explanation**
**Choice "N" is correct. 1,580,000.** The general capital assets line item on the government wide statement of net assets would include the courthouse improvements ($1,527,000) and the office equipment ($78,000) less the police car sold ($25,000), or $1,580,000.

**CPA-04524 Type1 M/C A-O Corr Ans: F PM#105 F 8-99**

184. CPA-04524 ARE 96 OOAF #3 9 Page 3

The following events affected the financial statements of Jey City during 20X5:

Budgetary activities:

- Total general fund estimated revenues $8,000,000
- Total general fund budgeted expenditures 7,500,000
- Planned construction of a courthouse improvement expected to cost $1,500,000, and to be financed in the following manner: $250,000 from the general fund, $450,000 from state entitlements, and $800,000 from the proceeds of 20-year, 8% bonds dated and expected to be issued at par on June 30, 20X5. Interest on the bonds is payable annually on July 1, together with one-twentieth of the bond principal from general fund revenues of the payment period.
- A budgeted general fund payment of $180,000 to subsidize operations of a solid waste landfill enterprise fund.

Actual results included the following:

- Jey recorded property tax revenues of $5,000,000 and a related allowance for uncollectibles-current of $60,000. On December 31, 20X5, the remaining $56,000 balance of the allowance for uncollectibles-current was closed, and an adjusted allowance for uncollectibles-delinquent was recorded equal to the property tax receivables balance of $38,000.
- A police car with an original cost of $25,000 was sold for $7,000.
- Office equipment to be used by the city's fire department was acquired through a capital lease. The lease required 10 equal annual payments of $10,000, beginning with the July 1, 20X5, acquisition date. Using a 6% discount rate, the 10 payments had a present value of $78,000 at the acquisition date.


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- The courthouse was improved and financed as budgeted except for a $27,000 cost overrun that was paid for by the general fund. Jey plans to transfer cash to the debt service fund during 20X6 to service the interest and principal payments called for in the bonds.
- Information related to the solid waste landfill at December 31, 20X5:

| | |
|---|---|
| Capacity | 1,000,000 cubic yards |
| Usage prior to 20X5 | 500,000 cubic yards |
| Usage in 20X5 | 40,000 cubic yards |
| Estimated total life | 20 years |
| Closure costs incurred to date | $300,000 |
| Estimated future costs of closure and post-closure care | 1,700,000 |
| Expense for closure and post-closure care recognized prior to 20X5 | 973,000 |

Jey does not record depreciation for nonproprietary fund-type assets.

Determine the amount based solely on the above information.

What 20X5 closure and postclosure care expenses should be reported in the solid waste landfill enterprise fund?

A. 0
B. 5,000
C. 10,000
D. 50,000
E. 70,000
F. 107,000
G. 200,000
H. 430,000
I. 450,000
J. 500,000
K. 780,000
L. 868,000
M. 1,000,000
N. 1,580,000
O. 5,018,000

**CPA-04524 Explanation**
**Choice "F" is correct. 107,000.** The solid waste landfill is been used 54% of estimated capacity (540,000 / 1,000,000). Thus, 54% of the closure and postclosure costs should be reported as a liability: $300,000 + $1,700,000 = $2,000,000 total costs. 54% x $2,000,000 = $1,080,000. The difference between this total liability to date and the amount recognized prior to 20X5 ($973,000) is the closure and postclosure care expense that should be reported in 20X5, $1,080,000 - $973,000 = $107,000.

**CPA-04525 Type1 M/C A-O Corr Ans: K PM#106 F 8-99**

185. CPA-04525 ARE 96 OOAF #3 10 Page 3

The following events affected the financial statements of Jey City during 20X5:

Budgetary activities:

- Total general fund estimated revenues $8,000,000
- Total general fund budgeted expenditures 7,500,000
- Planned construction of a courthouse improvement expected to cost $1,500,000, and to be financed in the following manner: $250,000 from the general fund, $450,000 from state entitlements, and $800,000 from the proceeds of 20-year, 8% bonds dated and expected to be issued at par on June 30, 20X5. Interest on the bonds is payable annually on July 1, together with one-twentieth of the bond principal from general fund revenues of the payment period.


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- A budgeted general fund payment of $180,000 to subsidize operations of a solid waste landfill enterprise fund.

Actual results included the following:

- Jey recorded property tax revenues of $5,000,000 and a related allowance for uncollectibles-current of $60,000. On December 31, 20X5, the remaining $56,000 balance of the allowance for uncollectibles-current was closed, and an adjusted allowance for uncollectibles-delinquent was recorded equal to the property tax receivables balance of $38,000.
- A police car with an original cost of $25,000 was sold for $7,000.
- Office equipment to be used by the city's fire department was acquired through a capital lease. The lease required 10 equal annual payments of $10,000, beginning with the July 1, 20X5, acquisition date. Using a 6% discount rate, the 10 payments had a present value of $78,000 at the acquisition date.
- The courthouse was improved and financed as budgeted except for a $27,000 cost overrun that was paid for by the general fund. Jey plans to transfer cash to the debt service fund during 20X6 to service the interest and principal payments called for in the bonds.
- Information related to the solid waste landfill at December 31, 20X5:

| | |
|---|---|
| Capacity | 1,000,000 cubic yards |
| Usage prior to 20X5 | 500,000 cubic yards |
| Usage in 20X5 | 40,000 cubic yards |
| Estimated total life | 20 years |
| Closure costs incurred to date | $300,000 |
| Estimated future costs of closure and post-closure care | 1,700,000 |
| Expense for closure and post-closure care recognized prior to 20X5 | 973,000 |

Jey does not record depreciation for nonproprietary fund-type assets.

Determine the amount based solely on the above information.

What should be the December 31, 20X5, closure and postclosure care liability reported in the solid waste landfill enterprise fund?

A. 0
B. 5,000
C. 10,000
D. 50,000
E. 70,000
F. 107,000
G. 200,000
H. 430,000
I. 450,000
J. 500,000
K. 780,000
L. 868,000
M. 1,000,000
N. 1,580,000
O. 5,018,000

**CPA-04525 Explanation**
**Choice "K" is correct. 780,000.** The solid waste landfill is been used 54% of estimated capacity (540,000 / 1,000,000). Thus, 54% of the closure and postclosure costs should be reported as a liability: $300,000 + $1,700,000 = $2,000,000 total costs. 54% x $2,000,000 = $1,080,000. Note that of this amount, $300,000 has already been incurred to date: $1,080,000 - $300,000 = $780,000.

**CPA-04526 Type1 M/C A-E Corr Ans: D PM#107 F 8-99**


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186. CPA-04526 ARE 96 OOAF #3 11 Page 3

The following events affected the financial statements of Jey City during 20X5:

Budgetary activities:

- Total general fund estimated revenues $8,000,000
- Total general fund budgeted expenditures 7,500,000
- Planned construction of a courthouse improvement expected to cost $1,500,000, and to be financed in the following manner: $250,000 from the general fund, $450,000 from state entitlements, and $800,000 from the proceeds of 20-year, 8% bonds dated and expected to be issued at par on June 30, 20X5. Interest on the bonds is payable annually on July 1, together with one-twentieth of the bond principal from general fund revenues of the payment period.
- A budgeted general fund payment of $180,000 to subsidize operations of a solid waste landfill enterprise fund.

Actual results included the following:

- Jey recorded property tax revenues of $5,000,000 and a related allowance for uncollectibles-current of $60,000. On December 31, 20X5, the remaining $56,000 balance of the allowance for uncollectibles-current was closed, and an adjusted allowance for uncollectibles-delinquent was recorded equal to the property tax receivables balance of $38,000.
- A police car with an original cost of $25,000 was sold for $7,000.
- Office equipment to be used by the city's fire department was acquired through a capital lease. The lease required 10 equal annual payments of $10,000, beginning with the July 1, 20X5, acquisition date. Using a 6% discount rate, the 10 payments had a present value of $78,000 at the acquisition date.
- The courthouse was improved and financed as budgeted except for a $27,000 cost overrun that was paid for by the general fund. Jey plans to transfer cash to the debt service fund during 20X6 to service the interest and principal payments called for in the bonds.
- Information related to the solid waste landfill at December 31, 20X5:

| | |
|---|---|
| Capacity | 1,000,000 cubic yards |
| Usage prior to 20X5 | 500,000 cubic yards |
| Usage in 20X5 | 40,000 cubic yards |
| Estimated total life | 20 years |
| Closure costs incurred to date | $300,000 |
| Estimated future costs of closure and post-closure care | 1,700,000 |
| Expense for closure and post-closure care recognized prior to 20X5 | 973,000 |

Jey does not record depreciation for nonproprietary fund-type assets.

Indicate the measurement focus of the Jey fund mentioned.

- Capital project fund.

A. Subsidy restrictions.
B. Bond restrictions.
C. Expenditures.
D. Current financial resources.
E. Economic measurement focus.

**CPA-04526 Explanation**

**Choice "D" is correct.** The capital project fund is a governmental type fund. The measurement focus of governmental type funds is current financial resources. Simply, the fund reports current assets and current liabilities along with fund balance. They use the modified accrual basis of accounting.


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**CPA-04527 Type1 M/C A-E Corr Ans: E PM#108 F 8-99**

187. CPA-04527 ARE 96 OOAF #3 12 Page 3

The following events affected the financial statements of Jey City during 20X5:

Budgetary activities:

- Total general fund estimated revenues $8,000,000
- Total general fund budgeted expenditures 7,500,000
- Planned construction of a courthouse improvement expected to cost $1,500,000, and to be financed in the following manner: $250,000 from the general fund, $450,000 from state entitlements, and $800,000 from the proceeds of 20-year, 8% bonds dated and expected to be issued at par on June 30, 20X5. Interest on the bonds is payable annually on July 1, together with one-twentieth of the bond principal from general fund revenues of the payment period.
- A budgeted general fund payment of $180,000 to subsidize operations of a solid waste landfill enterprise fund.

Actual results included the following:

- Jey recorded property tax revenues of $5,000,000 and a related allowance for uncollectibles-current of $60,000. On December 31, 20X5, the remaining $56,000 balance of the allowance for uncollectibles-current was closed, and an adjusted allowance for uncollectibles-delinquent was recorded equal to the property tax receivables balance of $38,000.
- A police car with an original cost of $25,000 was sold for $7,000.
- Office equipment to be used by the city's fire department was acquired through a capital lease. The lease required 10 equal annual payments of $10,000, beginning with the July 1, 20X5, acquisition date. Using a 6% discount rate, the 10 payments had a present value of $78,000 at the acquisition date.
- The courthouse was improved and financed as budgeted except for a $27,000 cost overrun that was paid for by the general fund. Jey plans to transfer cash to the debt service fund during 20X6 to service the interest and principal payments called for in the bonds.
- Information related to the solid waste landfill at December 31, 20X5:

| | |
|---|---|
| Capacity | 1,000,000 cubic yards |
| Usage prior to 20X5 | 500,000 cubic yards |
| Usage in 20X5 | 40,000 cubic yards |
| Estimated total life | 20 years |
| Closure costs incurred to date | $300,000 |
| Estimated future costs of closure and post-closure care | 1,700,000 |
| Expense for closure and post-closure care recognized prior to 20X5 | 973,000 |

Jey does not record depreciation for nonproprietary fund-type assets.

Indicate the measurement focus of the Jey fund mentioned.

- Solid waste landfill enterprise fund.

A. Subsidy restrictions.
B. Bond restrictions.
C. Expenditures.
D. Current financial resources.
E. Economic measurement focus.

**CPA-04527 Explanation**

**Choice "E" is correct.** Enterprise funds are proprietary type funds. It uses the economic measurement focus. Simply, the enterprise funds report both current and noncurrent assets and liabilities. They use the full accrual basis of accounting.


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**CPA-04528 Type1 M/C A-J Corr Ans: C PM#109 F 8-99**

188. CPA-04528 ARE 96 OOAF #4 1 Page 3

Dease City is a governmental organization that has governmental-type funds and reports both government wide financial statements and fund financial statements.

This question represents a transaction by governmental-type funds and account groups based on the following selected information taken from Dease City's 20X6 financial records:

*General fund*

| | |
|---|---|
| Fund balance at beginning of 20X6 | $700,000 |
| 20X6 estimated revenues | 10,000,000 |
| 20X6 actual revenues | 10,500,000 |
| 20X6 appropriations | 9,000,000 |
| 20X6 expenditures | 8,200,000 |
| Encumbrances at end of 20X6 | 500,000 |
| Vouchers payable at end of 20X6 | 300,000 |
| 20X6 transfers in | 100,000 |
| 20X6 property tax levy | 9,500,000 |
| 20X6 property taxes estimated to be uncollectible when property tax levy for 20X6 recorded | 100,000 |
| 20X6 property taxes delinquent at end of 20X6 | 150,000 |

*Capital projects fund*

| | |
|---|---|
| 20X6 operating transfers in construction of new library wing started and completed in 20X6 | 100,000 |
| • Proceeds from bonds issued at 100 in 20X6 | 2,000,000 |
| • Expenditures for 20X6 | 2,100,000 |

Determine the amounts based solely on the given information.

What was the net amount credited to the budgetary fund balance when the budget was approved?

A. 0
B. 500,000
C. 1,000,000
D. 2,000,000
E. 2,100,000
F. 3,500,000
G. 5,000,000
H. 8,000,000
I. 9,000,000
J. 9,350,000

**CPA-04528 Explanation**
**Choice "C" is correct. 1,000,000.** The net amount credited to the budgetary fund balance is simply the estimated revenues ($10,000,000) less the appropriations ($9,000,000), or $1,000,000.

**CPA-04529 Type1 M/C A-J Corr Ans: J PM#110 F 8-99**

189. CPA-04529 ARE 96 OOAF #4 2 Page 3

Dease City is a governmental organization that has governmental-type funds and reports both government wide financial statements and fund financial statements.

This question represents a transaction by governmental-type funds and account groups based on the following selected information taken from Dease City's 20X6 financial records:

*General fund*


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| | |
|---|---|
| Fund balance at beginning of 20X6 | $700,000 |
| 20X6 estimated revenues | 10,000,000 |
| 20X6 actual revenues | 10,500,000 |
| 20X6 appropriations | 9,000,000 |
| 20X6 expenditures | 8,200,000 |
| Encumbrances at end of 20X6 | 500,000 |
| Vouchers payable at end of 20X6 | 300,000 |
| 20X6 transfers in | 100,000 |
| 20X6 property tax levy | 9,500,000 |
| 20X6 property taxes estimated to be uncollectible when property tax levy for 20X6 recorded | 100,000 |
| 20X6 property taxes delinquent at end of 20X6 | 150,000 |

*Capital projects fund*

| | |
|---|---|
| 20X6 operating transfers in construction of new library wing started and completed in 20X6 | 100,000 |
| • Proceeds from bonds issued at 100 in 20X6 | 2,000,000 |
| • Expenditures for 20X6 | 2,100,000 |

Determine the amounts based solely on the given information.

What was the amount of property taxes collected on the property tax levy for 20X6?

A. 0
B. 500,000
C. 1,000,000
D. 2,000,000
E. 2,100,000
F. 3,500,000
G. 5,000,000
H. 8,000,000
I. 9,000,000
J. 9,350,000

**CPA-04529 Explanation**
**Choice "J" is correct. 9,350,000.** The amount of property taxes levied (bills sent out) was $9,500,000. Of this amount $150,000 was still delinquent at year-end. Thus, $9,350,000 was collected during the period.

**CPA-04530 Type1 M/C A-J Corr Ans: A PM#111 F 8-99**

190. CPA-04530 ARE 96 OOAF #4 3 Page 3

Dease City is a governmental organization that has governmental-type funds and reports both government wide financial statements and fund financial statements.

This question represents a transaction by governmental-type funds and account groups based on the following selected information taken from Dease City's 20X6 financial records:

*General fund*

| | |
|---|---|
| Fund balance at beginning of 20X6 | $700,000 |
| 20X6 estimated revenues | 10,000,000 |
| 20X6 actual revenues | 10,500,000 |
| 20X6 appropriations | 9,000,000 |
| 20X6 expenditures | 8,200,000 |
| Encumbrances at end of 20X6 | 500,000 |
| Vouchers payable at end of 20X6 | 300,000 |
| 20X6 transfers in | 100,000 |
| 20X6 property tax levy | 9,500,000 |


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| | |
|---|---|
| 20X6 property taxes estimated to be uncollectible when property tax levy for 20X6 recorded | 100,000 |
| 20X6 property taxes delinquent at end of 20X6 | 150,000 |
| *Capital projects fund* | |
| 20X6 operating transfers in construction of new library wing started and completed in 20X6 | 100,000 |
| • Proceeds from bonds issued at 100 in 20X6 | 2,000,000 |
| • Expenditures for 20X6 | 2,100,000 |

Determine the amounts based solely on the given information.

What amount for the new library wing was included in the capital projects fund balance at the end of 20X6?

A. 0
B. 500,000
C. 1,000,000
D. 2,000,000
E. 2,100,000
F. 3,500,000
G. 5,000,000
H. 8,000,000
I. 9,000,000
J. 9,350,000

**CPA-04530 Explanation**
**Choice "A" is correct. 0.** Since the new library wing was started and completed in 20X6, all amounts would have been closed out at completion time. The balance remaining would then be zero.

**CPA-04531 Type1 M/C A-J Corr Ans: E PM#112 F 8-99**

191. CPA-04531 ARE 96 OOAF #4 4 Page 3

Dease City is a governmental organization that has governmental-type funds and reports both government wide financial statements and fund financial statements.

This question represents a transaction by governmental-type funds and account groups based on the following selected information taken from Dease City's 20X6 financial records:

| | |
|---|---|
| *General fund* | |
| Fund balance at beginning of 20X6 | $700,000 |
| 20X6 estimated revenues | 10,000,000 |
| 20X6 actual revenues | 10,500,000 |
| 20X6 appropriations | 9,000,000 |
| 20X6 expenditures | 8,200,000 |
| Encumbrances at end of 20X6 | 500,000 |
| Vouchers payable at end of 20X6 | 300,000 |
| 20X6 transfers in | 100,000 |
| 20X6 property tax levy | 9,500,000 |
| 20X6 property taxes estimated to be uncollectible when property tax levy for 20X6 recorded | 100,000 |
| 20X6 property taxes delinquent at end of 20X6 | 150,000 |
| *Capital projects fund* | |
| 20X6 operating transfers in construction of new library wing started and completed in 20X6 | 100,000 |
| • Proceeds from bonds issued at 100 in 20X6 | 2,000,000 |
| • Expenditures for 20X6 | 2,100,000 |


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Determine the amounts based solely on the given information.

What amount for the new library wing was charged to the general capital assets line item in the governmental activities column of the government wide statement of net assets at the end of 20X6?

A. 0
B. 500,000
C. 1,000,000
D. 2,000,000
E. 2,100,000
F. 3,500,000
G. 5,000,000
H. 8,000,000
I. 9,000,000
J. 9,350,000

**CPA-04531 Explanation**
**Choice "E" is correct. 2,100,000.** The new library wing would be recorded in the general capital assets account reported in the government wide statement of net assets at actual cost, $2,100,000.

**CPA-04532 Type1 M/C A-J Corr Ans: D PM#113 F 8-99**

192. CPA-04532 ARE 96 OOAF #4 5 Page 3

Dease City is a governmental organization that has governmental-type funds and reports both government wide financial statements and fund financial statements.

This question represents a transaction by governmental-type funds and account groups based on the following selected information taken from Dease City's 20X6 financial records:

| | |
|---|---|
| *General fund* | |
| Fund balance at beginning of 20X6 | $700,000 |
| 20X6 estimated revenues | 10,000,000 |
| 20X6 actual revenues | 10,500,000 |
| 20X6 appropriations | 9,000,000 |
| 20X6 expenditures | 8,200,000 |
| Encumbrances at end of 20X6 | 500,000 |
| Vouchers payable at end of 20X6 | 300,000 |
| 20X6 transfers in | 100,000 |
| 20X6 property tax levy | 9,500,000 |
| 20X6 property taxes estimated to be uncollectible when property tax levy for 20X6 recorded | 100,000 |
| 20X6 property taxes delinquent at end of 20X6 | 150,000 |
| *Capital projects fund* | |
| 20X6 operating transfers in construction of new library wing started and completed in 20X6 | 100,000 |
| • Proceeds from bonds issued at 100 in 20X6 | 2,000,000 |
| • Expenditures for 20X6 | 2,100,000 |

Determine the amounts based solely on the given information.

What amount for the new library wing bonds was included in the general long-term liabilities line of the government activities column of the government wide statement of net assets at the end of 20X6?

A. 0
B. 500,000
C. 1,000,000
D. 2,000,000
E. 2,100,000


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F. 3,500,000
G. 5,000,000
H. 8,000,000
I. 9,000,000
J. 9,350,000

**CPA-04532 Explanation**
**Choice "D" is correct. 2,000,000.** The bonds issued for the new library wing would be recorded in the general long-term liabilities account reported in the government wide statement of net assets at par, $2,000,000.

