

1. CPA-00005

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-00005 Explanation

Choice "a" is correct. Gain contingencies should not be recognized prior to realization as a prudent reaction to the uncertainty surrounding the realization of the gain as reflected in the convention of conservatism. SFAS 5 para. 17, SFAC 2 Glossary and para. 95

Choice "b" is incorrect. Overall the qualities of information apply equally to all accounting information, not just gain contingencies. Relevance is a primary quality of information, which dictates that any information relative to the entity should be reported if it might be useful to the third party user (that is the information is timely with predictive and feedback value). SFAC 2 para. 32

Choice "c" is incorrect. Overall the qualities of information apply equally to all accounting information, not just gain contingencies. This includes consistency, an element of comparability, the secondary quality of information, which specifies that, when a choice of accounting principles has been made, the same principle be used in accounting for subsequent years' transactions. SFAC 2 para. 32

Choice "d" is incorrect. Overall the qualities of information apply equally to all accounting information, not just gain contingencies. This includes reliability, a primary quality, which requires that information, be verifiable, neutral, and representationally faithful. SFAC 2 para. 32

2. CPA-00010

According to Statements of Financial Accounting Concepts, neutrality is an ingredient of:

	<u>Reliability</u>	<u>Relevance</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

CPA-00010 Explanation

Choice "b" is correct. The characteristics of reliability are verifiability, representational faithfulness, and neutrality. The characteristics of relevance are predictive value, feedback value, and timeliness. SFAC 2 para. 62

3. CPA-00020

On December 31, 1992, Brooks Co. decided to end operations and dispose of its assets within three months. At December 31, 1992, the net realizable value of the equipment was below historical cost. What is the appropriate measurement basis for equipment included in Brooks' December 31, 1992, balance sheet?

- a. Historical cost.
- b. Current reproduction cost.
- c. Net realizable value.
- d. Current replacement cost.

CPA-00020 Explanation

Choice "c" is correct. Net realizable value is the appropriate measurement basis for equipment included in Brooks' Dec. 31, 1992 balance sheet, because of the decision to end operations and quickly (3 months) dispose of its assets.

Choice "a" is incorrect. Historical cost is appropriate if operations were continuing.

Choice "b" is incorrect. Current reproduction cost (producing new and substantially identical assets, at current prices, adjusted for depreciation to date) is appropriate in optional supplemental price level financial statements.

Choice "d" is incorrect. Current replacement cost (acquiring new and substantially equivalent property at current prices, adjusted for estimated depreciation since acquisition) is appropriate in optional supplemental price level financial statements.

4. CPA-00031

Scott Corporation sold a fixed asset used for operations for greater than its carrying amount. Scott should report the transaction in the income statement using the:

- a. Gross concept, showing the proceeds as part of revenues and the carrying amount as part of expenses in the continuing operations section.
- b. Net concept, showing the total amount as an extraordinary item, net of income taxes.
- c. Net concept, showing the total gain as part of discontinued operations, net of income taxes.
- d. Net concept, showing the total gain as part of continuing operations, not net of income taxes.

CPA-00031 Explanation

Choice "d" is correct. The transaction resulted in a gain, which should be reported using the net concept (i.e., proceeds less carrying amount). This gain resulted in the recognition of an asset not in the ordinary course of business, but it did not qualify as an extraordinary item or as part of discontinued operations.

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

5. CPA-00052

Which of the following should be included in general and administrative expenses?

	<u>Interest</u>	<u>Advertising</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

CPA-00052 Explanation

Choice "d" is correct. Interest expense is classified as a separate line item on the income statement. Advertising is classified as a selling expense.

6. CPA-00045

During January 20X3, Doe Corp. agreed to sell the assets and product line of its Hart division. The sale was completed on January 15, 20X4 and resulted in a gain on disposal of \$900,000. Hart's operating losses were \$600,000 for 20X3 and \$50,000 for the period January 1 through January 15, 20X4. Disregarding income taxes, what amount of net gain (loss) should be reported in Doe's comparative 20X4 and 20X3 income statements?

	<u>20X3</u>	<u>20X4</u>
a.	\$0	\$250,000
b.	\$250,000	\$0
c.	\$(600,000)	\$850,000
d.	\$(650,000)	\$900,000

CPA-00045 Explanation

Choice "c" is correct. The 20X3 operating losses would be reported in the 20X3 income statement. The 20X4 operating losses and the gain on disposal would be netted and reported in the 20X4 income statement. Each amount would be reported in the period it occurred.

Choice "a" is incorrect. It reports the total projected gains and losses in 20X4 and nothing in 20X3. Each amount should be reported in the period it occurred.

Choice "b" is incorrect. It reports the total projected gains and losses in 20X3 and nothing in 20X4. Each amount should be reported in the period it occurred.