**CPA-04533 Type1 M/C A-R Corr Ans: P PM#114 F 8-99**

193. CPA-04533 ARE R98 OOAF #4 1 Page 3

The following information relates to actual results from Central Town's general fund for the year ended December 31, 20X7:

| | *Revenues* | *Expenditures* |
|---|---|---|
| Property tax collections: | | |
| Current year taxes collected | $630,000 | |
| Prior year taxes due 12/1/X6, collected 2/1/X7 as expected | 50,000 | |
| Current year taxes due 12/1/X7, collection expected by 2/15/X8 | 70,000 | |
| Other cash receipts | 190,000 | |
| General government expenditures: | | |
| General government expenditures: | | |
| Salaries and wages | | $160,000 |
| Other | | 100,000 |
| Public safety and welfare expenditures: | | |
| Salaries and wages | | 350,000 |
| Other | | 150,000 |
| Capital outlay | | 140,000 |
| Transfer to debt service fund | | 30,000 |

- *Other cash receipts* include a county grant of $100,000 for a specified purpose, of which $80,000 was expended; $50,000 in fines; and $40,000 in fees.
- *General government expenditures - other* includes employer contributions to the pension plan and $20,000 in annual capital lease payments for computers over three years; the fair value and present value at lease inception is $50,000.
- *Capital outlay* is for police vehicles.
- *Debt service* represents annual interest payments due December 15th of each year on $500,000 face value, 6%, 20-year term bonds.

*Capital projects fund:*

Central's council approved $750,000 for construction of a fire station, to be financed by $600,000 in general obligation bonds and a $150,000 state grant. Construction began during 20X7, but the fire station was not completed until April 20X8. During 20X7, the following transactions were recorded:

| | |
|---|---|
| State grant | $150,000 |
| Bond proceeds | 610,000 |
| Expenditures | 500,000 |
| Unpaid invoices at year end | 30,000 |
| Outstanding encumbrances at year end, which do not lapse and are to be honored the following year | 25,000 |


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The unreserved fund balance at January 1, 20X7, was $110,000.

Determine the December 31, 20X7, year-end amount to be recognized in the particular fund or account group. Select your answer from the list of amounts below and indicate the corresponding letter.

What amount was recorded for property tax revenues in the general fund?

*Amounts*

A. $0
B. $35,000
C. $50,000
D. $55,000
E. $60,000
F. $140,000
G. $150,000
H. $170,000
I. $190,000
J. $315,000
K. $345,000
L. $370,000
M. $500,000
N. $525,000
O. $630,000
P. $700,000
Q. $710,000
R. $760,000

**CPA-04533 Explanation**
**Choice "P" is correct. $700,000.**

| | |
|---|---|
| Current year collections | $630,000 |
| Collections due BEFORE year-end and anticipated to be collected within 60 days of year end | 70,000 |
| Property Tax Revenues | $700,000 |

Governmental fund revenues are recorded on the modified accrual basis. Earnings are accrued only when both measurable and available. (Modified Accrual = Measurable and Available). Funds due BEFORE year-end and collected within 60 days of year-end are deemed to be available. Current year taxes collected plus amount due in the current year collected within 60 days of year-end would be included in current year revenues. Prior year taxes collected within 60 days of year-end would have been included in prior year revenues using the same rule and would not be relevant to this calculation.

**CPA-04534 Type1 M/C A-R Corr Ans: H PM#115 F 8-99**

194. CPA-04534 ARE R98 OOAF #4 2 Page 3

The following information relates to actual results from Central Town's general fund for the year ended December 31, 20X7:

| | *Revenues* | *Expenditures* |
|---|---|---|
| Property tax collections: | | |
| Current year taxes collected | $630,000 | |
| Prior year taxes due 12/1/X6, collected 2/1/X7 as expected | 50,000 | |
| Current year taxes due 12/1/X7, collection expected by 2/15/X8 | 70,000 | |
| Other cash receipts | 190,000 | |
| General government expenditures: | | |
| General government expenditures: | | |
| Salaries and wages | | $160,000 |


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| | |
|---|---|
| Other | 100,000 |
| Public safety and welfare expenditures: | |
| Salaries and wages | 350,000 |
| Other | 150,000 |
| Capital outlay | 140,000 |
| Transfer to debt service fund | 30,000 |

- *Other cash receipts* include a county grant of $100,000 for a specified purpose, of which $80,000 was expended; $50,000 in fines; and $40,000 in fees.
- *General government expenditures - other* includes employer contributions to the pension plan and $20,000 in annual capital lease payments for computers over three years; the fair value and present value at lease inception is $50,000.
- *Capital outlay* is for police vehicles.
- *Debt service* represents annual interest payments due December 15th of each year on $500,000 face value, 6%, 20-year term bonds.

*Capital projects fund:*

Central's council approved $750,000 for construction of a fire station, to be financed by $600,000 in general obligation bonds and a $150,000 state grant. Construction began during 20X7, but the fire station was not completed until April 20X8. During 20X7, the following transactions were recorded:

| | |
|---|---|
| State grant | $150,000 |
| Bond proceeds | 610,000 |
| Expenditures | 500,000 |
| Unpaid invoices at year end | 30,000 |
| Outstanding encumbrances at year end, which do not lapse and are to be honored the following year | 25,000 |

The unreserved fund balance at January 1, 20X7, was $110,000.

Determine the December 31, 20X7, year-end amount to be recognized in the particular fund or account group. Select your answer from the list of amounts below and indicate the corresponding letter.

What amount was recorded for other revenues in the general fund?

*Amounts*

A. $0
B. $35,000
C. $50,000
D. $55,000
E. $60,000
F. $140,000
G. $150,000
H. $170,000
I. $190,000
J. $315,000
K. $345,000
L. $370,000
M. $500,000
N. $525,000
O. $630,000
P. $700,000
Q. $710,000
R. $760,000

**CPA-04534 Explanation**


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**Choice "H" is correct. $170,000.** Other cash receipts includes both revenue and liability (deferred credit, revenue collected in advance) amounts. The following schedule analyzes the components of other receipts:

| | *Cash Receipts* | | |
|---|---|---|---|
| | *Revenue* | *Deferred Credit* | *Total* |
| Grant receipts | **$ 80,000** | $20,000 | $100,000 |
| Fines | **50,000** | | 50,000 |
| Fees | **40,000** | | 40,000 |
| Total | **$170,000** | $20,000 | $190,000 |

Grant revenues are typically earned as they are expended for their intended purpose. Unspent grant receipts represent revenue collected in advance, a deferred credit accounted for as a liability. Other cash receipts include $170,000 in revenue and $20,000 in liability.

**CPA-04535 Type1 M/C A-R Corr Ans: C PM#116 F 8-99**

195. CPA-04535 ARE R98 OOAF #4 3 Page 3

The following information relates to actual results from Central Town's general fund for the year ended December 31, 20X7:

| | *Revenues* | *Expenditures* |
|---|---|---|
| Property tax collections: | | |
| Current year taxes collected | $630,000 | |
| Prior year taxes due 12/1/X6, collected 2/1/X7 as expected | 50,000 | |
| Current year taxes due 12/1/X7, collection expected by 2/15/X8 | 70,000 | |
| Other cash receipts | 190,000 | |
| General government expenditures: | | |
| General government expenditures: | | |
| Salaries and wages | | $160,000 |
| Other | | 100,000 |
| Public safety and welfare expenditures: | | |
| Salaries and wages | | 350,000 |
| Other | | 150,000 |
| Capital outlay | | 140,000 |
| Transfer to debt service fund | | 30,000 |

- *Other cash receipts* include a county grant of $100,000 for a specified purpose, of which $80,000 was expended; $50,000 in fines; and $40,000 in fees.
- *General government expenditures - other* includes employer contributions to the pension plan and $20,000 in annual capital lease payments for computers over three years; the fair value and present value at lease inception is $50,000.
- *Capital outlay* is for police vehicles.
- *Debt service* represents annual interest payments due December 15th of each year on $500,000 face value, 6%, 20-year term bonds.

*Capital projects fund:*

Central's council approved $750,000 for construction of a fire station, to be financed by $600,000 in general obligation bonds and a $150,000 state grant. Construction began during 20X7, but the fire station was not completed until April 20X8. During 20X7, the following transactions were recorded:

| | |
|---|---|
| State grant | $150,000 |
| Bond proceeds | 610,000 |
| Expenditures | 500,000 |


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| | |
|---|---|
| Unpaid invoices at year end | 30,000 |
| Outstanding encumbrances at year end, which do not lapse and are to be honored the following year | 25,000 |

The unreserved fund balance at January 1, 20X7, was $110,000.

Determine the December 31, 20X7, year-end amount to be recognized in the particular fund or account group. Select your answer from the list of amounts below and indicate the corresponding letter.

What amount was recorded for capital leases of computers in the general capital assets line item in the governmental activities column of Central's government wide statement of net assets?

*Amounts*

A. $0
B. $35,000
C. $50,000
D. $55,000
E. $60,000
F. $140,000
G. $150,000
H. $170,000
I. $190,000
J. $315,000
K. $345,000
L. $370,000
M. $500,000
N. $525,000
O. $630,000
P. $700,000
Q. $710,000
R. $760,000

**CPA-04535 Explanation**
**Choice "C" is correct. $50,000.** Equipment acquired under a capital lease in Governmental funds would be recorded in the General Capital Asset Account displayed in the government wide statement of net assets, while related capital lease liabilities would be recorded in the General Long-term Liability Account displayed in the government wide statement of net assets. Computers acquired by capital lease whose present value was $50,000 at the inception of the lease would be recorded at $50,000.

**CPA-04536 Type1 M/C A-R Corr Ans: F PM#117 F 8-99**

196. CPA-04536 ARE R98 OOAF #4 4 Page 3

The following information relates to actual results from Central Town's general fund for the year ended December 31, 20X7:

| | *Revenues* | *Expenditures* |
|---|---|---|
| Property tax collections: | | |
| Current year taxes collected | $630,000 | |
| Prior year taxes due 12/1/X6, collected 2/1/X7 as expected | 50,000 | |
| Current year taxes due 12/1/X7, collection expected by 2/15/X8 | 70,000 | |
| Other cash receipts | 190,000 | |
| General government expenditures: | | |
| General government expenditures: | | |
| Salaries and wages | | $160,000 |
| Other | | 100,000 |
| Public safety and welfare expenditures: | | |


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| | |
|---|---|
| Salaries and wages | 350,000 |
| Other | 150,000 |
| Capital outlay | 140,000 |
| Transfer to debt service fund | 30,000 |

- *Other cash receipts* include a county grant of $100,000 for a specified purpose, of which $80,000 was expended; $50,000 in fines; and $40,000 in fees.
- *General government expenditures - other* includes employer contributions to the pension plan and $20,000 in annual capital lease payments for computers over three years; the fair value and present value at lease inception is $50,000.
- *Capital outlay* is for police vehicles.
- *Debt service* represents annual interest payments due December 15th of each year on $500,000 face value, 6%, 20-year term bonds.

*Capital projects fund:*

Central's council approved $750,000 for construction of a fire station, to be financed by $600,000 in general obligation bonds and a $150,000 state grant. Construction began during 20X7, but the fire station was not completed until April 20X8. During 20X7, the following transactions were recorded:

| | |
|---|---|
| State grant | $150,000 |
| Bond proceeds | 610,000 |
| Expenditures | 500,000 |
| Unpaid invoices at year end | 30,000 |
| Outstanding encumbrances at year end, which do not lapse and are to be honored the following year | 25,000 |

The unreserved fund balance at January 1, 20X7, was $110,000.

Determine the December 31, 20X7, year-end amount to be recognized in the particular fund or account group. Select your answer from the list of amounts below and indicate the corresponding letter.

What amount was recorded as capital outlay for police vehicles in the general fund?

*Amounts*

A. $0
B. $35,000
C. $50,000
D. $55,000
E. $60,000
F. $140,000
G. $150,000
H. $170,000
I. $190,000
J. $315,000
K. $345,000
L. $370,000
M. $500,000
N. $525,000
O. $630,000
P. $700,000
Q. $710,000
R. $760,000

**CPA-04536 Explanation**

**Choice "F" is correct. $140,000.** Capital Outlay displayed on the trial balance is exclusively attributable to police cars according to the facts. Capital outlay for police vehicles would be recorded as an expenditure in the General Fund. The assets themselves would only be recorded in the government-wide financial statements. The General Capital Asset Account appearing in the government wide financials


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would include the fixed assets of a governmental jurisdiction which are not accounted for in either the Proprietary Funds or Fiduciary Funds.

**CPA-04537 Type1 M/C A-R Corr Ans: R PM#118 F 8-99**

197. CPA-04537 ARE R98 OOAF #4 5 Page 3

The following information relates to actual results from Central Town's general fund for the year ended December 31, 20X7:

| | *Revenues* | *Expenditures* |
|---|---|---|
| Property tax collections: | | |
| Current year taxes collected | $630,000 | |
| Prior year taxes due 12/1/X6, collected 2/1/X7 as expected | 50,000 | |
| Current year taxes due 12/1/X7, collection expected by 2/15/X8 | 70,000 | |
| Other cash receipts | 190,000 | |
| General government expenditures: | | |
| General government expenditures: | | |
| Salaries and wages | | $160,000 |
| Other | | 100,000 |
| Public safety and welfare expenditures: | | |
| Salaries and wages | | 350,000 |
| Other | | 150,000 |
| Capital outlay | | 140,000 |
| Transfer to debt service fund | | 30,000 |

- *Other cash receipts* include a county grant of $100,000 for a specified purpose, of which $80,000 was expended; $50,000 in fines; and $40,000 in fees.
- *General government expenditures - other* includes employer contributions to the pension plan and $20,000 in annual capital lease payments for computers over three years; the fair value and present value at lease inception is $50,000.
- *Capital outlay* is for police vehicles.
- *Debt service* represents annual interest payments due December 15th of each year on $500,000 face value, 6%, 20-year term bonds.

*Capital projects fund:*

Central's council approved $750,000 for construction of a fire station, to be financed by $600,000 in general obligation bonds and a $150,000 state grant. Construction began during 20X7, but the fire station was not completed until April 20X8. During 20X7, the following transactions were recorded:

| | |
|---|---|
| State grant | $150,000 |
| Bond proceeds | 610,000 |
| Expenditures | 500,000 |
| Unpaid invoices at year end | 30,000 |
| Outstanding encumbrances at year end, which do not lapse and are to be honored the following year | 25,000 |

The unreserved fund balance at January 1, 20X7, was $110,000.

Determine the December 31, 20X7, year-end amount to be recognized in the particular fund or account group. Select your answer from the list of amounts below and indicate the corresponding letter.

What was the total amount recorded for functional expenditures in the general fund?

*Amounts*

A. $0


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B. $35,000
C. $50,000
D. $55,000
E. $60,000
F. $140,000
G. $150,000
H. $170,000
I. $190,000
J. $315,000
K. $345,000
L. $370,000
M. $500,000
N. $525,000
O. $630,000
P. $700,000
Q. $710,000
R. $760,000

**CPA-04537 Explanation**
**Choice "R" is correct. $760,000.**

| | | |
|---|---|---|
| Current | | |
| General government | | |
| Salaries and wages | $160,000 | |
| Other | 100,000 | |
| Total General government | | $260,000 |
| Public safety and welfare | | |
| Salaries and wages | 350,000 | |
| Other | 150,000 | |
| Total Public safety and welfare | | 500,000 |
| **Total Functional Expenditures** | | **$760,000** |
| Capital Outlay | | $140,000 |
| Other Financing Sources and Uses | | |
| Transfer to debt service fund | | $30,000 |

Functional expenditures of the government represent those current operating expenditures used to meet ongoing and routine obligations of the government. Capital outlay expenditures whose character is non-recurring and transfers (which represent other financing uses, not expenditures) are not considered functional expenditures.

**CPA-04538 Type1 M/C A-R Corr Ans: G PM#119 F 8-99**

198. CPA-04538 ARE R98 OOAF #4 6 Page 3

The following information relates to actual results from Central Town's general fund for the year ended December 31, 20X7:

| | *Revenues* | *Expenditures* |
|---|---|---|
| Property tax collections: | | |
| Current year taxes collected | $630,000 | |
| Prior year taxes due 12/1/X6, collected 2/1/X7 as expected | 50,000 | |
| Current year taxes due 12/1/X7, collection expected by 2/15/X8 | 70,000 | |
| Other cash receipts | 190,000 | |
| General government expenditures: | | |
| General government expenditures: | | |


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| | |
|---|---|
| Salaries and wages | $160,000 |
| Other | 100,000 |
| Public safety and welfare expenditures: | |
| Salaries and wages | 350,000 |
| Other | 150,000 |
| Capital outlay | 140,000 |
| Transfer to debt service fund | 30,000 |

- *Other cash receipts* include a county grant of $100,000 for a specified purpose, of which $80,000 was expended; $50,000 in fines; and $40,000 in fees.
- *General government expenditures - other* includes employer contributions to the pension plan and $20,000 in annual capital lease payments for computers over three years; the fair value and present value at lease inception is $50,000.
- *Capital outlay* is for police vehicles.
- *Debt service* represents annual interest payments due December 15th of each year on $500,000 face value, 6%, 20-year term bonds.

*Capital projects fund:*

Central's council approved $750,000 for construction of a fire station, to be financed by $600,000 in general obligation bonds and a $150,000 state grant. Construction began during 20X7, but the fire station was not completed until April 20X8. During 20X7, the following transactions were recorded:

| | |
|---|---|
| State grant | $150,000 |
| Bond proceeds | 610,000 |
| Expenditures | 500,000 |
| Unpaid invoices at year end | 30,000 |
| Outstanding encumbrances at year end, which do not lapse and are to be honored the following year | 25,000 |

The unreserved fund balance at January 1, 20X7, was $110,000.

Determine the December 31, 20X7, year-end amount to be recognized in the particular fund or account group. Select your answer from the list of amounts below and indicate the corresponding letter.

What amount was recorded for revenues in the capital projects fund?

*Amounts*

A. $0
B. $35,000
C. $50,000
D. $55,000
E. $60,000
F. $140,000
G. $150,000
H. $170,000
I. $190,000
J. $315,000
K. $345,000
L. $370,000
M. $500,000
N. $525,000
O. $630,000
P. $700,000
Q. $710,000
R. $760,000

**CPA-04538 Explanation**


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**Choice "G" is correct. $150,000.**

| | |
|---|---|
| Revenues | |
| State Grant | 150,000 |
| Other Financing Sources Bond Proceeds | 610,000 |

State grants would be classified as revenues in the governmental fund types, while proceeds from debt, sales of assets, or transfers would be classified as Other Financing Sources. Revenues in the Capital Projects fund are equal to the amount of the State Grant.

**CPA-04539 Type1 M/C A-R Corr Ans: M PM#120 F 8-99**

199. CPA-04539 ARE R98 OOAF #4 7 Page 3

The following information relates to actual results from Central Town's general fund for the year ended December 31, 20X7:

| | *Revenues* | *Expenditures* |
|---|---|---|
| Property tax collections: | | |
| Current year taxes collected | $630,000 | |
| Prior year taxes due 12/1/X6, collected 2/1/X7 as expected | 50,000 | |
| Current year taxes due 12/1/X7, collection expected by 2/15/X8 | 70,000 | |
| Other cash receipts | 190,000 | |
| General government expenditures: | | |
| General government expenditures: | | |
| Salaries and wages | | $160,000 |
| Other | | 100,000 |
| Public safety and welfare expenditures: | | |
| Salaries and wages | | 350,000 |
| Other | | 150,000 |
| Capital outlay | | 140,000 |
| Transfer to debt service fund | | 30,000 |

- *Other cash receipts* include a county grant of $100,000 for a specified purpose, of which $80,000 was expended; $50,000 in fines; and $40,000 in fees.
- *General government expenditures - other* includes employer contributions to the pension plan and $20,000 in annual capital lease payments for computers over three years; the fair value and present value at lease inception is $50,000.
- *Capital outlay* is for police vehicles.
- *Debt service* represents annual interest payments due December 15th of each year on $500,000 face value, 6%, 20-year term bonds.

*Capital projects fund:*

Central's council approved $750,000 for construction of a fire station, to be financed by $600,000 in general obligation bonds and a $150,000 state grant. Construction began during 20X7, but the fire station was not completed until April 20X8. During 20X7, the following transactions were recorded:

| | |
|---|---|
| State grant | $150,000 |
| Bond proceeds | 610,000 |
| Expenditures | 500,000 |
| Unpaid invoices at year end | 30,000 |
| Outstanding encumbrances at year end, which do not lapse and are to be honored the following year | 25,000 |

The unreserved fund balance at January 1, 20X7, was $110,000.


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Determine the December 31, 20X7, year-end amount to be recognized in the particular fund or account group. Select your answer from the list of amounts below and indicate the corresponding letter.

What amount was recorded as construction-in-progress for reporting in the general capital assets line item in the governmental activities column of Central's government wide statement of net assets?

*Amounts*

A. $0
B. $35,000
C. $50,000
D. $55,000
E. $60,000
F. $140,000
G. $150,000
H. $170,000
I. $190,000
J. $315,000
K. $345,000
L. $370,000
M. $500,000
N. $525,000
O. $630,000
P. $700,000
Q. $710,000
R. $760,000

**CPA-04539 Explanation**

**Choice "M" is correct. $500,000.** Construction in Progress on the fire station is equal to the amount of capital outlay expenditure incurred on the construction project inception to date. The construction of the fire station was begun in 20X7 but not completed until the four months after year-end. Construction in Progress displayed in the General Capital Asset Account displayed in the government wide statement of net assets is equal to the capital outlay expenditures of $500,000. Unpaid invoices would have been accrued as part of the amount displayed as expenditure in the Capital Projects Fund. Unpaid invoice amounts are not relevant to this calculation.

**CPA-04540 Type1 M/C A-R Corr Ans: K PM#121 F 8-99**

200. CPA-04540 ARE R98 OOAF #4 8 Page 3

The following information relates to actual results from Central Town's general fund for the year ended December 31, 20X7:

| | *Revenues* | *Expenditures* |
|---|---|---|
| Property tax collections: | | |
| Current year taxes collected | $630,000 | |
| Prior year taxes due 12/1/X6, collected 2/1/X7 as expected | 50,000 | |
| Current year taxes due 12/1/X7, collection expected by 2/15/X8 | 70,000 | |
| Other cash receipts | 190,000 | |
| General government expenditures: | | |
| General government expenditures: | | |
| Salaries and wages | | $160,000 |
| Other | | 100,000 |
| Public safety and welfare expenditures: | | |
| Salaries and wages | | 350,000 |
| Other | | 150,000 |
| Capital outlay | | 140,000 |


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| | |
|---|---|
| Transfer to debt service fund | 30,000 |

- *Other cash receipts* include a county grant of $100,000 for a specified purpose, of which $80,000 was expended; $50,000 in fines; and $40,000 in fees.
- *General government expenditures - other* includes employer contributions to the pension plan and $20,000 in annual capital lease payments for computers over three years; the fair value and present value at lease inception is $50,000.
- *Capital outlay* is for police vehicles.
- *Debt service* represents annual interest payments due December 15th of each year on $500,000 face value, 6%, 20-year term bonds.

*Capital projects fund:*

Central's council approved $750,000 for construction of a fire station, to be financed by $600,000 in general obligation bonds and a $150,000 state grant. Construction began during 20X7, but the fire station was not completed until April 20X8. During 20X7, the following transactions were recorded:

| | |
|---|---|
| State grant | $150,000 |
| Bond proceeds | 610,000 |
| Expenditures | 500,000 |
| Unpaid invoices at year end | 30,000 |
| Outstanding encumbrances at year end, which do not lapse and are to be honored the following year | 25,000 |

The unreserved fund balance at January 1, 20X7, was $110,000.

Determine the December 31, 20X7, year-end amount to be recognized in the particular fund or account group. Select your answer from the list of amounts below and indicate the corresponding letter.

What amount was reported as the unreserved fund balance at December 31, 20X7, in the capital projects fund?

*Amounts*

A. $0
B. $35,000
C. $50,000
D. $55,000
E. $60,000
F. $140,000
G. $150,000
H. $170,000
I. $190,000
J. $315,000
K. $345,000
L. $370,000
M. $500,000
N. $525,000
O. $630,000
P. $700,000
Q. $710,000
R. $760,000

**CPA-04540 Explanation**
**Choice "K" is correct. $345,000.**

| | | |
|---|---|---|
| Beginning Fund Balance | | $110,000 |
| PLUS | | |
| State Grant Revenues | $150,000 | |
| Bond Proceeds | 610,000 | |
| LESS | | |


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| | | |
|---|---|---|
| Capital Outlay | (500,000) | |
| | | 260,000 |
| Ending Fund Balance | | 370,000 |
| LESS | | |
| Fund Balance Reserved for Encumbrances | | (25,000) |
| Unreserved Fund Balance | | $345,000 |

Unreserved Fund Balance is the sum of beginning fund balance and operating activity for the year minus any reservations, such as for encumbrances.

**CPA-04541 Type1 M/C A-C Corr Ans: B PM#122 F 8-99**

201. CPA-04541 ARE R98 OOAF #4 9 Page 3

The following information relates to actual results from Central Town's general fund for the year ended December 31, 20X7:

| | *Revenues* | *Expenditures* |
|---|---|---|
| Property tax collections: | | |
| Current year taxes collected | $630,000 | |
| Prior year taxes due 12/1/X6, collected 2/1/X7 as expected | 50,000 | |
| Current year taxes due 12/1/X7, collection expected by 2/15/X8 | 70,000 | |
| Other cash receipts | 190,000 | |
| General government expenditures: | | |
| General government expenditures: | | |
| Salaries and wages | | $160,000 |
| Other | | 100,000 |
| Public safety and welfare expenditures: | | |
| Salaries and wages | | 350,000 |
| Other | | 150,000 |
| Capital outlay | | 140,000 |
| Transfer to debt service fund | | 30,000 |

- *Other cash receipts* include a county grant of $100,000 for a specified purpose, of which $80,000 was expended; $50,000 in fines; and $40,000 in fees.
- *General government expenditures - other* includes employer contributions to the pension plan and $20,000 in annual capital lease payments for computers over three years; the fair value and present value at lease inception is $50,000.
- *Capital outlay* is for police vehicles.
- *Debt service* represents annual interest payments due December 15th of each year on $500,000 face value, 6%, 20-year term bonds.

*Capital projects fund:*

Central's council approved $750,000 for construction of a fire station, to be financed by $600,000 in general obligation bonds and a $150,000 state grant. Construction began during 20X7, but the fire station was not completed until April 20X8. During 20X7, the following transactions were recorded:

| | |
|---|---|
| State grant | $150,000 |
| Bond proceeds | 610,000 |
| Expenditures | 500,000 |
| Unpaid invoices at year end | 30,000 |
| Outstanding encumbrances at year end, which do not lapse and are to be honored the following year | 25,000 |

The unreserved fund balance at January 1, 20X7, was $110,000.


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Select the required reporting disclosure for Central's defined-benefit pension plan.

- Schedule of employer contributions.

*Reporting Disclosures*

A. Notes to the financial statements.
B. Required supplementary information.
C. No required disclosure.

**CPA-04541 Explanation**
**Choice "B" is correct.** Public Employee Retirement Systems are required to report six-year historical trend data as related to Revenues by Source as Supplementary Information. Revenues by source include employer contributions, employee contributions, investment income, and other income.

**CPA-04542 Type1 M/C A-C Corr Ans: A PM#123 F 8-99**

202. CPA-04542 ARE R98 OOAF #4 10 Page 3

The following information relates to actual results from Central Town's general fund for the year ended December 31, 20X7:

| | *Revenues* | *Expenditures* |
|---|---|---|
| Property tax collections: | | |
| Current year taxes collected | $630,000 | |
| Prior year taxes due 12/1/X6, collected 2/1/X7 as expected | 50,000 | |
| Current year taxes due 12/1/X7, collection expected by 2/15/X8 | 70,000 | |
| Other cash receipts | 190,000 | |
| General government expenditures: | | |
| General government expenditures: | | |
| Salaries and wages | | $160,000 |
| Other | | 100,000 |
| Public safety and welfare expenditures: | | |
| Salaries and wages | | 350,000 |
| Other | | 150,000 |
| Capital outlay | | 140,000 |
| Transfer to debt service fund | | 30,000 |

- *Other cash receipts* include a county grant of $100,000 for a specified purpose, of which $80,000 was expended; $50,000 in fines; and $40,000 in fees.
- *General government expenditures - other* includes employer contributions to the pension plan and $20,000 in annual capital lease payments for computers over three years; the fair value and present value at lease inception is $50,000.
- *Capital outlay* is for police vehicles.
- *Debt service* represents annual interest payments due December 15th of each year on $500,000 face value, 6%, 20-year term bonds.

*Capital projects fund:*

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| | |
|---|---|
| State grant | $150,000 |
| Bond proceeds | 610,000 |
| Expenditures | 500,000 |


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| | |
|---|---|
| Unpaid invoices at year end | 30,000 |
| Outstanding encumbrances at year end, which do not lapse and are to be honored the following year | 25,000 |

The unreserved fund balance at January 1, 20X7, was $110,000.

Select the required reporting disclosure for Central's defined-benefit pension plan.

- Classes of employees covered, such as general employees and public safety employees.

*Reporting Disclosures*

A. Notes to the financial statements.
B. Required supplementary information.
C. No required disclosure.

**CPA-04542 Explanation**
**Choice "A" is correct.** Public Employee Retirement Systems are required to disclose their plan description in the notes to their financial statements.


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# CPA PassMaster Questions–Financial 9
# Export Date: 10/30/08


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**Governmental Accounting (Part B)**

**CPA-00967 Type1 M/C A-D Corr Ans: B PM#2 F 9-01**

1. CPA-00967 ARE R03 #17 Page 22

Nox City reported a $25,000 net increase in the fund balances for total governmental funds. Nox also reported an increase in net assets for the following funds:

| | |
|---|---|
| Motor pool internal service fund | $9,000 |
| Water enterprise fund | 12,000 |
| Employee pension fund | 7,000 |

The motor pool internal service fund provides service to the general fund departments. What amount should Nox report as the change in net assets for governmental activities?

a. $25,000
b. $34,000
c. $41,000
d. $46,000

**CPA-00967 Explanation**
Choice "b" is correct. The reconciliation of the change in fund balances in governmental fund financial statements to the change in net assets for governmental activities in the government-wide financials is computed using the GOES BARE mnemonic. The fact pattern only describes measurement focus (GOES) issues computed as follows:

| | | |
|---|---|---|
| **G** | Change in **G**overnmental Fund Balance | $25,000 |
| **O** | Capital **O**utlay | 0 |
| | (net of depreciation) | 0 |
| **E** | Expenditure Principal Payments on Debt - Proceeds from New Debt | 0 |
| **S** | Internal **S**ervice Fund Net Income | 9,000 |
| | Change in Net Assets in government-wide financial statements | $34,000 |

Choice "a" is incorrect. The change in fund balance is not equal to the change in net assets after consideration of the reconciling items described above.

Choice "c" is incorrect. The change in fund balance reconciles to the change in net assets as a result of considering only the change in internal service fund net assets per above. Changes in pension fund net assets are not relevant to the reconciliation.

Choice "d" is incorrect. The change in fund balance reconciles to the change in net assets as a result of considering only the change in internal service fund net assets per above. Changes in water and sewer (enterprise) net assets are not relevant to the reconciliation.

**CPA-00986 Type1 M/C A-D Corr Ans: A PM#5 F 9-01**

2. CPA-00986 ARE R02 #12 Page 28

Hunt Community Development Agency (HCDA), a financially independent authority, provides loans to commercial businesses operating in Hunt County. This year, HCDA made loans totaling $500,000. How should HCDA classify the disbursements of loans on the cash flow statement?

a. Operating activities.
b. Non-capital financing activities.
c. Capital and related financing activities.
d. Investing activities.

**CPA-00986 Explanation**


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**Rule:** Government proprietary funds (enterprise and internal service) prepare a statement of cash flows in a manner similar to commercial enterprises.

Choice "a" is correct. Cash activities associated with the ongoing and central activities of an entity would be classified as operating activities on its statement of cash flows. The HCDA is in the business of providing loans. Cash activities associated with the HCDA's loans consistent with its charter would be classified as operating activities.

Choices "b", "c", and "d" are incorrect per the rule above.

**CPA-01002 Type1 M/C A-D Corr Ans: B PM#8 F 9-01**

3. CPA-01002 ARE C00 #4 Page 3

The financial statements of governments have focused on two forms of accountability. Government-wide financial statements focus the reader on accountability in which way(s):

| | *Fiscal Accountability* | *Operational Accountability* |
|---|---|---|
| a. | Yes | Yes |
| b. | No | Yes |
| c. | Yes | No |
| d. | No | No |

**CPA-01002 Explanation**

Choice "b" is correct. Government-wide financial statements focus on the operational accountability of the government. Operational accountability takes an economic view that reports on the long-term efficient and effective use of resources. Fiscal accountability takes a short-term view that focuses the reader on compliance and current year performance.

Choices "a", "c", and "d" are incorrect. Government-wide financial statements focus on the operational accountability, not the fiscal accountability of the organization. Fund financial statements focus the reader on fiscal accountability.

**CPA-01015 Type1 M/C A-D Corr Ans: B PM#9 F 9-01**

4. CPA-01015 ARE C00 #5 Page 3

The City of Reformville has elected to early adopt the reporting standards of GASB #34. Citizens of the City of Reformville can expect to find the following items in their basic financial statements:

a. Management's Discussion and Analysis, Required Supplementary Information, Government-wide Financial Statements and Notes to the Financial Statements.
b. Government-wide financial statements, Fund financial statements and notes to the financial statements.
c. Statement of Net Assets and a Statement of Activities.
d. Statement of Net Assets, Statement of Activities and a Statement of Public Accountability.

**CPA-01015 Explanation**

**Rule:** Government reporting standards established by GASB #34 require presentation of basic financial statements and required supplementary information. Basic financial statements are defined as government-wide financial statements, fund financial statements and notes to the financial statements. Supplementary information covers a wide range of information including management's discussion and analysis and supporting schedules such as combining financial statements by fund type and budget versus actual presentations.

Choice "b" is correct. Basic financial statements include government-wide financial statements, fund financial statements and notes to the financial statements.


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Choice "a" is incorrect. Management's discussion and analysis and required supplementary information represent part of the total requirement to meet GASB #34 reporting standards, not the basic financial statements.

Choice "c" is incorrect. The Statement of Net Assets and Statement of Activities are included in the government-wide financial statements.

Choice "d" is incorrect. The Statement of Net Assets and Statement of Activities are included in the government-wide financial statements. The "Statement of Public Accountability" is a well-designed distracter.

**CPA-01022 Type1 M/C A-D Corr Ans: D PM#10 F 9-01**

5. CPA-01022 ARE C00 #6 Page 3

GASB #34 establishes financial reporting standards for state and local government. Basic financial statements and required supplementary information for general purpose governments should consist of:

a. Liftable financial statements, notes to the financial statements, and statistical schedules.
b. General purpose financial statements, notes to the financial statements, combining financial statements and statistical schedules.
c. Basic financial statements and required supplementary information introduced after the basic financial statements.
d. Management's Discussion and Analysis, Basic Financial Statements and Required Supplementary Information.

**CPA-01022 Explanation**

Choice "d" is correct. The basic financial statements and required supplementary information should consist of Management's Discussion and Analysis, Basic Financial Statements and Required Supplementary Information.

Choice "a" is incorrect. Basic financial statements and required supplementary information do not include the terms liftable or statistical schedules.

Choice "b" is incorrect. Basic financial statements and required supplementary information do not include the terms general purpose financial statements, combining financial statements or statistical schedules.

Choice "c" is incorrect. Basic financial statements and required supplementary information include a section for Management's Discussion and Analysis that is required to appear before the financial statements in addition to basic financial statements and other required supplementary information.

**CPA-01026 Type1 M/C A-D Corr Ans: B PM#11 F 9-01**

6. CPA-01026 ARE C00 #7 Page 3

The presentation of government-wide financial statements prepared using a uniform method of accounting and measurement focus in combination with both fund based financial statements that use the method of accounting and measurement focus appropriate to the particular fund type along with appropriate reconciliation is best referred to as:

a. The Financial Reporting Pyramid.
b. The Integrated Approach.
c. The Segregated Approach.
d. The Public Accountability Approach.

**CPA-01026 Explanation**

Choice "b" is correct. The joint presentation of government-wide and fund financial statements and appropriate reconciliation is called the integrated approach.

Choice "a" is incorrect. The Financial Reporting Pyramid was the reporting model used prior to the introduction of GASB #34 reporting standards. The pyramid was comprised of individual, combining and


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combined or general purpose financial statement, which essentially built from a broad base of information to, condensed summary information similar to a pyramid.

Choice "c" is incorrect. The term segregated approach is a distracter.

Choice "d" is incorrect. The public accountability approach is a distracter.

**CPA-01030 Type1 M/C A-D Corr Ans: C PM#12 F 9-01**

7. CPA-01030 ARE C00 #8 Page 5

Sample City has elected to adopt the standards of GASB #34 early relative to the preparation of their financial statements. The city has identified the non-major funds within its fund types. In its financial report, Sample City:

a. Must include combining financial statements for non-major funds for each fund type in the basic financial statements.
b. Must include combing financial statements for non-major funds for each fund type in the required supplementary information.
c. May include combining financial statements for non-major funds for each fund type in the supplementary information.
d. Must include combining financial statement disclosures for non-major funds for each fund type in the notes to the financial statements.

**CPA-01030 Explanation**
Choice "c" is correct. Sample City may report combining non-major individual fund financial statements in the supplementary information. Reporting the combining fund financial statements is optional.

Choices "a", "b", and "d" are incorrect. Sample City's reporting is optional.

**CPA-01036 Type1 M/C A-D Corr Ans: B PM#13 F 9-01**

8. CPA-01036 ARE C00 #9 Page 5

A government's Comprehensive Annual Financial Report (CAFR) is divided into three sections as follows:

a. Management's Discussion and Analysis, Basic Financial Statements and Required Supplementary Information.
b. Introductory Section, Basic Financial Statements and Required Supplementary Information, and Statistical Section.
c. Introductory Section, Financial Section, Required Supplementary Information.
d. Introductory Section, General Purpose Financial Statements and Combining Financial Statements, and Statistical Section.

**CPA-01036 Explanation**
Choice "b" is correct. The CAFR is divided into an introductory section, which includes a title page and table of contents, a section for the Basic financial statements and the required supplementary information (including the Management's Discussion and Analysis) and a section for statistical data (ten years of revenue by type, expenses by type, assessed property values, etc.).

Choice "a" is incorrect. Management's Discussion and Analysis, Basic Financial Statements and Required Supplementary Information define the reporting standards required by GASB #34.

Choice "c" is incorrect. The components of the CAFR included an introductory section, a statistical section and a section that included the Basic financial statements and required supplementary information.

Choice "d" is incorrect. Financial statement titles described by GASB #34 reporting standards exclude the terms General Purposes Financial Statements.


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**CPA-01039 Type1 M/C A-D Corr Ans: B PM#14 F 9-01**

9. CPA-01039 ARE C00 #10 Page 5

Readers of the Comprehensive Annual Report of the City of Scenic Beach would expect to find Management's Discussion Analysis in the CAFR section titled:

a. Introductory Section.
b. Basic Financial Statements and Required Supplementary Information.
c. Statistical Section.
d. Management's Discussion and Analysis.

**CPA-01039 Explanation**
Choice "b" is correct. Management's Discussion and Analysis is considered to be Required Supplementary Information that precedes the Basic Financial Statements but is still part of the Basic Financial Statements and Required Supplementary Information.

Choice "a" is incorrect. The Introductory Section of the CAFR includes extremely limited information about the government.

Choice "c" is incorrect. The Statistical Section included ten years of historical statistical data pertaining to the government.

Choice "d" is incorrect. The CAFR does not devote a separate section to Management's Discussion and Analysis.

**CPA-01049 Type1 M/C A-D Corr Ans: D PM#16 F 9-01**

10. CPA-01049 ARE C00 #12 Page 9

A government's management's discussion and analysis would likely include all of the following features, **except**:

a. An objective and easily readable analysis of the government's financial activities based on currently known facts, decisions or conditions.
b. A comparison of current year to the prior year based on government-wide information along with other information helpful in assessing the improvement or deterioration of the government's financial position.
c. A discussion of significant changes in individual funds and significant budget variances.
d. A reconciliation of fund financial statements and government-wide financial statements.

**CPA-01049 Explanation**
**Rule:** The management's discussion and analysis (MD&A) is part of required supplementary information and is meant to introduce the basic financial statements and provide an analytical overview of the government's financial activities. The MD&A may include objective analysis of current conditions, comparison of prior and current year activities and significant results reported in fund financial statements. Reconciliation of the fund financial statements is included as part of the basic financial statements, not required supplementary information.

Choice "d" is correct. A reconciliation of fund financial statements and government-wide financial statements would not be included in the MD&A.

Choices "a", "b", and "c" are incorrect, per the rule above.

**CPA-01055 Type1 M/C A-D Corr Ans: D PM#17 F 9-01**

11. CPA-01055 ARE C00 #13 Page 10

Government-wide financial statements would include all government-wide activities associated with operational accountability for all activities, **except**:

a. Governmental Activities.


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b. Business-type Activities.
c. Component Unit Activities.
d. Fiduciary Activities.

**CPA-01055 Explanation**
Choice "d" is correct. Fiduciary activities should be excluded from government-wide measures of operational accountability since fiduciary resources cannot be used to support the government's programs or other services.

Choices "a", "b", and "c" are incorrect. Governmental Type, Business-type and Component Units are specifically included in the Statement of Activities.