Choice "d" is incorrect. It reports the total projected losses in 20X3 and the gain in 20X4. Each amount should be reported in the period it occurred.

7. CPA-00055

On October 1, 20X4, Host Co. approved a plan to dispose of one of the company's operating segments. Host expected that the sale would occur on April 1, 20X5 at an estimated gain of \$350,000. The segment had actual and estimated operating losses as follows:

1/1/X4 to 9/30/X4	\$(300,000)
10/1/X4 to 12/31/X4	(200,000)
1/1/X5 to 3/31/X5	(400,000)

In its 20X4 income statement, what should Host report as a loss from discontinued operations before income taxes?

- a. \$200,000
- b. \$550,000
- c. \$500,000
- d. \$900,000

CPA-00055 Explanation

Choice "c" is correct. In its 20X4 income statement, Host would include in its loss from discontinued operations the 20X4 losses but not the projected 20X5 operating losses and not the projected gain on disposal. The 20X4 losses are \$500,000 in total.

The projected 20X5 operating loss of \$400,000 and the projected gain on disposal would be included in its 20X5 income statement.

Choice "a" is incorrect. It includes only a portion of the 20X4 operating losses in the 20X4 loss from discontinued operations. Each amount should be reported in the period it occurred, and the entire 20X4 operating loss, not just the portion that occurred after the decision date, would be included.

Choice "b" is incorrect. It includes all of the projected operating losses and the projected gain in the 20X4 loss from discontinued operations. Each amount should be reported in the period it occurred.

Choice "d" is incorrect. It includes all of the projected operating losses in the 20X4 loss from discontinued operations. Each amount should be reported in the period it occurred.

8. CPA-00065

On October 1, 20X3, Wand, Inc. committed itself to a formal plan to sell its Kam division's assets early in 20X4. On that date, Wand estimated that the fair value of the component's assets was \$25,000 less than the carrying value. Wand also estimated that Kam would incur operating losses of \$100,000 for the period of October 1, 20X3 through December 31, 20X3 and \$50,000 for the period January 1, 20X4 through February 28, 20X4. All estimates proved to be materially correct. Disregarding income taxes, what should Wand report as loss from discontinued operations in its comparative 20X3 and 20X4 income statements?

	<u>20X3</u>	<u>20X4</u>
a.	\$175,000	\$0
b.	\$125,000	\$50,000
c.	\$100,000	\$75,000
d.	\$0	\$175,000

CPA-00065 Explanation

Choice "b" is correct. The loss from discontinued operations for 20X3 includes the 20X3 operating losses of \$100,000 and the impairment loss of \$25,000. Since the fair value of the component's assets is less than the carrying value, there has been an impairment of the assets of the component, and the impairment loss is recognized in 20X3, the year in which the component is classified as held for sale. Thus, disregarding income taxes, the 20X3 loss from discontinued operations is \$125,000.

The loss from discontinued operations for 20X4 includes the 20X4 operating losses of \$50,000. If there had been a loss on disposal larger than what had been estimated as the \$25,000 difference between the fair value and carrying value of the component's assets, that "additional" loss would have been included in 20X4, the year in which it occurred.

Choice "a" is incorrect. It includes all projected losses in the earlier of the two years. That used to be the rule under APB 30 but is no longer the rule under SFAS 144. The results of operations are now included in the period in which they occur; projected losses from operations are not anticipated.

Choice "c" is incorrect. It excludes the impairment loss of \$25,000 from 20X3. The results of operations of the component, including any loss recognized in recording impairment of the component, are reported in discontinued operations in the period in which the component is either disposed of or classified as held for sale. In this question, the plan to sell the assets was committed to in 20X3, and that would be the period in which the assets were held for sale. At that date, the impairment had already occurred, and the impairment loss is recognized in that period and not in the later period of disposal.

Choice "d" is incorrect. It includes all projected losses in the later of the two years.

9. CPA-00050

During 1994 both Raim Co. and Cane Co. suffered losses due to the flooding of the Mississippi River. Raim is located two miles from the river and sustains flood losses every two to three years. Cane, which has been located fifty miles from the river for the past twenty years, has never before had flood losses. How should the flood losses be reported in each company's 1994 income statement?

- | <u>Raim</u> | <u>Cane</u> |
|--|---|
| a. As a component of income from continuing operations | As an extraordinary item |
| b. As a component of income from continuing operations | As a component of income from continuing operations |
| c. As an extraordinary item | As a component of income from continuing operations |
| d. As an extraordinary item | As an extraordinary item |

CPA-00050 Explanation

Choice "a" is correct.

Raim - component of income from continuing operations. Because Raim sustains flood losses every two to three years, the flood losses are not "infrequent." Thus, the flood loss is not an "extraordinary item."

Cane - as an extraordinary item. Here, the flood losses are infrequent because Cane never before (in the last 20 years) had flood losses. Furthermore, the flood losses are unusual in nature in that they are unrelated to the ordinary and typical activities of the company.

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

10. CPA-00098

Midway Co. had the following transactions during 1992:

- \$1,200,000 pretax loss on foreign currency exchange due to a major unexpected devaluation by the foreign government.
- \$500,000 pretax loss from discontinued operations of a division.
- \$800,000 pretax loss on equipment damaged by a hurricane. This was the first hurricane ever to strike in Midway's area. Midway also received \$1,000,000 from its insurance company to replace a building, with a carrying value of \$300,000 that had been destroyed by the hurricane.

What amount should Midway report in its 1992 income statement as extraordinary loss before income taxes?

- a. \$100,000
- b. \$1,300,000
- c. \$1,800,000
- d. \$2,500,000

CPA-00098 Explanation

Choice "a" is correct. Foreign currency devaluations and losses from discontinued operations are not extraordinary items. The hurricane is an extraordinary item and the loss, net of insurance, is \$100,000.

Choice "b" is incorrect. The loss from devaluation is not considered to be extraordinary.

Choice "c" is incorrect. The hurricane loss is as follows:

Equipment loss	\$ 800,000
Building loss	300,000
Insurance proceeds	(1,000,000)
Hurricane loss	<u>\$ 100,000</u>

APB 30 para. 23

Choice "d" is incorrect. Foreign currency devaluations and losses from discontinued operations are not extraordinary items. When the loss on the hurricane is reported, it should include the \$800,000 equipment loss and the \$300,000 building loss, net of the \$1,000,000 insurance proceeds.

11. CPA-00071

Which of the following statements is correct regarding accounting changes that result in financial statements that are, in effect, the statements of a different reporting entity?

- a. Cumulative-effect adjustments should be reported as separate items on the income statement in the year of change.
- b. No restatements or adjustments are required if the changes involve consolidated methods of accounting for subsidiaries.
- c. No restatements or adjustments are required if the changes involve the cost or equity methods of accounting for investments.
- d. The financial statements of all prior periods presented should be restated.

CPA-00071 Explanation

Choice "d" is correct. Financial statements of all prior periods presented should be restated when there is a "change in entity" such as resulting from:

- 1. Changing companies in consolidated financial statements.
- 2. Consolidated financial statements vs. Previous individual financial statements.

Choice "a" is incorrect. Cumulative-effect adjustments are reported in the retained earnings statement in the year of change.

Choice "b" is incorrect. Restatements are required for changes in entity (of subsidiaries).

Choice "c" is incorrect. Restatements are required for changes of GAAP involving the cost or equity methods of accounting for investments. Changes from the equity method to the cost method are accounted for prospectively.

12. CPA-00081

For 1991, Pac Co. estimated its two-year equipment warranty costs based on \$100 per unit sold in 1991. Experience during 1992 indicated that the estimate should have been based on \$110 per unit. The effect of this \$10 difference from the estimate is reported:

- a. In 1992 income from continuing operations.
- b. As an accounting change, net of tax, below 1992 income from continuing operations.
- c. As an accounting change requiring 1991 financial statements to be restated.
- d. As a correction of an error requiring 1991 financial statements to be restated.

CPA-00081 Explanation

Choice "a" is correct. The effect of the new estimate of warranty costs (from \$100 to \$110) is a change in estimate and will be reported in 1992 "income from continuing operations."

Rule: Changes in estimates affect only the current and subsequent periods (not "prior periods," not "retained earnings").

Choice "b" is incorrect. An accounting change of "principle" is shown net of tax on the retained earnings statement.

Choice "c" is incorrect. Restating prior years financial statements is only required when comparative financial statements are shown for prior period adjustments of subsequently discovered "corrections of errors," changes in entity or changes in accounting principle.

Choice "d" is incorrect. The facts stating a new estimate of warranty costs indicate a "change of estimate," not a "correction of an error."

13. CPA-00102

One of the elements of a financial statement is comprehensive income. Comprehensive income excludes changes in equity resulting from which of the following?

- a. Loss from discontinued operations.
- b. Prior period error correction.
- c. Dividends paid to stockholders.
- d. Unrealized loss on investments in noncurrent marketable equity securities.

CPA-00102 Explanation

Choice "c" is correct. Comprehensive income includes all changes in equity during a period except those resulting from owner investments and distributions to owners. SFAC 6 para. 70 and SFAS 130

Choice "a" is incorrect. Loss from discontinued operations is included in net income, which is a component of comprehensive income. SFAC 6 para. 70

Choice "b" is incorrect. Prior period error correction is a change in stockholders' equity not resulting from owner investments and distributions to owners and so is included in comprehensive income. SFAC 6 para. 70

Choice "d" is incorrect. Unrealized loss on investments in noncurrent marketable equity securities is a change in stockholders' equity not resulting from owner investments and distributions to owners and so is included in comprehensive income. SFAC 6 para. 70

14. CPA-00103

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

- a. Refinancing of debt subsequent to the balance sheet date.
- b. Guarantees of indebtedness of others.
- c. Criteria for determining which investments are treated as cash equivalents.
- d. Adequacy of pension plan assets relative to vested benefits.