**CPA-01059 Type1 M/C A-D Corr Ans: B PM#18 F 9-01**

12. CPA-01059 ARE C00 #14 Page 10

The City of Accountability has decided to adopt the reporting standards of GASB #34. As a result, the city will report its net assets in its government-wide financial statements classified in three categories as follows:

a. Unrestricted, Permanently Restricted and Temporarily Restricted.
b. Invested in capital assets (net of related debt), restricted and unrestricted.
c. Invested in capital assets, restricted for debt service and unrestricted.
d. Reserved, Designated, Undesignated and unreserved.

**CPA-01059 Explanation**
**Rule:** Government-wide financial statements should classify net assets as:

1. Invested in capital assets (net of related debt).
2. Restricted and
3. Unrestricted.

Choice "b" is correct. Invested in capital assets (net of related debt), restricted and unrestricted.

Choice "a" is incorrect. Classification of net assets as permanently restricted, temporarily restricted and unrestricted is used in not-for-profit entities, not governments.

Choice "c" is incorrect. Invested in capital assets, restricted for debt service and unrestricted are not appropriate classifications per the above rule.

Choice "d" is incorrect. Reserved, designated and undesignated and unreserved were the terms applied to Fund Equity in the governmental reporting standards in effect prior to the issuance of GASB #34.

**CPA-01063 Type1 M/C A-D Corr Ans: D PM#19 F 9-01**

13. CPA-01063 ARE C00 #15 Page 11

Under the modified approach to capitalizing infrastructure, governments apply the following principles to recording current year additions:

a. Roads and streets are recorded as capital additions only when they are both measurable and available.
b. All infrastructure expenditures are reflected as capital outlay expenditures.
c. All infrastructure expenditures are capitalized and depreciated over their useful lives.
d. Infrastructure expenditures are reported as expenses except for outlays that result in additions or improvements, which would be capitalized.

**CPA-01063 Explanation**
Choice "d" is correct. Under the modified approach, infrastructure expenditures are reported as expenses except for outlays that result in additions or improvements, which would be capitalized.


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Choice "a" is incorrect. The modified accrual basis of accounting requires recording of revenues when they are both measurable and available. The modified approach to recording infrastructure is not related to this concept.

Choice "b" is incorrect. Not all infrastructure outlays are expensed. Infrastructure additions and improvements are capitalized, not expensed.

Choice "c" is incorrect. Not all infrastructure outlays are capitalized. Infrastructure expenditures other than improvements or additions are expensed.

**CPA-01065 Type1 M/C A-D Corr Ans: A PM#20 F 9-01**

14. CPA-01065 ARE C00 #16 Page 10

The City of Basicville is preparing its basic financial statements in conformity with GASB #34. The readers of Basicville's government-wide financial statements prepared as part of the basic financial statements should expect to find information about all of the assets, liabilities, revenues, expenses and gains and losses of the city in:

a. A statement of net assets and a statement of activities using the economic resources measurement focus and the accrual basis of accounting.
b. A balance sheet, income statement and statement of cash flows using the capital maintenance measurement focus and the accrual basis of accounting.
c. A statement of financial position, statement of revenues, expenditures and changes in fund balance and statement of cash flows using various measurement focuses and methods of accounting as appropriate to each fund type.
d. A statement of comprehensive public accountability prepared on the cash basis.

**CPA-01065 Explanation**

Choice "a" is correct. The government-wide financial statements include a statement of net assets and a statement of activities prepared using the economic resources measurement focus and the accrual basis of accounting distinguishing between governmental and business-type activities.

Choice "b" is incorrect. Government-wide financial statements are not titled balance sheet and income statement, do not include a statement of cash flows and do not use a capital maintenance measurement focus.

Choice "c" is incorrect. Government-wide financial statements do not include fund financial statements prepared using differing measurement focuses or methods of accounting.

Choice "d" is incorrect. Well designed distracter. There is no report titled statement of comprehensive public accountability and the cash basis is inappropriate for GAAP basis accounting.

**CPA-01066 Type1 M/C A-D Corr Ans: D PM#21 F 9-01**

15. CPA-01066 ARE C00 #17 Page 16

The Statement of Activities includes separately displayed categories of program revenues. Categories include:

| | *Charges for Services* | *Operating Grants & Contributions* | *Capital Grants & Contributions* |
|---|---|---|---|
| a. | Yes | No | No |
| b. | No | Yes | Yes |
| c. | Yes | Yes | No |
| d. | Yes | Yes | Yes |

**CPA-01066 Explanation**

Choice "d" is correct. Program revenues include earnings classified as charges for services, operating grants and contributions, and capital grants and contributions.

Choices "a", "b", and "c" are incorrect, per the above.


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**CPA-01069 Type1 M/C A-D Corr Ans: B PM#22 F 9-01**

16. CPA-01069 ARE C00 #18 Page 19

Fund financial statements report major funds based on the following criteria:

| | *Aggregate Revenues and Expenditures/Expenses* | *Aggregate Assets and Liabilities* | *Aggregate Fund Balance/Equity* |
|---|---|---|---|
| a. | Yes | Yes | Yes |
| b. | Yes | Yes | No |
| c. | Yes | No | No |
| d. | No | Yes | Yes |

**CPA-01069 Explanation**
**Rule:** The criteria for determining major funds includes qualification as to **revenues, expenditures/expenses**, **assets, or liabilities** that are at least 10 percent of the associated total for ALL governmental OR enterprise (as appropriate) AND at least 5 percent of the total of the associated totals for ALL governmental AND enterprise funds.

Choice "b" is correct. Governments evaluate the classification of major funds using aggregate revenues and expenditures/expenses and aggregate assets and liabilities.

Choices "a", "c", and "d" are incorrect. Governments evaluate the classification of major funds using aggregate revenues and expenditures/expenses and aggregate assets and liabilities per the rule above, not fund balance/equity.

**CPA-01110 Type1 M/C A-D Corr Ans: C PM#23 F 9-01**

17. CPA-01110 ARE C00 #19 Page 34

Progressive Township has elected to early adopt GASB #34. As a result, the town's financial statements will:

a. Include the net book value of its general governmental assets in its General Fixed Asset Account Group.
b. Include a mandatory comprehensive transmittal letter as part of its required supplementary information that focuses on the positive elements.
c. Include a comparison of the town's budgeted and actual performance including disclosure of the originally adopted budget and all amendments included in the final amended budget.
d. Display of combined financial statements by fund type in government-wide financial statements.

**CPA-01110 Explanation**
**Rule:** Financial statements prepared in accordance with the provisions of GASB #34 will include: government-wide financial statements prepared using accrual basis accounting, fund financial statements, notes to the financial statements and required supplementary information that encompasses a letter titled "management's discussion and analysis," combining fund financial statements for non-major funds and budget versus actual comparisons including display of the originally adopted budget and the changes that resulted in the final amended budget.

Choice "c" is correct. Government financial statements prepared in accordance with GASB #34 include a comparison of the government's budgeted and actual performance including disclosure of the originally adopted budget and all amendments included in the final amended budget.

Choice "a" is incorrect. GASB #34 eliminates the presentation of a General Fixed Asset Account Group in favor of presentation of capital assets, net of accumulated depreciation, in the Statement of Net Assets for Government Activities.


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Choice "b" is incorrect. GASB #34 requires presentation of letter called management's discussion and analysis, which objectively describes the economic, financial and administrative performance of the government. A transmittal letter is used in Comprehensive Annual Financial Reports prepared in conformity with standards issued by the Government Finance Officers Association.

Choice "d" is incorrect. GASB #34 requires presentation of fund financial statements separate from government-wide financial statements. Fund financial statements display major funds by fund type with non-major funds disclosed as required supplementary information.

**CPA-01113 Type1 M/C A-D Corr Ans: C PM#24 F 9-01**

18. CPA-01113ARE C00 #20 Page 34

The City of Budgetburg has elected to adopt the standards of GASB #34 early relative to the preparation of their financial statements. The city plans to present its Budgetary Comparison Schedules as part of required supplementary information. Which of the following is not a true statement regarding this schedule?

a. The schedule may use either GAAP or budgetary presentation formats and basis of accounting.
b. The schedule must include the originally adopted budget, the final amended budget and the actual results for the year.
c. The schedule must include the variance of actual performance from the final amended budget.
d. The schedule may include the computed difference between the original budget and the final amended budget.

**CPA-01113 Explanation**
Choice "c" is correct. Presentation of the computed variance between the final amended budget and actual results is optional and not required.

Choice "a" is incorrect. The government may use any format or basis of accounting to present its budgetary comparison schedule as long as a reconciliation to GAAP is also prepared.

Choice "b" is incorrect. The originally adopted budget, final amended budget and actual data must be presented in the budgetary comparison schedule.

Choice "d" is incorrect. The schedule may compute the difference between original and final budget.

**CPA-01122 Type1 M/C A-D Corr Ans: C PM#25 F 9-01**

19. CPA-01122ARE C00 #21 Page 34

The City of Accountability Junction has applied GASB #34 reporting standards to its current year financials. Readers of the financial statements should expect to find the following financial reports relative to the city's performance in relation to budget:

a. A presentation of government-wide budget in comparison to government-wide financial statements.
b. A presentation of budget and actual data for all governmental fund types with variances of actual performance computed from both the original budget and the final adjusted budget.
c. Presentation of budget versus actual amounts for the General Fund and each major Special Revenue Fund with a legally adopted budget presented in either the Required Supplementary Information or within the Basic Financial Statements.
d. Presentation of budget versus actual data on the cash basis in the Required Supplementary Information for all funds with a legally adopted budget.

**CPA-01122 Explanation**
Choice "c" is correct. Budgetary comparison schedules should be presented as required supplementary information or in the Basic Financial Statements for the general fund and for each major special revenue fund that has a legally adopted annual budget.

Choice "a" is incorrect. Budgetary comparisons are made relative to fund financial statements, not government-wide financial statements.


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Choice "b" is incorrect. Budgetary comparisons are mandated for General and Special Revenue Funds with legally adopted budget, not all governmental funds. Schedules should present both the original and amended budgets. Presentation of variances of the amended budget to the actual results are optional. Presentation of the variance of the original budget to the final amended budget is also optional.

Choice "d" is incorrect. No such requirement, the GASB does not mandate a specific basis of accounting for budgetary comparisons and does not mandate the point at which it is displayed.

**CPA-01134 Type1 M/C A-D Corr Ans: C PM#26 F 9-01**

20. CPA-01134 ARE C00 #22 Page 36

Olde Towne has relatively few records pertaining to the value of its roads, bridges, and other general governmental infrastructure and has elected to use the modified approach for reporting infrastructure. In order to comply with the requirements of the modified approach to reporting infrastructure, Olde Towne must prepare schedules which:

a. Disclose the government's election, by policy to provide no accounting for infrastructure assets.
b. Disclose the assumptions made as part of the annual appraisal of infrastructure value and useful life along with the associated allocation of costs to prior periods.
c. Describe the assessed condition of the infrastructure (updated once every three years) and the estimated annual amount to maintain and preserve the condition level established and disclosed.
d. Disclose the historical cost of all infrastructure assets, inflated using the historical cost constant dollar index net of associated depreciation.

**CPA-01134 Explanation**

Choice "c" is correct. The modified approach allows governments to not report depreciation expense for eligible infrastructure assets if (a) the government manages the eligible infrastructure assets using an asset management system that possesses certain characteristics and (b) documents that the eligible infrastructure assets are being preserved at (or above) a condition level established by the government. The government must report the assessed condition of the infrastructure every three years and the estimated annual amount to maintain and preserve the conditions level established and disclosed.

Choice "a" is incorrect. Governments no longer have the option to simply not report infrastructure, the option available prior to issuance of GASB #34.

Choice "b" is incorrect. The modified approach does not require an annual appraisal and disclosure of accumulated depreciation as of the end of the prior year.

Choice "d" is incorrect. The modified approach does not contemplate inflation adjusted historical cost net of accumulated depreciation.

**CPA-01138 Type1 M/C A-D Corr Ans: C PM#27 F 9-01**

21. CPA-01138 ARE R98 #21 Page 7

Valley Town's public school system is administered by a separately elected board of education. The board of education is not organized as a separate legal entity and does not have the power to levy taxes or issue bonds. Valley's city council approves the school system's budget. How should Valley report the public school system's annual financial results?

| | *Discrete presentation* | *Blended* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | Yes |
| d. | No | No |

**CPA-01138 Explanation**

Choice "c" is correct. Valley Town's Board of Education is a special purpose local government with a separately elected board, but it is not a separate legal entity and it does not have the power to levy taxes


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or issue debt. The governing ability of the board is so intertwined with the town that it should be blended with Valley Town.

**Rule:** Blending is used when the component unit is so intertwined with the primary government that it is in substance the same as the primary government.

Choice "a" is incorrect. Simultaneous presentation of a component unit in both a blended and discrete manner is impossible.

Choice "b" is incorrect. Discrete presentation is not appropriate for the board of education because it meets the criteria for blended presentation.

Choice "d" is incorrect. Valley Town's Board of Education is a special purpose local government that fails to qualify as a primary government because it does not stand by itself. Although separately elected, the entity's board does not represent a legally separate entity and does not have the authority to function as a fiscally independent entity. The Valley Town Board of Public Education does not qualify as a primary government and must be included as a component unit of another government.

**CPA-01146 Type1 M/C A-D Corr Ans: B PM#29 F 9-01**

22. CPA-01146 ARE R97 #14 Page 7

Marta City's school district is a legally separate entity, but two of its seven board members are also city council members and the district is financially dependent upon the city. The school district should be reported as a:

a. Blended unit.
b. Discrete presentation.
c. Note disclosure.
d. Primary government.

**CPA-01146 Explanation**

Choice "b" is correct. Marta City's school district meets the test of component unit of the City: It is financially accountable to the City. Thus, its financial data needs to be reported with the City's financial data. However, since the school district is not substantially the same as the City and since the school district does not exclusively service or benefit the City itself, the financial data should be reported using the discrete presentation method.

Choice "a" is incorrect. Since Marta City's school district meets the test of component unit, its financial data needs to be reported with the City's financial data. The financial data would not be blended since the school district does not meet the tests for blending-the school district is not substantially the same as the City and the school district does not exclusively service or benefit the City itself.

Choice "c" is incorrect. Marta City's school district meets the test of component unit of the City: It is financially accountable to the City. Thus, its financial data needs to be reported with the City's financial data. However, since the school district is not substantially the same as the City and since the school district does not exclusively service or benefit the City itself, the financial data should be reported using the discrete presentation method. The discrete presentation is either in condensed financial statements with the notes to the reporting entity's financial statements, or in combining statements in its general purpose financial statement. Thus the response *note disclosure* is not sufficient in itself and a better alternative exists among the responses.

Choice "d" is incorrect. Marta City's school district meets the test of component unit, not of the primary government. Its financial data needs to be reported with the City's financial data.

**CPA-01151 Type1 M/C A-D Corr Ans: D PM#30 F 9-01**

23. CPA-01151 ARE Nov 95 #62 Page 6

What is the basic criteria used to determine the reporting entity for a governmental unit?

a. Special financing arrangement.


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b. Geographic boundaries.
c. Scope of public services.
d. Financial accountability.

**CPA-01151 Explanation**
Choice "d" is correct. The reporting entity is the oversight unit and all related component units. The basic criteria include financial interdependency, selection of governing authority, designation of management, ability to significantly influence operations, and accountability of fiscal matters.

**CPA-01153 Type1 M/C A-D Corr Ans: B PM#31 F 9-01**

24. CPA-01153 ARE Nov 95 #63 Page 28

Which event(s) should be included in a statement of cash flows for a governmental entity?

I. Cash inflow from issuing bonds to finance city hall construction.
II. Cash outflow from a city utility representing payments in lieu of property taxes.

a. I only.
b. II only.
c. Both I and II.
d. Neither I nor II.

**CPA-01153 Explanation**
Choice "b" is correct. The cash inflow from issuing bonds to finance city hall construction is a cash inflow for a governmental fund. Governmental funds do not prepare a statement of cash flows since the measurement focus is financial resources. The cash outflow from a city utility representing payments in lieu of property taxes is a cash outflow from operating activities for an enterprise fund. Enterprise funds prepare a statement of cash flows.

**CPA-01158 Type1 M/C A-D Corr Ans: D PM#32 F 9-01**

25. CPA-01158 ARE May 95 #53 (Adapted) Page 40

In preparing government-wide financial statements for a governmental entity, interfund receivables and payables between governmental and enterprise funds should be:

a. Reported as reservations of fund balance.
b. Reported as additions to or reductions from the unrestricted fund balance.
c. Reported as amounts due to and due from other funds.
d. Reported as internal balances.

**CPA-01158 Explanation**
Choice "d" is correct. When government-wide financial statements are prepared for a governmental entity, interfund receivables and payables that occur between funds categorized as governmental activities and funds classified as business type activities should be reported as internal balances and aligned so that they sum to zero on the financial statements. They are not eliminated from individual fund activities prior to preparation of the government-wide financial statements.

Choice "a" is incorrect. Reservations of fund balance are used only for portions of the fund balance, which are not appropriable or are legally segregated for a specific future use, such as reserve for encumbrances and are appropriate for fund financial statements.

Choice "b" is incorrect. Interfund receivables and payables should not be used to adjust the fund balance.

Choice "c" is incorrect. Interfund receivables and payables are displayed in the fund financial statements but are eliminated as part of the preparation of the government-wide financial statements.

**CPA-01162 Type1 M/C A-D Corr Ans: A PM#33 F 9-01**


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26. CPA-01162 ARE Nov 94 #5 Page 14

If a primary government's general fund has an equity interest in a joint venture, all or a portion of this equity interest should be reported in the:

a. Government-wide statement of net assets.
b. Trust fund.
c. Agency fund.
d. Internal service fund.

**CPA-01162 Explanation**
Choice "a" is correct. Since the general fund has the equity interest, only the available and expendable portion of the investment should be recorded in that fund. The available and expendable portion would not include any equity interest. The portion of the equity interest in the joint venture that represents the government's investment in the net assets of the venture is recorded in the government-wide statement of net assets.

Choice "b" is incorrect. Trust funds are used to account for resources of the governmental unit acting as a trustee.

Choice "c" is incorrect. Agency funds are used to account for funds where the governmental entity is acting as a custodian.

Choice "d" is incorrect. Internal service funds are used to account for resources within a governmental unit, not a joint venture.

**CPA-01167 Type1 M/C A-D Corr Ans: D PM#34 F 9-01**

27. CPA-01167 ARE Nov 94 #7 Page 11

Fixed assets of a governmental unit, other than those accounted for in proprietary funds or fiduciary funds, should be accounted for in the:

a. General fund.
b. Capital projects fund.
c. Permanent fund.
d. Governmental activities column of the government-wide statements of net assets.

**CPA-01167 Explanation**
Choice "d" is correct. Since proprietary funds and trust funds use the full accrual basis of accounting and economic measurement focus, fixed assets of those funds are accounted for within those funds. All other fixed assets of the governmental unit are considered general capital assets and are recorded in the governmental activities column of the government-wide statement of net assets.

Choice "a" is incorrect. The general fund is used to account for financial resources only. Capital assets and long-term liabilities are not accounted for in the general fund since they will neither provide nor use financial resources.

Choice "b" is incorrect. Capital projects funds account for the sources and uses of financial resources in the construction of major fixed assets. Once constructed, the capital asset is no longer accounted for through the capital projects fund since it will neither provide nor use financial resources.

Choice "c" is incorrect. The permanent fund is used to account for assets whose principal cannot be spent. Capital assets are not recorded in the permanent fund.

**CPA-01170 Type1 M/C A-D Corr Ans: B PM#35 F 9-01**

28. CPA-01170 ARE Nov 94 #16 Page 38

During the year, a city's electric utility, which is operated as an enterprise fund, rendered billings for electricity supplied to the general fund. Which of the following accounts should be debited by the general fund?


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a. Appropriations.
b. Expenditures.
c. Due to electric utility enterprise fund.
d. Other financing uses-operating transfers out.

**CPA-01170 Explanation**
Choice "b" is correct. Transfers between funds do not generally give rise to operating expenditures and revenues. However, an exception is made for quasi-external transactions (one in which the governmental fund acquires a good or service that could have been purchased from an unrelated business enterprise). Routine service charges for utilities is one example of a quasi-external transaction. The following entry should be made in the general fund to record billings from the enterprise fund:

| | | |
|---|---|---|
| Expenditures | XXX | |
| Due to electric utility enterprise fund | | XXX |

Choice "a" is incorrect. Appropriations are recorded when the budget is formally integrated into the accounting system.

Choice "c" is incorrect. Due to electric utility enterprise fund is credited, not debited.

Choice "d" is incorrect. Transfers between funds do not generally give rise to operating expenditures and revenues. However, an exception is made for quasi-external transactions (one in which the governmental fund acquires a good or service that could have been purchased from an unrelated business enterprise). Routine service charges for utilities is one example of a quasi-external transaction.

**CPA-01172 Type1 M/C A-D Corr Ans: C PM#37 F 9-01**

29. CPA-01172 PII Nov 93 #19 Page 28

Hill City's water utility fund held the following investments in U.S. Treasury securities at June 30, 1993:

| *Investment* | *Date purchased* | *Maturity date* | *Carrying amount* |
|---|---|---|---|
| 3-month T-bill | 5/31/93 | 7/31/93 | $ 30,000 |
| 3-year T-note | 6/15/93 | 8/31/93 | 50,000 |
| 5-year T-note | 10/1/89 | 9/30/94 | 100,000 |

In the fund's balance sheet, what amount of these investments should be reported as cash and cash equivalents at June 30, 1993?

a. $0
b. $30,000
c. $80,000
d. $180,000

**CPA-01172 Explanation**
Choice "c" is correct. Cash equivalents are short-term, highly liquid investments that are both readily convertible to known amounts of cash and so near their maturity that they present insignificant risk of changes in interest rates. Generally, only investments with *original* maturities of 3 months or less qualify as cash equivalents. Original maturity is determined from the date an investment was purchased by the reporting entity, not the date of issuance of the security. Both the 3-month $30,000 T-bill and the 3-year $50,000 T-note mature in 3 months or less from the date purchased, for a total cash equivalents of $80,000.

Choice "a" is incorrect. Cash equivalents include investments with original maturities (from date purchased) of 3 months or less.

Choice "b" is incorrect. Cash equivalents include investments with original maturities (from date purchased) of 3 months or less. The 3-year T-note has a 2 ½ month maturity from the date purchased so it qualifies as a cash equivalent.


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Choice "d" is incorrect. The $100,000 5-year T-note has a 5-year maturity from the date purchased. To qualify as a cash equivalent, it must mature in 3 months or less from the date purchased.

**CPA-01173 Type1 M/C A-D Corr Ans: C PM#38 F 9-01**

30. CPA-01173 Th Nov 93 #58 Page 28

With regard to the statement of cash flows for a governmental unit's enterprise fund, items generally presented as cash equivalents are:

| | *2-month treasury bills* | *3-month certificates of deposit* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | Yes |
| d. | Yes | No |

**CPA-01173 Explanation**
Choice "c" is correct. Cash equivalents include highly liquid items that mature within 3 months of acquisition. Both the treasury bills and the certificates of deposit meet this definition.

**CPA-01302 Type1 M/C A-D Corr Ans: D PM#39 F 9-01**

31. CPA-01302 PII Nov 93 #9 Page 40

The following information pertains to Grove City's interfund receivables and payables at December 31, 1992:

| | |
|---|---|
| Due to special revenue fund from general fund | $10,000 |
| Due to agency fund from special revenue fund | 4,000 |

In Grove's special revenue fund balance sheet at December 31, 1992, how should these interfund amounts be reported?

a. As an asset of $6,000.
b. As a liability of $6,000.
c. As an asset of $4,000 and a liability of $10,000.
d. As an asset of $10,000 and a liability of $4,000.

**CPA-01302 Explanation**
Choice "d" is correct. In the special revenue fund balance sheet, the $10,000 Due From General Fund is an asset because it is a receivable to the special revenue fund. The $4,000 Due to Agency Fund is a liability that the special revenue fund has to the agency fund.

Choice "a" is incorrect. Do not net the due from/due to accounts. They are shown separately as assets and liabilities.

Choice "b" is incorrect. Do not net the due from/due to accounts. They are shown separately as assets and liabilities.

Choice "c" is incorrect. The $10,000 Due From General Fund is the asset to the special revenue fund, while the $4,000 is the liability.

**CPA-04670 Type1 M/C A-D Corr Ans: C PM#40 F 9-01**

32. CPA-04670 Released 2005 Page 15

During the current year, Knoxx County levied property taxes of $2,000,000, of which 1% is expected to be uncollectible. The following amounts were collected during the current year:

| | |
|---|---|
| Prior year taxes collected within the 60 days of the current year | $ 50,000 |
| Prior year taxes collected between 60 days and 90 days into the current year | 120,000 |


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| | |
|---|---|
| Current year taxes collected in the current year | 1,800,000 |
| Current year taxes collected within the first 60 days of the subsequent year | 80,000 |

What amount of property tax revenue should Knoxx County report in its entity-wide statement of activities?

a. $1,800,000
b. $1,970,000
c. $1,980,000
d. $2,000,000

**CPA-04670 Explanation**
Choice "c" is correct. Knoxx County would report revenue from its governmental funds on the full accrual basis in its entity wide (government-wide) statement of activities. As such, Knoxx County would recognize revenues from property taxes, net of estimated refunds and estimated uncollectible amounts in the period in which they are levied. The examiners provide additional irrelevant data necessary to compute earnings on the modified accrual basis. Earnings on the accrual basis are computed as follows:

| | |
|---|---|
| Property tax levy | $2,000,000 |
| Estimated uncollectible (1%) | (20,000) |
| **Revenue recognized** | **$1,980,000** |

Choice "a" is incorrect. The amount collected from the current year levy ($1,800,000) would not be the amount recognized as property tax revenue on the accrual basis.

Choice "b" is incorrect. The total of all amounts collected in the current year from both prior year and current year levies ($1,970,000 = $50,000 + $120,000 + $1,800,000) would not be the amount recognized as property tax revenue on the accrual basis.

Choice "d" is incorrect. The total amount of the levy ($2,000,000) or the revenue computed on the modified accrual basis (also $2,000,000 representing the sum of the $120,000 collected after the 60 day availability criteria from the prior year, the $1,800,000 in current year collections and the $80,000 collected within 60 days of the current year) would not be the amount recognized as property tax revenue on the accrual basis.

**CPA-05213 Type1 M/C A-D Corr Ans: D PM#51 F 9-01**

33. CPA-05213 Released 2006 Page 32

Assuming no outstanding encumbrances at year end, closing entries for which of the following situations would increase the unreserved fund balance at year end?

a. Actual revenues were **less** than estimated revenues.
b. Estimated revenues exceed actual appropriations.
c. Actual expenditures exceed appropriations.
d. Appropriations exceed actual expenditures.

**CPA-05213 Explanation**
**RULE:** Unreserved fund balance represents the amount of current resources carried forward into the following year that will be available for appropriations. Assuming there are no encumbrances, the relationships between estimated and actual amounts has a determinable relationship with final fund balance amounts. The Budgetary Comparison Schedule illustrated for Progressive Township in your text shows that the "Final" budgeted fund balance at the beginning of the year is equal to the "Actual" fund balance a the beginning of the year. The examiners question effectively asks when the relationships between budgeted and actual results create an actual fund balance greater than expected.

Choice "d" is correct. Appropriations (estimated expenditures) in excess of actual expenditures would increase the unreserved fund balance. Not all of the original budget (appropriations) was spent, and the excess was returned to fund balance.


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Choice "a" is incorrect. Actual revenues less than estimated revenues would indicate that the unreserved fund balance would decrease. There was effectively a revenue shortfall, and it had to come out of fund balance.

Choice "b" is incorrect. The relationship between estimated revenues exceeding actual appropriations is a comparison of budgeted amounts that does not give sufficient information to draw any conclusion with regard to the impact on unreserved fund balance. The "actual" appropriations is a distracter.

Choice "c" is incorrect. Actual expenditures in excess of appropriations would decrease the unreserved fund balance. More money was spent than was anticipated.

**CPA-05231 Type1 M/C A-D Corr Ans: A PM#52 F 9-01**

34. CPA-05231 Released 2006 Page 15

Which of the following would be reported as program revenues on a local government's government-wide statement of activities?

a. Charges for services.
b. Taxes levied for a specific function.
c. Proceeds from the sale of a capital asset used for a specific function.
d. Interest revenues.

**CPA-05231 Explanation**
Choice "a" is correct. For a local government's government-wide statement of activities, charges for services are reported as program revenue. Program revenue is revenue directly associated with a program or function. Remember the categories of program revenue and recall that the government can "SOC" away these revenues:

**S** Charges (for services)

**O** Operating grants and contributions

**C** Capital grants and contributions

Choice "b" is incorrect. Taxes are not program revenue. Even though the taxes are levied for the specific function, taxes are not revenue. The words "levied for a specific function" were included to attempt to confuse.

Choice "c" is incorrect. Proceeds from the sale of a capital asset used for a specific function are not program revenue. Again, the words "used for a specific function" were included to confuse.

Choice "d" is incorrect. Interest revenue is not program revenue.

**CPA-05453 Type1 M/C A-D Corr Ans: B PM#53 F 9-01**

35. CPA-05453 Released 2007 Page 28

Cash receipts from grants and subsidies to decrease operating deficits should be classified in which of the following sections of the statement of cash flows for governmental, not-for-profit entities?

a. Operating.
b. Noncapital financing.
c. Capital and related financing.
d. Investing.

**CPA-05453 Explanation**
**Rule:** Cash flows from noncapital financing activities include:

1. Proceeds or payments related to borrowing not attributable to the acquisition, construction or improvement of capital assets.
2. Cash receipts or payments related to grants or subsidies not attributable to capital purposes.


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3. Property taxes not designated for capital purposes.
4. Cash paid to other funds (other than for interfund services).

Choice "b" is correct. Cash receipts from grants and subsidies used to decrease operating deficits (not used for capital purposes) should be classified as noncapital financing activities in the statement of cash flows of a proprietary fund.

Choice "a" is incorrect. Noncapital cash receipts from grants and subsidies are noncapital financing activities. Operating cash flows related to receipts and disbursements related to sales of goods and services, interfund reimbursements, etc.

Choice "c" is incorrect. Noncapital cash receipts from grants and subsidies are noncapital financing activities. Capital and related financing activity is typically associated with cash activities related to acquisition, construction or improvement of capital assets, etc.

Choice "d" is incorrect. Noncapital cash receipts from grants and subsidies are noncapital financing activities. Investing activities include cash receipts and disbursements associated with the purchase and sale of equity or debt securities, etc.

**Not-for-profit Organizations**

**CPA-01207 Type1 M/C A-D Corr Ans: B PM#1 F 9-02**

36. CPA-01207 ARE R03 #11 Page 59

Oz, a non-governmental not-for-profit organization, received $50,000 from Ame Company to sponsor a play given by Oz at the local theater. Oz gave Ame 25 tickets, which generally cost $100 each. Ame received no other benefits. What amount of ticket sales revenue should Oz record?

a. $0
b. $2,500
c. $47,500
d. $50,000

**CPA-01207 Explanation**
**Rule:** Generally, the difference between the fair value of purchases and the amount transferred is classified as a contribution.

Choice "b" is correct. Oz would account for the $50,000 receipt from Ame Company as a contribution and as ticket sales revenue. Ticket sales revenue is equal to the fair value of the purchase ($25 $\times$ 100 tickets = $2,500). Contribution revenue is equal to the difference between the amount contributed and the fair value of purchases given in the exchange ($50,000 – $2,500 = $47,500).

Choice "a" is incorrect. The fair market value of the tickets purchased by the Ame Company is accounted for as ticket sales revenue.

Choice "c" is incorrect. The difference between the fair market value of the tickets sold to the Ame Company and the total transferred is contribution revenue, not ticket sales revenue.

Choice "d" is incorrect. The total amount of the transfer is not accounted for as ticket sale revenue, only the fair market value of the items sold.

**CPA-01215 Type1 M/C A-D Corr Ans: C PM#3 F 9-02**

37. CPA-01215 ARE R03 #15 Page 56

Pica, a non-governmental not-for-profit organization, received unconditional promises of $100,000 expected to be collected within one year. Pica received $10,000 prior to year-end. Pica anticipates collecting 90% of the contributions and has a June 30 fiscal year-end. What amount should Pica record as contribution revenue as of June 30?

a. $10,000


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b. $80,000
c. $90,000
d. $100,000

**CPA-01215 Explanation**
Choice "c" is correct. Pica would recognize contribution revenue based on the net realizable value of its pledges receivable.

| | |
|---|---|
| Total Pledge Receivable | $100,000 |
| Net realizable value | × 90% |
| Contributed revenues | $ 90,000 |
| Allowance for Doubtful Accounts | $ 10,000 |

**Rule:** Recording promises to give are journalized as follows:

| | | | |
|---|---|---|---|
| Dr. | Pledge Receivable | $100,000 | |
| | Cr. Allowance for Doubtful Accounts | | $10,000 |
| | Cr. Contributed Revenue | | $90,000 |

Choice "a" is incorrect. Pica would recognize contribution in the amount of unconditional pledges whose collection is deemed to be probable along with actual receipts. Pica would not limit its recognition of contribution revenue to only those amounts received.

Choice "b" is incorrect. Pica would recognize contribution in the amount of unconditional pledges whose collection is deemed to be probable and in addition to amounts actually received. Pica would not limit its recognition of contribution revenue to only the uncollected amounts whose receipt is deemed to be probable.

Choice "d" is incorrect. Pica would not recognize the full amount of pledges as contribution revenue if some amounts are deemed to be uncollectible.

**CPA-01216 Type1 M/C A-D Corr Ans: C PM#4 F 9-02**

38. CPA-01216ARE R03 #18 Page 62

A not-for-profit voluntary health and welfare organization received a $500,000 permanent endowment. The donor stipulated that the income must be used for a mental health program. The endowment fund reported $60,000 net decrease in market value and $30,000 investment income. The organization spent $45,000 on the mental health program during the year. What amount of change in temporarily restricted net assets should the organization report?

a. $75,000 decrease.
b. $15,000 decrease.
c. $0
d. $425,000 increase.

**CPA-01216 Explanation**
**Rule:** Generally, losses on the investments of a donor-restricted endowment fund serve to reduce temporarily restricted net assets to the extent that donor-imposed temporary restrictions on net appreciation (cumulative losses minus gains) of the fund have not been met before the loss occurs. Any remaining loss reduces unrestricted net assets.

Choice "c" is correct. The change in temporarily restricted net assets is comprised of the increase in temporarily restricted net assets related to investment earnings and the amounts released from temporary restrictions. Losses in excess of satisfaction of donor-restricted stipulations are treated as unrestricted as follows.

| | *Unrestricted* | *Temporarily Restricted* | *Permanently Restricted* | *Total* |
|---|---|---|---|---|
| **Mental Health Program** | | | | |
| Investment Income | | 30,000 | | 30,000 |


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| | | | | |
|---|---|---|---|---|
| Release restriction | 30,000 | (30,000) | | 0 |
| Expenses | (45,000) | 0 | | (45,000) |
| Subtotal | (15,000) | 0 | | (15,000) |
| **Investments** | | | | |
| Losses | (60,000) | 0 | 0 | (60,000) |
| Beginning of year | 0 | 0 | 500,000 | 500,000 |
| End of year | (75,000) | 0 | 500,000 | 425,000 |

The decline in fair value of the assets of the endowment fund first reduce the temporarily restricted net assets and then reduce unrestricted net assets.

Choice "a" is incorrect. The unrealized loss on the investment and the net operating loss associated with unrestricted activities are not combined and reported as temporarily restricted.

Choice "b" is incorrect. The net loss in operations is not displayed as temporarily restricted.

Choice "d" is incorrect. The net value of permanent and temporarily restricted net assets and unrestricted net assets are not displayed as temporarily restricted.

**CPA-01230 Type1 M/C A-D Corr Ans: C PM#9 F 9-02**

39. CPA-01230C01 #6 Page 59

Not-for-profit organizations are considered financially interrelated organizations in the event that one of the organizations:

a. Is able to influence the operating and financial decisions of the other.
b. Has an ongoing economic interest in the net assets of the other.
c. Is both able to influence the operating and financial decisions of the other AND has an ongoing economic interest in the net assets of the other.
d. Serves a broader geographic area that fully includes the area defined by mission of the interrelated organization.

**CPA-01230 Explanation**

Choice "c" is correct. In order for not-for-profit organizations to be financially interrelated as defined by FAS 136, their relationship must share both characteristics: one organization must be able to influence the operating and financial decisions of the other AND have an ongoing economic interest in the net assets of the other.

Choice "a" is incorrect. Although the ability to influence operating and financial decisions is significant to determining if organizations are financially interrelated, the ability to influence must be coupled with an economic interest.

Choice "b" is incorrect. Although the economic interest is significant to determining if organizations are financially interrelated, the economic interest must be coupled with the ability to influence operating and financial decisions of the other organization.

Choice "d" is incorrect. Coincidence of coverage area is not relevant to the determination of financial interrelationship.

**CPA-01236 Type1 M/C A-D Corr Ans: C PM#10 F 9-02**

40. CPA-01236ARE R99 #2 (Adapted) Page 56

On July 1, 1998, Mission Goodworks, a religious organization, received property as a gift from a local corporation with the understanding that the building would be used principally for a purpose consistent with the organization's mission. How should Mission Goodworks record this gift on its December 31,1998 financial statement?

a. Record the property as an increase in assets and revenue at the donor's basis.
b. Record the property as an increase in assets and unrestricted net assets at its fair market value.


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c. Record the property as an increase in assets on the Statement of Financial Position and as support on the Statement of Activities and measure the property at its fair value.
d. Memorandum only.

**CPA-01236 Explanation**

Choice "c" is correct. Donated property is recorded at its fair market value and is recognized as support.

Choice "a" is incorrect. Donated property should be recorded at its fair market value. Contributions are typically recorded as support, not revenue (exchange transactions).

Choice "b" is incorrect. Donated property is recorded as support, not as a direct increase to net assets.

Choice "d" is incorrect. Donated property must be recorded at fair market value.

**CPA-01237 Type1 M/C A-D Corr Ans: D PM#11 F 9-02**

41. CPA-01237 ARE R99 #3 Page 58

Altruistic University, a not-for-profit research university, conducts cancer research as part of its normal ongoing activities and regularly receives contributions to support these efforts. Experimental Pharmaceuticals Corporation, a large for profit corporation that markets drugs for cancer treatment, provides resources to Altruistic University to perform clinical trial research on an experimental drug to treat cancer. Resources are provided on the condition that Altruistic University comply with specific restrictions governing the manner in which the research is conducted and the frequency and the character of outcome reports. Altruistic University should account for the resources provided by Experimental Pharmaceuticals as:

a. A contribution that increases permanently restricted net assets.
b. A contribution that increases temporarily restricted net assets and is reclassified as an increase to unrestricted net assets upon satisfaction of research and reporting restrictions.
c. A contribution that increases unrestricted net assets provided the restrictions are met in the current year and the university uniformly applies this method of recognition to all similar transactions.
d. An exchange transaction that increases unrestricted net assets.

**CPA-01237 Explanation**

Choice "d" is correct. This is an exchange transaction, which increases unrestricted net assets. The results of the clinical trials performed by altruistic university have a commercial value to experimental pharmaceuticals corporation, resources have been provided in exchange for research results and do not constitute a contribution.

Choice "a" is incorrect. The transaction represents a reciprocal transfer, or exchange, not a contribution.

Choice "b" is incorrect. The transaction represents a reciprocal transfer, or exchange, not a contribution.

Choice "c" is incorrect per the above explanation.

**CPA-01238 Type1 M/C A-D Corr Ans: A PM#12 F 9-02**

42. CPA-01238 ARE R99 #22 Page 51

Functional expenses recorded in the general ledger of ABC, a non-governmental not-for-profit organization, are as follows:

| | |
|---|---|
| Soliciting prospective members | $45,000 |
| Printing membership benefits brochures | 30,000 |
| Soliciting membership dues | 25,000 |
| Maintaining donor list | 10,000 |

What amount should ABC report as fund-raising expenses?

a. $10,000
b. $35,000


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c. $70,000
d. $110,000

**CPA-01238 Explanation**
Choice "a" is correct. The expense categories used by not-for-profit organizations generally fall under two main headings: program services and support services. Program services relate to functional expenses directly related to the mission of the organization. Support services summarize the functional expenses related to general and administrative costs, costs of membership development, and fund-raising. Fund-raising contemplates inducing potential donors to contribute to the entity. Membership activities involve seeking prospective members, ensuring current member satisfaction, etc. The $10,000 cost incurred to maintain a donor list for contributions is the only fund-raising expense listed.

**CPA-01243 Type1 M/C A-D Corr Ans: B PM#13 F 9-02**

43. CPA-01243 ARE R99 #23 Page 55

Famous, a non-governmental not-for-profit art museum, has elected not to capitalize its permanent collections. In 1998 a bronze statue was stolen. The statue was not recovered and insurance proceeds of $35,000 were paid to Famous in 1999. This transaction would be reported in:

I. The statement of activities as permanently restricted revenues.
II. The statement of cash flows as cash flows from investing activities.

a. I only.
b. II only.
c. Both I and II.
d. Neither I nor II.

**CPA-01243 Explanation**
Choice "b" is correct. Investing activities in the statement of cash flows should include proceeds from the sale of long lived assets or insurance proceeds associated with the loss of long lived assets. Entities that do not capitalize their permanent collections display insurance proceeds from lost, stolen or damaged items on the statement of activities in an appropriate change in net asset classification separate from revenues, expenses, gains, and losses.

**CPA-01248 Type1 M/C A-D Corr Ans: B PM#14 F 9-02**

44. CPA-01248 ARE R97 #15 Page 56

Child Care Centers, Inc., a not-for-profit organization, receives revenue from various sources during the year to support its day care centers. The following cash amounts were received during 1996.

- $2,000 restricted by the donor to be used for meals for the children.
- $1,500 received for subscriptions to a monthly child care magazine with a fair market value to subscribers of $1,000.
- $10,000 to be used only upon completion of a new playroom that was 75% complete at December 31, 1996.

What amount should Child Care Centers record as contribution revenue in its 1996 Statement of Activities?

a. $2,000
b. $2,500
c. $10,000
d. $11,000

**CPA-01248 Explanation**
Choice "b" is correct. Contributions to a non-profit include transactions which are unconditional (not requiring a future event to occur), non-reciprocal, voluntary, and not of an ownership investment. Contribution revenue for 1996 includes the $2,000 to be used for meals and $500 above the FMV of the


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subscriptions. The $10,000 contribution requires a future event to take place-completion of the playroom and is, thus, not included.

Choice "a" is incorrect. Contributions to a non-profit include transactions which are unconditional (not requiring a future event to occur), non-reciprocal, voluntary, and not of an ownership investment. Contribution revenue for 1996 includes the $2,000 to be used for meals plus some other amount.

Choice "c" is incorrect. The $10,000 contribution requires a future event to take place-completion of the playroom and is, thus, not considered a contribution in 1996.

Choice "d" is incorrect. The $10,000 contribution requires a future event to take place-completion of the playroom and is, thus, not considered a contribution in 1996.

**CPA-01249 Type1 M/C A-D Corr Ans: B PM#15 F 9-02**

45. CPA-01249 ARE R97 #16 Page 59

A not-for-profit organization receives $150 from a donor. The donor receives two tickets to a theater show and an acknowledgment in the theater program. The tickets have a fair market value of $100. What amount is recorded as contribution revenue?

a. $0
b. $50
c. $100
d. $150

**CPA-01249 Explanation**

Choice "b" is correct. Contributions to a non-profit include transactions which are unconditional (not requiring a future event to occur), non-reciprocal, voluntary, and not of an ownership investment. The FMV of the theater tickets (the exchange part of the transaction) must not be considered in determining the amount of the contribution revenue. The $50 above the FMV of the tickets is contribution revenue.

Choice "a" is incorrect. Contributions to a non-profit include transactions which are unconditional (not requiring a future event to occur), non-reciprocal, voluntary, and not of an ownership investment. Part of the $150 from the donor can be considered contribution revenue meeting these criteria.

Choice "c" is incorrect. Contributions to a non-profit include transactions which are unconditional (not requiring a future event to occur), non-reciprocal, voluntary, and not of an ownership investment. The $100 from the donor is an exchange transaction, as the donor received theater tickets with a FMV of $100.

Choice "d" is incorrect. Contributions to a non-profit include transactions which are unconditional (not requiring a future event to occur), non-reciprocal, voluntary, and not of an ownership investment. The $150 from the donor includes both an exchange transaction and contribution revenue.

**CPA-01253 Type1 M/C A-D Corr Ans: B PM#16 F 9-02**

46. CPA-01253 ARE R97 #17 Page 47

Which of the following classifications is required for reporting of expenses by all not-for-profit organizations?

a. Natural classification in the statement of activities or notes to the financial statements.
b. Functional classification in the statement of activities or notes to the financial statements.
c. Functional classification in the statement of activities and natural classification in a matrix format in a separate statement.
d. Functional classification in the statement of activities and natural classification in the notes to the financial statements.

**CPA-01253 Explanation**


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Choice "b" is correct. A not-for-profit organization needs to report its expenses in the statement of activities by their functional classification (program classification, supporting activities, fund-raising, etc.). This method helps donors and others in assessing an organization's service efforts.

Choice "a" is incorrect. There is no requirement that the not-for-profit organization must report its expenses in a natural classification, except for voluntary health and welfare organizations.

Choice "c" is incorrect. A not-for-profit organization needs to report its expenses in the statement of activities by their functional classification (program classification, supporting activities, fund-raising, etc.). There is no requirement that the organization must also report the expenses in a natural classification in a separate statement, except for voluntary health and welfare organizations.

Choice "d" is incorrect. A not-for-profit organization needs to report its expenses in the statement of activities by their functional classification (program classification, supporting activities, fund-raising, etc.). There is no requirement that the organization must also report the expenses in a natural classification in a separate statement, except for voluntary health and welfare organizations.

**CPA-01261 Type1 M/C A-D Corr Ans: B PM#19 F 9-02**

47. CPA-01261 ARE R96 #6 Page 55

A storm damaged the roof of a new building owned by K-9 Shelters, a not-for-profit organization. A supporter of K-9, a professional roofer, repaired the roof at no charge. In K-9's statement of activities, the damage and repair of the roof should:

a. Be reported by note disclosure only.
b. Be reported as an increase in both expenses and contributions.
c. Be reported as an increase in both net assets and contributions.
d. Not be reported

**CPA-01261 Explanation**
Choice "b" is correct. Donated services are recognized if the services received either (1) create or enhance non-financial assets, or (2) require specialized skills, are provided by individuals possessing those skills, and would typically need to be purchased if not provided by donation. Both of these conditions are met so the following entry would be made to record the damage and repair of the roof:

| | | |
|---|---|---|
| Expense | XXX | |
| Contributions | | XXX |

**CPA-01268 Type1 M/C A-D Corr Ans: B PM#20 F 9-02**

48. CPA-01268 ARE R96 #11 Page 43

In 1995, Gamma, a not-for-profit organization, deposited at a bank $1,000,000 given to it by a donor to purchase endowment securities. The securities were purchased January 2, 1996. At December 31, 1995, the bank recorded $2,000 interest on the deposit. In accordance with the bequest, this $2,000 was used to finance ongoing program expenses in March 1996. At December 31, 1995, what amount of the bank balance should be included as current assets in Gamma's classified balance sheet?

a. $0
b. $2,000
c. $1,000,000
d. $1,002,000

**CPA-01268 Explanation**
Choice "b" is correct. Since the external donor restricted the $1,000,000 gift for the purchase of endowment securities, that deposit is restricted cash and a non-current asset. The earnings on the endowment is designated by the external donor for ongoing program expense. As such, it is unrestricted cash and a current asset.


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Choice "a" is incorrect. Some portion of the cash is for ongoing program services. As such, it can be classified as unrestricted cash and a current asset.

Choice "c" is incorrect. Since the external donor restricted the $1,000,000 gift for the purchase of endowment securities, that deposit is restricted cash and a non-current asset.

Choice "d" is incorrect. Since the external donor restricted the $1,000,000 gift for the purchase of endowment securities, that deposit is restricted cash and a non-current asset. The earnings on the endowment is designated by the external donor for ongoing program expense. As such, it is unrestricted cash and a current asset.

**CPA-01273 Type1 M/C A-D Corr Ans: A PM#21 F 9-02**

49. CPA-01273 ARE Nov 95 #74 Page 46

A large not-for-profit organization's statement of activities should report the net change for net assets that are:

| | *Unrestricted* | *Permanently restricted* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | No |
| d. | No | Yes |

**CPA-01273 Explanation**
Choice "a" is correct. A not-for-profit organization prepares a Statement of Activities that presents changes in unrestricted net assets, temporarily restricted net assets, and permanently restricted net assets.

**CPA-01276 Type1 M/C A-D Corr Ans: B PM#22 F 9-02**

50. CPA-01276 ARE Nov 95 #75 Page 69

Which of the following should normally be considered ongoing or central transactions for a not-for-profit hospital?

I. Room and board fees from patients.
II. Recovery room fees.

a. Neither I nor II.
b. Both I and II.
c. II only.
d. I only.

**CPA-01276 Explanation**
Choice "b" is correct. Revenues and expenses for a non-profit hospital arise from "activities associated with the provision of health care services, which constitute the ongoing major or central operations of providers of health care services." Both room and board fees from patients and recovery room fees are activities, which are considered patient service revenues.

**CPA-01280 Type1 M/C A-D Corr Ans: D PM#23 F 9-02**

51. CPA-01280 ARE May 95 #58 Page 46

The Jones family lost its home in a fire. On December 25, 1994, a philanthropist sent money to the Amer Benevolent Society to purchase furniture for the Jones family. During January 1995, Amer purchased this furniture for the Jones family. Amer, a not-for-profit organization, elected early adoption of FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made.* How should Amer report the receipt of the money in its 1994 financial statements?


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a. As an unrestricted contribution.
b. As a temporarily restricted contribution.
c. As a permanently restricted contribution.
d. As a liability.

**CPA-01280 Explanation**
Choice "d" is correct. The Amer Benevolent Society received a donation from a philanthropist for the benefit of a specific beneficiary and the Amer Benevolent Society has no variance power (discretion) relative to the use of the contribution. Receipt of this cash is not a contribution received.

Choice "a" is incorrect. The contribution received is subject to a specific donor-imposed restriction and is not unrestricted.

Choice "b" is incorrect. Although the Amer Benevolent Society received a restricted contribution whose restriction can be satisfied by the purchase of furniture, a temporary restriction, the Society has no variance power over the resources and would therefore account for the transaction as a liability.

Choice "c" is incorrect. Although the contribution received is subject to a restriction, the restriction can be satisfied by the Amer Benevolent Society by the expenditure of the contribution. The restriction is not permanent, it is temporary.

**CPA-01283 Type1 M/C A-D Corr Ans: B PM#24 F 9-02**

52. CPA-01283 ARE May 95 #59 Page 55

The Pel Museum, a not-for-profit organization, elected early adoption of FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made.* If Pel received a contribution of historical artifacts, it need **not** recognize the contribution if the artifacts are to be sold and the proceeds used to:

a. Support general museum activities.
b. Acquire other items for collections.
c. Repair existing collections.
d. Purchase buildings to house collections.

**CPA-01283 Explanation**
Choice "b" is correct. An entity need not recognize contributions of works of art, historical treasures, and similar assets if the donated items are added to collections that meet all of the following conditions:

1. Are held for public exhibition, education, or research in furtherance of public service rather than financial gain.
2. Are protected, kept unencumbered, cared for, and preserved.
3. Are subject to an organizational policy that requires the proceeds from sale of collection items to be used to acquire other items for collections.

**CPA-01290 Type1 M/C A-D Corr Ans: C PM#26 F 9-02**

53. CPA-01290 ARE Nov 94 #26 Page 47

Cancer Educators, a not-for-profit organization, incurred costs of $10,000 when it combined program functions with fund-raising functions. Which of the following cost allocations might Cancer report in its statement of activities?

| | *Program services* | *Fund raising* | *General services* |
|---|---|---|---|
| a. | $0 | $0 | $10,000 |
| b. | $0 | $6,000 | $4,000 |
| c. | $6,000 | $4,000 | $0 |
| d. | $10,000 | $0 | $0 |

**CPA-01290 Explanation**


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Choice "c" is correct. The three functional classifications for expenses incurred by a non-profit organization are: program services, management and general costs, and fund-raising and other supporting services. When common costs are incurred, they should be allocated to the appropriate classifications. Since Cancer Educators' $10,000 common costs were for program functions and fund-raising functions, the costs should be allocated to those two classifications only.

Choice "a" is incorrect. No part of the $10,000 common costs was for general services.

Choice "b" is incorrect. Part of the $10,000 relates to program services and must be allocated.

Choice "d" is incorrect. Part of the $10,000 relates to fund-raising services and must be allocated.

**CPA-01292 Type1 M/C A-D Corr Ans: C PM#27 F 9-02**

54. CPA-01292 ARE Nov 94 #27 Page 55

Lea Meditators, a not-for-profit religious organization, elected early adoption of FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made.* A storm broke glass windows in Lea's building. A member of Lea's congregation, a professional glazier, replaced the windows at no charge. In Lea's statement of activities, the breakage and replacement of the windows should:

a. Not be reported.
b. Be reported by note disclosure only.
c. Be reported as an increase in both expenses and contributions.
d. Be reported as an increase in both net assets and contributions.

**CPA-01292 Explanation**

Choice "c" is the correct answer. Contributions of services are recognized if the services received either (1) create or enhance non-financial assets, or (2) require specialized skills, are provided by individuals possessing those skills, and would typically need to be purchased if not provided by donation. Both of these conditions are met so the following entry would be made to record the breakage and replacement of the windows:

| | | |
|---|---|---|
| Expense | XXX | |
| Contributions | | XXX |

**CPA-01294 Type1 M/C A-D Corr Ans: C PM#28 F 9-02**

55. CPA-01294 ARE Nov 94 #28 Page 70

Which of the following normally would be included in other operating revenues of a hospital?

| | *Revenues from educational programs* | *Unrestricted gifts* |
|---|---|---|
| a. | No | No |
| b. | No | Yes |
| c. | Yes | No |
| d. | Yes | Yes |

**CPA-01294 Explanation**

Choice "c" is correct. The three revenue classifications for a hospital are patient services revenues, other operating revenues, and non-operating revenues. Other operating revenues are those generated by operations other than patient services. Revenues from educational programs would be classified as other operating revenues while unrestricted gifts would be classified as non-operating revenues.

**CPA-01297 Type1 M/C A-D Corr Ans: D PM#29 F 9-02**

56. CPA-01297 ARE Nov 94 #29 Page 42


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In a Statement of Activities of the People's Environmental Protection Association, a voluntary community organization, depreciation expense should:

a. Not be included.
b. Be included as an element of support.
c. Be included as an element of other changes in fund balances.
d. Be included as an element of expense.

**CPA-01297 Explanation**
Choice "d" is correct. Non-profit organizations record depreciation on fixed assets. Depreciation is reported as an element of expense in the organization's Statement of Activities.

**CPA-01298 Type1 M/C A-D Corr Ans: A PM#30 F 9-02**

57. CPA-01298 ARE Nov 94 #30 Page 42

FASB Statement No. 117, Financial Statements of Not-for-Profit Organizations, focuses on:

a. Basic information for the organization as a whole.
b. Standardization of funds nomenclature.
c. Inherent differences of not-for-profit organizations that impact reporting presentations.
d. Distinctions between current fund and non-current fund presentations.

**CPA-01298 Explanation**
Choice "a" is correct. SFAS #117 primarily focuses on basic information for the organization as a whole. The statement establishes standards for general-purpose external financial statements provided by a not-for-profit organization.

**CPA-01300 Type1 M/C A-D Corr Ans: C PM#31 F 9-02**

58. CPA-01300 ARE May 94 #59 Page 65

Which fund may account for a university's internally designated fund, the income from which will be used for a specified purpose?

a. Endowment fund.
b. Term endowment fund.
c. Quasi-endowment fund.
d. Restricted current fund.

**CPA-01300 Explanation**
Choice "c" is correct. Quasi-endowment funds account for assets that have been internally designated by the institution for a specific purpose.

Choice "a" is incorrect. Endowment funds are funds for which outside donors have stipulated that the principal is to be maintained intact in perpetuity.

Choice "b" is incorrect. Term endowment funds are funds for which outside donors have stipulated that the principal is to be maintained intact for a specified term or until the happening of some event.

Choice "d" is incorrect. The restricted current fund accounts for current assets that are outside donor-restricted for a specific purpose.

**CPA-01301 Type1 M/C A-D Corr Ans: D PM#32 F 9-02**

59. CPA-01301 ARE May 94 #60 Page 70

Valley's community hospital normally includes proceeds from sale of cafeteria meals in:

a. Deductions from dietary service expenses.
b. Ancillary service revenues.
c. Patient service revenues.


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d. Other revenues.

**CPA-01301 Explanation**
Choice "d" is correct. Cafeteria revenue of a hospital is classified as other revenues.

Choice "a" is incorrect. Cafeteria revenue is not offset against dietary service expenses.

Choice "b" is incorrect. There is no such category as ancillary service revenue.

Choice "c" is incorrect. Patient service revenue is the revenue earned for the services rendered to the patients. It does not include cafeteria revenue.

**CPA-01305 Type1 M/C A-D Corr Ans: C PM#33 F 9-02**

60. CPA-01305 PII May 93 #21 Page 44

In 1991, Citizens' Health, a voluntary health and welfare organization, received a bequest of a $200,000 certificate of deposit maturing in 1992. The testator's only stipulations were that this certificate be held until maturity and that the interest revenue be used to finance salaries for a preschool program. Interest revenue for 1992 was $16,000. When the certificate matured and was redeemed, the board of trustees adopted a formal resolution designating $40,000 of the proceeds for the future purchase of equipment for the preschool program. What amount should Citizen report in its 1992 year-end balance sheet as unrestricted net assets designated for the preschool program?

a. $0
b. $16,000
c. $40,000
d. $56,000

**CPA-01305 Explanation**
Choice "c" is correct. In 1992 when the $200,000 certificate of deposit matures, it is transferred from the internal endowment fund (temporarily restricted assets) to the internal current unrestricted fund (unrestricted net assets). Of the $200,000 proceeds, $40,000 is board-designated for the preschool program, the remaining $160,000 is undesignated. The $16,000 interest revenue for 1992 is donor-restricted to finance salaries for a preschool program; therefore, it is recorded in the internal current restricted fund (unrestricted net assets) as revenue. The 1992 year-end balance sheet should report net assets designated for the preschool program of $40,000.

Choice "a" is incorrect. Part of the proceeds of the certificate of deposit is board-designated and therefore would appear in the balance sheet as such.

Choice "b" is incorrect. The $16,000 interest revenue is donor-restricted. It is recorded in the internal current restricted fund.

Choice "d" is incorrect. Only part of the proceeds of the certificate of deposit is board-designated and therefore would appear in the balance sheet as such. The interest revenue is donor-restricted. As such, it is recorded as revenue in internal current restricted funds.

**CPA-01306 Type1 M/C A-D Corr Ans: C PM#34 F 9-02**

61. CPA-01306 PII May 93 #24 Page 51

The following expenditures were made by Green Services, a society for the protection of the environment:

| | |
|---|---|
| Printing of the annual report | $12,000 |
| Unsolicited merchandise sent to encourage contributions | 25,000 |
| Cost of an audit performed by a CPA firm | 3,000 |

What amount should be classified as fund-raising costs in the society's activity statement?

a. $37,000
b. $28,000
c. $25,000


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d. $0

**CPA-01306 Explanation**
Choice "c" is correct. Fund-raising expenses are incurred to induce contributions. Of the ones listed, only the unsolicited merchandise sent to encourage contributions qualifies as fund-raising. The printing of the annual report and the cost of an audit would be reported under Supporting services-management and general expenses.

**CPA-01308 Type1 M/C A-D Corr Ans: C PM#35 F 9-02**

62. CPA-01308 PII May 93 #25 Page 43

In addition to the statement of activities, which of the following financial statements should not-for-profit hospitals prepare?

a. Balance sheet.
b. Balance sheet, and statement of changes in financial position.
c. Balance sheet and statement of cash flows.
d. Statement of funds, statement of revenues and expenses, and statement of cash flows.

**CPA-01308 Explanation**
Choice "c" is correct. The required financial statements for a not-for-profit hospital are a balance sheet, a statement of activities, and a statement of cash flows.

Choice "a" is incorrect. A statement of cash flows is also required. The income statement is formally called a statement of activities.

Choice "b" is incorrect. A statement of cash flows, not a statement of changes in financial position, is required. The income statement is formally called a statement of activities.

Choice "d" is incorrect. A balance sheet, not a statement of funds, is required.

**CPA-01310 Type1 M/C A-D Corr Ans: B PM#36 F 9-02**

63. CPA-01310 PII May 93 #27 Page 44

At the end of the year, Cramer University's held assets of $15,000,000 and $9,000,000 of liabilities (including deferred revenues of $300,000). What is Cramer's net assets balance?

a. $5,700,000
b. $6,000,000
c. $6,300,000
d. $15,000,000

**CPA-01310 Explanation**
Choice "b" is correct. The net assets balance of the university equals its assets minus its liabilities (including deferred revenues). $15,000,000 - $9,000,000 = $6,000,000. Deferred revenues are not a component of net assets.

**CPA-01320 Type1 M/C A-D Corr Ans: D PM#37 F 9-02**

64. CPA-01320 PII May 93 #29 Page 44

In hospital accounting, restricted funds, both permanent and temporary, are:

a. Not available unless the board of directors remove the restrictions.
b. Restricted as to use only for board-designated purposes.
c. Not available for current operating use; however, the income generated by the funds is available for current operating use.
d. Restricted as to use by the donor, grantor, or other source of the resources.


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**CPA-01320 Explanation**
Choice "d" is correct. Restricted funds are restricted as to use by the donor, grantor, or other source of the resources. They are externally restricted funds.

Choice "a" is incorrect. Restricted funds are donor, not board-designated. Therefore, the board can not remove the restrictions.

Choice "b" is incorrect. Restricted funds are donor, not board-designated. Board-designated funds are part of unrestricted funds.

Choice "c" is incorrect. The principal and income of restricted funds may be available for current operating use if so specified by the outside donor.

**CPA-01321 Type1 M/C A-D Corr Ans: B PM#38 F 9-02**

65. CPA-01321 PII May 93 #30 Page 54

Super Seniors is a not-for-profit organization that provides services to senior citizens. Super employs a full-time staff of 10 people at an annual cost of $150,000. In addition, two volunteers work as part-time secretaries replacing last year's full-time secretary who earned $10,000. Services performed by other volunteers for special events had an estimated value of $15,000. These volunteers were employees of local businesses and they received small-value items for their participation. What amount should Super report for salary and wage expenses related to the above items?

a. $150,000
b. $160,000
c. $165,000
d. $175,000

**CPA-01321 Explanation**
Choice "b" is correct. The value of donated services should be recorded as both a contribution and an expense if the services performed are a normal part of the program or supporting services and would otherwise be performed by salaried personnel. Clearly the two volunteers who replaced the secretary (value $10,000) would qualify under these criteria. The services performed by the other volunteers for special events would not qualify since they are not a normal part of the program and would not otherwise be performed by salaried personnel. Total salary and wage expense equals $150,000 paid staff plus $10,000 donated services = $160,000.

**CPA-01322 Type1 M/C A-D Corr Ans: D PM#39 F 9-02**

66. CPA-01322 PII May 93 #33 Page 67

For the fall semester of 1992, Ames University assessed its students $3,000,000 for tuition and fees. The net amount realized was only $2,500,000 because scholarships of $400,000 were granted to students, and tuition remissions of $100,000 were allowed to faculty members' children attending Ames. What amount should Ames report for the period as unrestricted current fund gross revenues from tuition and fees?

a. $2,500,000
b. $2,600,000
c. $2,900,000
d. $3,000,000

**CPA-01322 Explanation**
Choice "d" is correct. Revenues from tuition and fees are reported at the gross amount. Only refunds are netted against the revenue. Scholarships and tuition remissions are shown separately as expenditures. The journal entry would be:

| | |
|---|---|
| Cash | 2,500,000 |
| Expenses - scholarships | 400,000 |


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| | | |
|---|---|---|
| Expenses - tuition remission | 100,000 | |
| Revenues - tuition and fees | | 3,000,000 |

**CPA-01323 Type1 M/C A-D Corr Ans: C PM#40 F 9-02**

67. CPA-01323 PII May 93 #35 Page 56

The League, a not-for-profit organization, received the following pledges:

| | |
|---|---|
| Unrestricted | $200,000 |
| Restricted for capital additions | 150,000 |

All pledges are legally enforceable; however, the League's experience indicates that 10% of all pledges prove to be uncollectible. What amount should the League report as pledges receivable, net of any required allowance account?

a. $135,000
b. $180,000
c. $315,000
d. $350,000

**CPA-01323 Explanation**
Choice "c" is correct. In a not-for-profit organization, if the pledges are legally enforceable, they are recorded in the accounts. Net pledges receivable are gross pledges receivable ($350,000) less allowance for uncollectible (10% $\times$ $350,000), or $315,000. The unrestricted pledges, net of allowance, are credited to Support-Private gifts, while the restricted pledges, net of allowance, are credited to Restricted Net Assets.

**CPA-01324 Type1 M/C A-D Corr Ans: A PM#41 F 9-02**

68. CPA-01324 PII May 93 #36 Page 63

In the balance sheet of a not-for-profit hospital, marketable equity securities should be reported at:

a. Fair value with gains and losses reported in the statement of activities.
b. Fair value with gains and losses reported as a component of net assets.
c. The lower of aggregate cost or market in separate portfolios for current and non-current assets.
d. Cost, with no valuation for declines in market value, and in separate portfolios for unrestricted and restricted assets.

**CPA-01324 Explanation**
Choice "a" is correct. Marketable equity securities with readily determinable fair values and all investments in debt securities are measured at fair value in the statement of financial position. Gains and losses on investments are reported in the statement of activities as increases or decreases in unrestricted net assets unless their use is temporarily or permanently restricted by explicit donor stipulations or law.

Choice "b" is incorrect. Marketable equity securities with readily determinable fair values and all investments in debt securities are measured at fair value in the statement of financial position. Gains and losses on investments are reported in the statement of activities as increases or decreases in unrestricted net assets unless their use is temporarily or permanently restricted by explicit donor stipulations or law.

Choice "c" is incorrect. Marketable equity securities with readily determinable fair values and all investments in debt securities are measured at fair value in the statement of financial position.

Choice "d" is incorrect. Marketable equity securities with readily determinable fair values and all investments in debt securities are measured at fair value in the statement of financial position.

**CPA-01326 Type1 M/C A-D Corr Ans: C PM#42 F 9-02**


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69. CPA-01326 PII May 93 #38 Page 63

Midtown Church received a donation of marketable equity securities from a church member. The securities had appreciated in value after they were purchased by the donor, and they continued to appreciate through the end of Midtown's fiscal year. At what amount should Midtown report its investment in marketable equity securities in its year-end balance sheet?

a. Donor's cost.
b. Market value at the date of receipt.
c. Market value at the balance sheet date.
d. Market value at either the date of receipt or the balance-sheet date.

**CPA-01326 Explanation**
Choice "c" is correct. In the case of non-profit organizations such as churches, marketable equity securities are reported at market value as of the balance sheet date. Therefore, Midtown Church would report the investment at market value at the date of the balance sheet date. The marketable equity securities are reported at market value.

**CPA-01328 Type1 M/C A-D Corr Ans: B PM#43 F 9-02**

70. CPA-01328 PII May 93 #40 Page 63

Maple Church has cash available for investments in several different accounting funds. Maple's policy is to maximize its financial resources. How may Maple pool its investments?

a. Maple may not pool its investments.
b. Maple may pool all investments, but must equitably allocate realized and unrealized gains and losses among participating funds.
c. Maple may pool only unrestricted investments, but must equitably allocate realized and unrealized gains and losses among participating funds.
d. Maple may pool only restricted investments, but must equitably allocate realized and unrealized gains and losses among participating funds.

**CPA-01328 Explanation**
Choice "b" is correct. Non-profit organizations such as churches may pool all investments of various funds, but must equitably allocate realized and unrealized gains and losses among the participating funds.

**CPA-01329 Type1 M/C A-D Corr Ans: B PM#44 F 9-02**

71. CPA-01329 Th May 93 #60 Page 47

When a non-profit organization combines fund-raising efforts with educational materials or program services, the total combined costs incurred are:

a. Reported as program services expenses.
b. Allocated between fund-raising and program services expenses using an appropriate allocation basis.
c. Reported as fund-raising costs.
d. Reported as management and general expenses.

**CPA-01329 Explanation**
Choice "b" is correct. An allocation, using an appropriate allocation basis, must be made between the fund-raising activities and educational materials or program services where the costs are combined.

**CPA-04654 Type1 M/C A-D Corr Ans: A PM#45 F 9-02**

72. CPA-04654 Released 2005 Page 48

An unrestricted cash contribution should be reported in a nongovernmental not-for-profit organization's statement of cash flows as an inflow from:


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a. Operating activities.
b. Investing activities.
c. Financing activities.
d. Capital and related financing activities.

**CPA-04654 Explanation**
Choice "a" is correct. Cash flows from Operating Activities in a non governmental not-for-profit organization include applicable agency transactions; including unrestricted cash contributions, program income, and interest income or dividend income from investments.

Choices "b", "c", and "d" are incorrect, per above.

**CPA-04655 Type1 M/C A-D Corr Ans: B PM#46 F 9-02**

73. CPA-04655 Released 2005 Page 53

Community Enhancers, a nongovernmental not-for-profit organization, received the following pledges:

| | |
|---|---|
| Unrestricted | $400,000 |
| Restricted for capital additions | 300,000 |

All pledges are legally enforceable. However, Community's experience indicates that 5% of all pledges prove to be uncollectible. What amount should Community report as pledges receivable, net of any required allowance account?

a. $700,000
b. $665,000
c. $380,000
d. $285,000

**CPA-04655 Explanation**
Choice "b" is correct. An allowance for uncollectible pledges should be recorded in accordance with commercial accounting principles for accounts receivable.

| | |
|---|---|
| Unrestricted pledges | $400,000 |
| Restricted | 300,000 |
| TOTAL PLEDGES | 700,000 |
| Less allowance (5% x 700,000) | (35,000) |
| Net Pledges Receivable | $665,000 |

**CPA-04674 Type1 M/C A-D Corr Ans: B PM#47 F 9-02**

74. CPA-04674 Released 2005 Page 49

A not-for-profit voluntary health and welfare organization should report a contribution for the construction of a new building as cash flows from which of the following in the statement of cash flows?

a. Operating activities.
b. Financing activities.
c. Capital financing activities.
d. Investing activities.

**CPA-04674 Explanation**
Choice "b" is correct. Cash received with donor-imposed restriction limiting its use to long-term purposes (such as construction of a new building) is displayed as a financing activity on the statement of cash flows of a not-for-profit organization.

Choice "a" is incorrect. Cash received with donor imposed restrictions limiting its use to long term purposes is a financing activity, not an operating activity, on the statement of cash flows of a not-for-profit


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organization. Operating activities include cash received for unrestricted purposes or used in the central on going activities of the organization.

Choice "c" is incorrect. This is a distracter. There is no classification in the statement of cash flows used for not for profit organizations entitled "Capital financing activities." This classification is used in the statement of cash flows prepared for a proprietary fund of a government.

Choice "d" is incorrect. Cash received with donor imposed restrictions limiting its use to long term purposes is a financing activity, not an investing activity, on the statement of cash flows of a not-for-profit organization. Investing activities include sources of cash from the sale of long lived assets or uses of cash associated with the acquisition of long lived assets.

**CPA-04688 Type1 M/C A-D Corr Ans: B PM#48 F 9-02**

75. CPA-04688 Released 2005 Page 69

Terry, an auditor, is performing test work for a not-for-profit hospital. Listed below are components of the statement of operations:

| | |
|---|---|
| Revenue relating to charity care | $100,000 |
| Bad debt expense | 70,000 |
| Net assets released from restrictions used for operations | 50,000 |
| Other revenue | 80,000 |
| Net patient service revenue (includes revenue related to charity care) | 500,000 |

What amount would be reported as unrestricted revenues, gains, and other support on the statement of operations?

a. $460,000
b. $530,000
c. $580,000
d. $630,000

**CPA-04688 Explanation**

Choice "b" is correct. The amount reported as unrestricted revenues, gains and other support on the statement of operations of a not-for-profit hospital would include all income earned by the hospital and any amounts released from restriction. Charity care, those health care services provided but never expected to result in cash flows to the hospital, are not recorded as receivable or as revenue. Charity care is not recognized on the face of the financial statements but is disclosed. Revenues, gains and other support is computed as follows:

| | |
|---|---|
| Net patient service revenue (including charity care) | $500,000 |
| Less: Charity care | (100,000) |
| Plus: Other revenue | 80,000 |
| Plus: Net assets released from restrictions used for used for operations | 50,000 |
| **Unrestricted revenues, gains and other support** | **$530,000** |

Choice "a" is incorrect. The amount represented by this selection ($460,000) is the amount properly recognized as total revenues, gains and other support ($530,000) net of bad debt expense of $70,000. Bad debt expense is recognized as an expense, not as a contra revenue.

Choice "c" is incorrect. The amount represented by this selection ($580,000) is the total patient service revenue including charity care ($500,000) and other revenue (80,000), exclusive of net assets released from restrictions. This amount does not represent the total to be recognized as revenues, gains and other support.

Choice "d" is incorrect. The amount represented by this selection ($630,000) is the amount properly recognized as total revenues, gains and other support ($530,000) plus charity care of $100,000. Charity care is improperly included and should not be recognized.


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**CPA-04695 Type1 M/C A-D Corr Ans: A PM#49 F 9-02**

76. CPA-04695 Released 2005 Page 69

Hospital, Inc., a not-for-profit organization with no governmental affiliation, reported the following in its accounts for the current year ended December 31:

| | |
|---|---|
| Gross patient service revenue from all services provided at the established billing rates of the hospital (note that this figure includes charity care of $25,000) | $775,000 |
| Provision for bad debts | 15,000 |
| Difference between established billing rates and fees negotiated with third-party payors (contractual adjustments) | 70,000 |

What amount would the hospital report as net patient service revenue in its statement of operations for the current year ended December 31?

a. $680,000
b. $690,000
c. $705,000
d. $735,000

**CPA-04695 Explanation**

Choice "a" is correct. Hospital, Inc. would report net patient revenue in an amount equal to its gross patient service revenue net of both charity care and the difference between established billing rates and fees negotiated with third party payors (sometimes called contractual adjustments). Net patient revenue for Hospital, Inc for the current year ended December 31, is computed as follows:

| | |
|---|---|
| Gross patient revenues including charity care of $25,000 | $775,000 |
| Less: Charity care | (25,000) |
| Less: Contractual adjustments | (70,000) |
| **Net patient service revenue** | **$680,000** |

Choice "b" is incorrect. The amount represented by this selection ($690,000) is the amount properly recognized as net patient service revenue ($680,000) plus charity care of $25,000 and net of bad debt expense of $15,000 given in the fact pattern. Charity care is improperly included and should not be recognized and bad debt expense is recognized as an expense, not a contra revenue.

Choice "c" is incorrect. The amount represented by this selection ($705,000) is the amount properly recognized as net patient service revenue ($680,000) plus charity care of $25,000. Charity care is improperly included and should not be recognized.

Choice "d" is incorrect. The amount represented by this selection ($735,000) is the amount properly recognized as net patient service revenue ($680,000) plus contractual adjustments of $70,000 and net of bad debt expense of $15,000 given in the fact pattern. Contractual adjustments are improperly included and should not be recognized and bad debt expense is recognized as an expense, not a contra revenue.

**CPA-05198 Type1 M/C A-D Corr Ans: C PM#50 F 9-02**

77. CPA-05198 Released 2006 Page 52

During the year, Private College received the following:

An unrestricted $50,000 pledge to be paid the following year.
A $25,000 cash gift restricted for scholarships.
A notice from a recent graduate that the college is named as a beneficiary of $10,000 in that graduate's will.

What amount of contribution revenue should Private College report in its statement of activities?

a. $25,000
b. $35,000
c. $75,000


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d. $85,000

**CPA-05198 Explanation**
Choice "c" is correct. Total contribution revenue is $75,000. The $50,000 unrestricted pledge is reported as contribution revenue on the statement of activities, even though it is to be paid (and collected) in the following year. The $25,000 cash gift is reported as contribution revenue on the statement of activities, even though it is restricted (it is recorded as restricted revenue). The "notice" from a recent graduate that the college is named as a beneficiary is not definite enough for the recording of revenue (the recent graduate may live a long time and may change his or her will at any time). Total contribution revenue is thus $75,000.

Choice "a" is incorrect. The $50,000 unrestricted pledge is reported as contribution revenue on the statement of activities, not just the $25,000 cash gift.

Choice "b" is incorrect. The $25,000 restricted gift is an element of recognized contribution revenue on the statement of activities, but the $10,000 "notice" is not.

Choice "d" is incorrect. The $10,000 "notice" is not reported as contribution revenue on the statement of activities, although the other two amounts related to actual receipts or receivables are recognized.

**CPA-05203 Type1 M/C A-D Corr Ans: B PM#51 F 9-02**

78. CPA-05203 Released 2006 Page 65

A voluntary health and welfare organization received a $700,000 permanent endowment during the year. The donor stipulated that the income and investment appreciation be used to maintain its senior center. The endowment fund reported a net investment appreciation of $80,000 and investment income of $50,000. The organization spent $60,000 to maintain its senior center during the year. What amount of change in temporarily restricted net assets should the organization report?

a. $50,000
b. $70,000
c. $130,000
d. $770,000

**CPA-05203 Explanation**
Choice "b" is correct. In this question, the donor stipulated that the income ($50,000) and the investment appreciation ($80,000) be used in maintain the senior center. Both the income and the investment appreciation represent increases in temporarily restricted net assets (total of $130,000). The actual $60,000 spent represents a decrease in temporarily restricted net assets. Thus, the total change is a $70,000 increase.

Choice "a" is incorrect. The change in temporarily restricted net assets is **not** only the investment income.

Choice "c" is incorrect. The change in temporarily restricted net assets is **not** just the income and investment appreciation. The $60,000 must be taken into account also.

Choice "d" is incorrect. The $700,000 endowment is a permanently restricted net asset, **not** a temporarily restricted net asset.

**CPA-05209 Type1 M/C A-D Corr Ans: D PM#52 F 9-02**

79. CPA-05209 Released 2006 Page 56

During the current year, a voluntary health and welfare organization receives $300,000 in unrestricted pledges. Of this amount, $100,000 has been designated by donors for use next year to support operations. If 15% of the unrestricted pledges are expected to be uncollectible, what amount of unrestricted support should the organization recognize in its current-year financial statements?

a. $300,000
b. $270,000


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c. $200,000
d. $170,000

**CPA-05209 Explanation**
Choice "d" is correct. The unrestricted support, net of expected uncollectibles, recognized in the current year financial statements is $170,000. Although $300,000 was pledged, 15% are anticipated to be uncollectible and $100,000 is effectively temporarily restricted by the time restriction limiting the use of the funds to the following year. The $200,000 ($300,000 - $100,000) of unrestricted current year pledges, reduced by $30,000 (15% of $200,000) is $170,000 ($200,000 - $30,000).

Choice "a" is incorrect. This answer incorrectly includes the entire amount pledged and ignores the $30,000 estimate of uncollectibility.

Choice "b" is incorrect. This answer incorrectly includes the entire amount pledged for current year recognition as unrestricted but does subtract the $30,000 estimate of uncollectibility.

Choice "c" is incorrect. This answer includes only the unrestricted pledges but does subtract the estimate of uncollectibility.

**CPA-05230 Type1 M/C A-D Corr Ans: A PM#53 F 9-02**

80. CPA-05230 Released 2006 Page 42

Which of the following assets of a nongovernmental not-for-profit charitable organization must be depreciated?

a. A freezer costing $150,000 for storing food for the soup kitchen.
b. Building costs of $500,000 for construction in progress for senior citizen housing.
c. Land valued at $1 million being used as the site of the new senior citizen home.
d. A bulk purchase of $20,000 of linens for its nursing home.

**CPA-05230 Explanation**
Choice "a" is correct. A nongovernmental not-for-profit charitable organization is accounted for using the accrual method, so normal accrual accounting is used. A freezer would be considered a fixed asset and would be depreciated.

Choice "b" is incorrect. Construction in progress is not depreciated, regardless of the type of organization.

Choice "c" is incorrect. Land is not depreciated, regardless of the type of organization.

Choice "d" is incorrect. Linens for a nursing home would not be considered a fixed asset and thus would not be depreciated. Linens would be considered a consumable (supplies).

**CPA-05232 Type1 M/C A-D Corr Ans: C PM#54 F 9-02**

81. CPA-05232 Released 2006 Page 48

A nongovernmental not-for-profit organization borrowed $5,000, which it used to purchase a truck. In which section of the organization's statement of cash flows should the transaction be reported?

a. In cash inflow and cash outflow from investing activities.
b. In cash inflow and cash outflow from financing activities.
c. In cash inflow from financing activities and cash outflow from investing activities.
d. In cash inflow from operating activities and cash outflow from investing activities.

**CPA-05232 Explanation**
Choice "c" is correct. For a nongovernmental not-for-profit organization, the borrowing would be a cash inflow from financing activities, and the purchase of the truck would be a cash outflow from investing activities. For a nongovernmental not-for-profit organization, the commercial format for the statement of cash flows is followed.


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Choice "a" is incorrect. The cash inflow for the borrowing is a financing activity, **not** an investing activity.

Choice "b" is incorrect. The cash outflow for the purchase of the truck is an investing activity, **not** a financing activity.

Choice "d" is incorrect. The cash inflow for the borrowing is a financing activity, **not** an operating activity.

**CPA-05233 Type1 M/C A-D Corr Ans: A PM#55 F 9-02**

82. CPA-05233 Released 2006 Page 52

Janna Association, a nongovernmental not-for-profit organization, received a cash gift with the stipulation that the principal be held for at least 20 years. How should the cash gift be recorded?

a. A temporarily restricted asset.
b. A permanently restricted asset.
c. An unrestricted asset.
d. A temporary liability.

**CPA-05233 Explanation**
Choice "a" is correct. For a nongovernmental non-for-profit organization, a cash gift (with a stipulation that the principal be held for at least 20 years) should be recorded as a temporarily (a 20-year spending restriction would be temporary because it can ultimately be satisfied) restricted asset.

Choice "b" is incorrect. The cash gift would be recorded as a temporarily, **not** permanently, restricted net asset.

Choice "c" is incorrect. The cash gift would be recorded as a temporarily restricted, **not** an unrestricted, asset.

Choice "d" is incorrect. The cash gift would be recorded as a temporarily restricted net asset, **not** a temporary liability. The term temporary liability is a distracter.

**CPA-05421 Type1 M/C A-D Corr Ans: B PM#56 F 9-02**

83. CPA-05421 Released 2007 Page 47

In the preparation of the statement of activities for a nongovernmental not-for-profit organization, all expenses are reported as decreases in which of the following net asset classes?

a. Total net assets.
b. Unrestricted net assets.
c. Temporarily restricted net assets.
d. Permanently restricted net assets.

**CPA-05421 Explanation**
Choice "b" is correct. Expenses are reported as decreases in unrestricted net assets.

Choice "a" is incorrect. Although expenses reduce a component of total net assets, they specifically reduce unrestricted net assets.

Choice "c" is incorrect. Expenses are reported as decreases in unrestricted net assets, no expenses are recorded to reduce temporarily restricted net assets. The focus of not for profit organization financial statements is the entity taken as a whole. Fund accounting is not used. The use of temporarily restricted assets for their intended purpose is not displayed as an expenditure of temporarily restricted funds. Satisfaction of temporarily restrictions are effected by reclassifications of net assets released from restrictions to unrestricted net assets and used for the central mission of the not for profit organization.

Choice "d" is incorrect. Permanently restricted net assets account for restricted corpus whose earnings are reclassified to either temporarily restricted or unrestricted categories for use. Expenses are not recorded for permanently restricted net assets.


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**CPA-05429 Type1 M/C A-D Corr Ans: A PM#57 F 9-02**

84. CPA-05429 Released 2007 Page 76

In a not-for-profit organization, which of the following should be included in total expenses?

| | *Grants to other organizations* | *Depreciation* |
|---|---|---|
| a. | Yes | Yes |
| b. | Yes | No |
| c. | No | No |
| d. | No | Yes |

**CPA-05429 Explanation**

Choice "a" is correct. Both grants to other organizations and depreciation are recorded as expenses in a not-for-profit organization.

Choice "b" is incorrect. Although partially correct in that grants to other organizations are recorded as expenses in not for profit organizations, excluding depreciation from total expenses of a not for profit organization is incorrect.

Choice "c" is incorrect. Both grants to other organizations and depreciation are recorded as expenses in a not-for-profit organization.

Choice "d" is incorrect. Although partially correct in that depreciation is recorded as an expense in not for profit organizations, excluding grants to other organizations from total expenses of a not for profit organization is incorrect.

**CPA-05444 Type1 M/C A-D Corr Ans: D PM#58 F 9-02**

85. CPA-05444 Released 2007 Page 63

RST Charities received equities securities valued at $100,000 as an unrestricted gift. During the year, RST received $5,000 in dividends from these securities; at year end, the securities had a fair market value of $110,000. By what amount did these transactions increase RST's net assets?

a. $100,000
b. $105,000
c. $110,000
d. $115,000

**CPA-05444 Explanation**

Choice "d" is correct. RST's net assets increased $115,000 during the year as a result of the contribution of equity securities, the increase in market value and the dividends received is computed as follows:

| | |
|---|---|
| Equity security received | $100,000 |
| Change in market value | 10,000 |
| Fair market value at year end | 110,000 |
| Dividends received | 5,000 |
| Total | $115,000 |

All debt securities and those equity securities that have readily determinable fair values are measured at fair value in the statement of financial position. Gains and losses on investments are reported in the statement of activities. Investment income (e.g., dividends and interest) is reported in the period earned as an increase in net assets.

Choice "a" is incorrect. The proposed solution excludes changes in market value and dividends from increases in net assets in error. Both the change in market value and the dividend would be considered as an increase in net assets.

Choice "b" is incorrect. The proposed solution excludes changes in market value from increases in net assets in error. Both the change in market value and the dividend would be considered as an increase in net assets.


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Choice "c" is incorrect. The proposed solution excludes dividends from increases in net assets in error. Both the change in market value and the dividend would be considered as an increase in net assets.

**CPA-05445 Type1 M/C A-D Corr Ans: A PM#59 F 9-02**

86. CPA-05445 Released 2007 Page 54

The Turtle Society, a nongovernmental not-for-profit organization, receives numerous contributed hours from volunteers during its busy season. Chris, a clerk at the local tax collector's office, volunteered ten hours per week for 24 weeks transferring turtle food from the port to the turtle shelter. His rate of pay at the tax office is $10 per hour, and the prevailing wage rate for laborers is $6.50 per hour. What amount of contribution revenue should Turtle Society record for this service?

a. $0
b. $840
c. $1,560
d. $2,400

**CPA-05445 Explanation**
Choice "a" is correct. No expense would be recognized for the work performed.

Donated services should be recorded as contribution revenue and expense at fair value if the services meet the following criteria:

1. They create or enhance a non-financial asset.
2. They require specialized skills that the provider possesses and would otherwise have been purchased by the organization.

Contributed services are, therefore, only recognized SOME of the time: when the service is Specialized, Otherwise needed, and Measured Easily.

Chris's work for the Turtle Society does not meet the criteria for expense recognition. The fact pattern makes a point of describing the work as being different from his normal profession and valued at an amount less that his normal wage. Chris's work is not specialized even though it is likely that it would be otherwise needed.

Choice "b" is incorrect. Chris's work for the Turtle Society is not sufficiently specialized to meet the criteria for expense recognition. The proposed response incorrectly attempts to value his volunteer labor as the difference between his compensation in an unrelated profession and the going rate for the work performed

Choice "c" is incorrect. Chris's work for the Turtle Society is not sufficiently specialized to meet the criteria for expense recognition. The proposed response incorrectly attempts to value his volunteer labor at the going rate the unspecialized work performed.

Choice "d" is incorrect. Chris's work for the Turtle Society is not sufficiently specialized to meet the criteria for expense recognition. The proposed response incorrectly attempts to value his volunteer labor as his compensation in an unrelated profession.

**Supplemental Questions**

**CPA-01330 Type1 M/C A-D Corr Ans: A PM#1 F 9-99**

87. CPA-01330 Nov 89 T #58 Page 76

In a statement of activity of a voluntary health and welfare organization, depreciation expense should:

a. Be included as an element of expense.
b. Be included as an element of other changes in a statement of activity.
c. Be included as an element of support.
d. Not be included.


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**CPA-01330 Explanation**
Choice "a" is correct. Depreciation is included as an element of expense in a "statement of activity" of a voluntary health and welfare organization.

Choices "b", "c", and "d" are incorrect, per above.

**CPA-01334 Type1 M/C A-D Corr Ans: B PM#2 F 9-99**

88. CPA-01334 May 90 II #14 Page 57

In 1991, Community Helpers, a private voluntary health and welfare organization, received a bequest of a $100,000 certificate of deposit maturing in 2001. The testator's only stipulations were that this certificate be held until maturity and that the interest revenue be used to finance salaries for a preschool program. Interest revenue for 2001 was $8,000. When the certificate was redeemed, the board of trustees adopted a formal resolution designating $20,000 of the proceeds for the future purchase of equipment for the preschool program.

In regard to the certificate of deposit, what should be reported in the 2001 statement of activities?

a. Legacies and bequests, $100,000.
b. Reclassification from temporarily restricted net assets of $100,000.
c. Transfer to land, building, and equipment fund, $20,000.
d. Revenues control, $100,000.

**CPA-01334 Explanation**
Choice "b" is correct. When the certificate was redeemed, the $100,000 amount was reported in the 2001 statement of activity as a reclassification from temporarily restricted net assets to unrestricted net assets on the face of the statement of activities.

Choices "a" and "c" are incorrect. The "contributions - temporarily restricted" account was increased when the $100,000 was originally received in 1991.

Choice "d" is incorrect. The $100,000 maturity of the CD is not revenues.

**CPA-01336 Type1 M/C A-D Corr Ans: C PM#3 F 9-99**

89. CPA-01336 May 90 II #15 Page 52

In 1991, Community Helpers, a private voluntary health and welfare organization, received a bequest of a $100,000 certificate of deposit maturing in 2001. The testator's only stipulations were that this certificate be held until maturity and that the interest revenue be used to finance salaries for a preschool program. Interest revenue for 2001 was $8,000. When the certificate was redeemed, the board of trustees adopted a formal resolution designating $20,000 of the proceeds for the future purchase of equipment for the preschool program.

What should be reported as "unrestricted contributions" in the 2001 statement of activity?

a. Investment income, $8,000.
b. Direct reduction of permanently restricted net assets of $20,000.
c. $0.
d. $108,000.

**CPA-01336 Explanation**
Choice "c" is correct. $0.

Choice "a" is incorrect. The $8,000 investment income from long-term investment is "contributions temporarily restricted" for salaries for a preschool program.

Choice "b" is incorrect. The board's formal resolution designating $20,000 of the maturing CD for the future purchase of equipment is not revenues and therefore not "unrestricted contributions."

Choice "d" is incorrect. The $100,000 CD bequest was reported in 1991 as "contributions-temporarily restricted." When it matures in 2001 it is reported as "$100,000 net assets released from restrictions -


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expiration of time." The $8,000 was "contributions temporarily restricted," not revenues "unrestricted contributions."

**CPA-01342 Type1 M/C A-D Corr Ans: B PM#4 F 9-99**

90. CPA-01342 May 90 II #16 Page 44

In 1991, Community Helpers, a private voluntary health and welfare organization, received a bequest of a $100,000 certificate of deposit maturing in 2001. The testator's only stipulations were that this certificate be held until maturity and that the interest revenue be used to finance salaries for a preschool program. Interest revenue for 2001 was $8,000. When the certificate was redeemed, the board of trustees adopted a formal resolution designating $20,000 of the proceeds for the future purchase of equipment for the preschool program.

What should be reported in the 2001 year-end statement of financial position?

a. Temporarily restricted net assets (for purchase of equipment), $20,000; unrestricted net assets, $80,000.
b. Unrestricted net assets, $100,000.
c. Net assets temporarily restricted - designated for preschool program salaries, $8,000. Unrestricted net assets, $100,000.
d. Temporarily restricted assets - designated for preschool program, $28,000; Net assets unrestricted, $80,000.

**CPA-01342 Explanation**
Choice "b" is correct. The 2001 year-end statement of financial position should report:

| | |
|---|---|
| Unrestricted net assets | $100,000 |

Choice "a" is incorrect. The $20,000 board of trustee's resolution designating $20,000 for future purchase of equipment is considered "unrestricted assets" because the board can change its mind. Only contributions from donors may be permanently or temporarily restricted and only by donors.

Choice "c" is incorrect. Note: the $8,000 of interest has already been expensed to finance the current period salaries and is no longer an asset.

Choice "d" is incorrect, as explained in "a" and "c".

**CPA-01344 Type1 M/C A-D Corr Ans: A PM#5 F 9-99**

91. CPA-01344 May 90 II #18 Page 14

Metro General is a municipally-owned and operated hospital and a component unit of Metro City. In 20X1, the hospital received $7,000 in unrestricted gifts and $4,000 in unrestricted bequests. The hospital has $800,000 in long-term debt and $1,200,000 in fixed assets.

The hospital has transferred certain resources to a hospital guild. Substantially all of the guild's resources are held for the benefit of the hospital. The hospital controls the guild through contracts that provide it with the authority to direct the guild's activities, management, and policies. The hospital has also assigned certain of its functions to a hospital auxiliary, which operates primarily for the benefit of the hospital. The hospital does not have control over the auxiliary. The financial statements of the guild and the auxiliary are not consolidated with the hospital's financial statements. The guild and the auxiliary have total assets of $20,000 and $30,000, respectively.

Before the hospital's financial statements were combined with those of the city, the city's statements included data on one special revenue fund and one enterprise fund. The city's statements showed $100,000 in enterprise fund long-term debt, $500,000 in enterprise fund fixed assets, $1,000,000 in general long-term debt, and $6,000,000 in general fixed assets.

The hospital's long-term debt should be reported in the city's financial statements as:


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a. Long term debt in the component unit column of the government-wide long-term debt in the financial statements.
b. An $800,000 contra amount against fixed assets.
c. Part of $1,800,000 in long-term debt displayed in the governmental activities column of the government-wide statement of net assets.
d. A separate "discrete presentation" of $800,000 in the hospital column.

**CPA-01344 Explanation**
Choice "a" is correct. The hospital's long-term debt should be reported in the city's financial statements as part of $900,000 component unit long-term debt in the government-wide financial statements.

Choice "b" is incorrect. Debt is not offset against assets.

Choice "c" is incorrect. The hospital is an enterprise fund component, not part of governmental activities.

Choice "d" is incorrect. There is no hospital column.

**CPA-01349 Type1 M/C A-D Corr Ans: D PM#6 F 9-99**

92. CPA-01349 Nov 90 II #58 Page 46

United Together, a labor union, had the following revenues and expenses for the year ended December 31, 20X1:

| | |
|---|---|
| *Receipts:* | |
| Per capita dues | $680,000 |
| Initiation fees | 90,000 |
| Sales of organizational supplies | 60,000 |
| Nonexpendable gift restricted by donor for loan purposes for 10 years | 30,000 |
| Nonexpendable gift restricted by donor for loan purposes in perpetuity | 25,000 |
| *Expenses:* | |
| Labor negotiations | 500,000 |
| Fund-raising | 100,000 |
| Membership development | 50,000 |
| Administrative and general | 200,000 |

*Additional information:*
The union's constitution provides that 10% of the per capita dues are designated for the Strike Insurance Fund to be distributed for strike relief at the discretion of the union's executive board.

In United Together's statement of activity for the year ended December 31, 20X1, what amount should be reported under the classification of unrestricted revenues, gains, and other support?

a. $740,000
b. $762,000
c. $770,000
d. $830,000

**CPA-01349 Explanation**
Choice "d" is correct. $830,000.

In United Together's statement of activity for the year ended December 31, 20X1, the amount that should be reported under the classification of unrestricted revenues, gains, and other support is $830,000 ($680,000 + $90,000 + $60,000). All other receipts are restricted.

**CPA-01354 Type1 M/C A-D Corr Ans: D PM#7 F 9-99**

93. CPA-01354 Nov 90 II #59 Page 47

United Together, a labor union, had the following receipts and expenses for the year ended December 31, 20X1:


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| | |
|---|---|
| *Receipts:* | |
| Per capita dues | $680,000 |
| Initiation fees | 90,000 |
| Sales of organizational supplies | 60,000 |
| Nonexpendable gift restricted by donor for loan purposes for 10 years | 30,000 |
| Nonexpendable gift restricted by donor for loan purposes in perpetuity | 25,000 |
| *Expenses:* | |
| Labor negotiations | 500,000 |
| Fund-raising | 100,000 |
| Membership development | 50,000 |
| Administrative and general | 200,000 |

*Additional information:*
The union's constitution provides that 10% of the per capita dues are designated for the Strike Insurance Fund to be distributed for strike relief at the discretion of the union's executive board.

In United Together's statement of activity for the year ended December 31, 20X1, what amount should be reported under the classification of program services?

a. $850,000
b. $600,000
c. $550,000
d. $500,000

**CPA-01354 Explanation**
Choice "d" is correct. $500,000.

In United Together's statement of activity for the year ended December 31, 20X1, the amount reported as program services should be $500,000 of labor negotiations. The other expenses which include fund raising, membership development and general and administrative would be included as part of supporting services.

**CPA-01359 Type1 M/C A-D Corr Ans: A PM#8 F 9-99**

94. CPA-01359 Nov 90 II #60 Page 53

United Together, a labor union, had the following receipts and expenses for the year ended December 31, 20X1:

| | |
|---|---|
| *Receipts:* | |
| Per capita dues | $680,000 |
| Initiation fees | 90,000 |
| Sales of organizational supplies | 60,000 |
| Nonexpendable gift restricted by donor for loan purposes for 10 years | 30,000 |
| Nonexpendable gift restricted by donor for loan purposes in perpetuity | 25,000 |
| *Expenses:* | |
| Labor negotiations | 500,000 |
| Fund-raising | 100,000 |
| Membership development | 50,000 |
| Administrative and general | 200,000 |

*Additional information:*
The union's constitution provides that 10% of the per capita dues are designated for the Strike Insurance Fund to be distributed for strike relief at the discretion of the union's executive board.

In United Together's statement of activity for the year ended December 31, 20X1, what amount should be reported under the classification of contributions - temporarily restricted?

a. $30,000


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b. $55,000
c. $25,000
d. $0

**CPA-01359 Explanation**
Choice "a" is correct. $30,000.

In United Together's statement of activity, the amount that should be reported under the classification of "contributions - temporarily restricted" would include the nonexpendable gifts restricted by the donor for loan purposes for 10 years. Funds restricted for loans in perpetuity would be classified as permanently restricted.

**CPA-01361 Type1 M/C A-D Corr Ans: A PM#9 F 9-99**

95. CPA-01361 Nov 91 T #57 Page 65

Funds received by a college from donors who have stipulated that the principal is nonexpendable but that the income generated may be expended by current operating funds would be accounted for internally in the:

a. Endowment fund.
b. Term endowment fund.
c. Agency fund.
d. Quasi-endowment fund.

**CPA-01361 Explanation**
Choice "a" is correct. Endowment fund.

Funds received by a college from donors who have stipulated that the principal is nonexpendable but that the income generated may be expended by current operating funds would be accounted for in an endowment fund.

Choice "b" is incorrect. A "term endowment fund" specifies that the principal may be expended at a certain time or on the happening of a certain event.

Choice "c" is incorrect. An agency fund is used as a clearing mechanism for cash to be transferred to other funds.

Choice "d" is incorrect. A quasi-endowment fund would be used of the governing board of the institution (not the donor) has the authority to determine the use of the income generated.

**CPA-01363 Type1 M/C A-D Corr Ans: B PM#10 F 9-99**

96. CPA-01363 May 92 II #40 Page 47

Environs, a community foundation, incurred $10,000 in management and general expenses during 1991. In Environs' statement of activity for the year ended December 31, 1991, the $10,000 should be reported as:

a. A direct reduction of net assets - unrestricted.
b. Part of supporting services.
c. Part of program services.
d. A contra account to offset revenue and support.

**CPA-01363 Explanation**
Choice "b" is correct. Part of supporting services.

"Management and general" expenses incurred by a community foundation should be reported as part of supporting services in the "statement of activity."

**CPA-01366 Type1 M/C A-D Corr Ans: A PM#11 F 9-99**


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97. CPA-01366 May 92 T #59 Page 11

Is the recognition of depreciation expense required for externally published fund financial statements of public colleges and external financial statements of private not-for-profit colleges?

| | *Public* | *Private* |
|---|---|---|
| a. | No | Yes |
| b. | No | No |
| c. | Yes | Yes |
| d. | Yes | No |

**CPA-01366 Explanation**
Choice "a" is correct. No - Yes.

The recognition of depreciation expense is required for "private not-for-profit colleges," but not for "public colleges" in their fund financial statements. Although public universities may use a proprietory fund model they may also use a governmental fund model that precludes the recognition of depreciation.

**CPA-01369 Type1 M/C A-D Corr Ans: C PM#12 F 9-99**

98. CPA-01369 May 93 II #31 Page 78

Financial resources of a college or university that are currently expendable at the discretion of the governing board and that have not been restricted externally nor designated by the board for specific purposes should be reported internally in the balance sheet of which fund?

a. Board-designated current fund.
b. Restricted current fund.
c. Unrestricted current fund.
d. General fund.

**CPA-01369 Explanation**
Choice "c" is correct. The unrestricted current fund of a college or university would account for financial resources that are currently expendable and that are free of internal or external designations.

Choice "b" is incorrect. Restricted current fund accounts for resources designated in some manner for specific purposes.

Choices "a" and "d" are incorrect. Nonsense answers. Board-designated current fund and general fund do not exist even in the internal financial statements of educational institutions.

**CPA-01370 Type1 M/C A-D Corr Ans: C PM#13 F 9-99**

99. CPA-01370 Nov 94 #20 Page 39

Transfers received by a governmental-type fund should be reported in the Statement of Revenues, Expenditures, and Changes in Fund Balance as a(an):

a. Addition to contributed capital.
b. Addition to retained earnings.
c. Other financing source.
d. Reimbursement.

**CPA-01370 Explanation**
Choice "c" is correct. Transfers received by a governmental-type fund should be reported in the statement of revenues, expenditures, and changes in fund balance as another financing source.

Choices "a", "b", and "d" are incorrect, per the above.

**CPA-04772 Type1 M/C A-D Corr Ans: B PM#14 F 9-99**


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100. CPA-04772 Released 2005 Page 44

During the current year, Mill Foundation, a nongovernmental not-for-profit organization, received $100,000 in unrestricted contributions from the general public. Mill's board of directors stipulated that $75,000 of these contributions would be used to create an endowment. At the end of the current year, how should Mill report the $75,000 in the net assets section of the statement of financial position?

a. Permanently restricted.
b. Unrestricted.
c. Temporarily restricted.
d. Donor restricted.

**CPA-04772 Explanation**

Choice "b" is correct. Mills Foundation would report internally designated but otherwise unrestricted net assets as unrestricted in its statement of financial position. Internally board designated funds are considered unrestricted. Only donor imposed restrictions are recognized on the financial statement.

Choice "a" is incorrect. Permanent restrictions can only be created by a donor. They can not be internally stipulated for financial statement purposes.

Choice "c" is incorrect. Temporary restrictions can only be created by a donor. They can not be internally stipulated for financial statement purposes.

Choice "d" is incorrect. Donor restrictions can only be created by a donor. They can not be internally stipulated for financial statement purposes.


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