CPA-00103 Explanation

Choice "c" is correct. The method of determining which assets are considered to be cash equivalents is a significant accounting policy. APB 22 para. 6

Choice "a" is incorrect. Debt refinancing would be disclosed in a separate indebtedness note.

Choice "b" is incorrect. Guarantees of other entity's indebtedness would be disclosed in a separate commitments and contingencies note.

Choice "d" is incorrect. Information about pension plan assets and pension plan liabilities is disclosed in a separate pensions note.

15. CPA-00107

For interim financial reporting, a company's income tax provision for the second quarter of 1992 should be determined using the:

- Effective tax rate expected to be applicable for the full year of 1992 as estimated at the end of the first quarter of 1992.
- Effective tax rate expected to be applicable for the full year of 1992 as estimated at the end of the second quarter of 1992.
- Effective tax rate expected to be applicable for the second quarter of 1992.
- Statutory tax rate for 1992.

CPA-00107 Explanation

Choice "b" is correct. The best, most current estimate of the annual effective tax rate should be used to determine the income tax provision for the second quarter. This rate is the effective tax rate expected to be applicable for the full year of 1992 as estimated at the end of the second quarter of 1992. APB 28 para. 19

16. CPA-00127

The following information pertains to revenue earned by Timm Co.'s industry segments for the year ended December 31, 1990:

<u>Segment</u>	<u>Sales to unaffiliated customers</u>	<u>Intersegment sales</u>	<u>Total revenue</u>
Alo	\$ 5,000	\$3,000	\$ 8,000
Bix	8,000	4,000	12,000
Cee	4,000	-	4,000
Dil	<u>43,000</u>	<u>16,000</u>	<u>59,000</u>
Combined	60,000	23,000	83,000
Elimination	-	<u>(23,000)</u>	<u>(23,000)</u>
Consolidated	<u>\$60,000</u>	<u>-</u>	<u>\$60,000</u>

In conformity with the revenue test, Timm's reportable segments were:

- Only Dil.
- Only Bix and Dil.
- Only Alo, Bix, and Dil.
- Alo, Bix, Cee, and Dil.

CPA-00127 Explanation

Choice "b" is correct. Only Bix and Dil.

Total sales to unaffiliated customers	\$60,000
Intersegment sales	<u>23,000</u>
Total combined sales	\$83,000
	$\times 10\%$
Minimum reportable segment	<u>\$ 8,300</u>

Only Bix and Dil qualify as reportable segments. When using revenues as a criteria, a segment must include at least 10% of combined revenues, including intersegment sales.

Bix and Dil division revenues exceed \$8300 while Alo and Cee division revenues do not. Additionally, Bix and Dil together account for more than 75% of Timm's total sales so no additional reportable segments need to be identified.

Class Questions

1. CPA-00555

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:

<u>1993</u>	<u>Room Rentals</u>	<u>Room Nights</u>
October	\$100,000	1,100
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?

	<u>Sales Taxes</u>	<u>Occupancy Taxes</u>
a.	\$39,000	\$6,000
b.	\$39,000	\$8,200
c.	\$54,000	\$6,000
d.	\$54,000	\$8,200

CPA-00555 Explanation

<u>1993</u>	<u>Room Rentals</u>	<u>15% Sales Taxes Payable</u>	<u>Room Nights</u>	<u>\$2 Per Room Night Occupancy Taxes Payable</u>
Oct	<u>100,000</u>	<u>Paid</u>	1,100	2,200
Nov	110,000	16,500	1,200	2,400
Dec	<u>150,000</u>	<u>22,500</u>	<u>1,800</u>	<u>3,600</u>
	<u>260,000</u>	<u>39,000</u>	<u>4,100</u>	<u>8,200</u>

Choice "b" is correct.

\$39,000 Sales taxes payable

\$8,200 Occupancy taxes payable

2. CPA-00544

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?

	<u>Prepaid insurance</u>	<u>Insurance expense</u>
a.	\$7,000	\$300
b.	\$7,000	\$500
c.	\$7,200	\$300
d.	\$7,300	\$200

CPA-00544 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 that has expired on the renewed policy.

Choice "d" is incorrect. The previous balance in prepaid insurance should be expensed.

3. CPA-00545

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?

- a. \$175,000
- b. \$180,000
- c. \$215,000
- d. \$225,000

CPA-00545 Explanation

Choice "c" is correct. \$215,000 service revenue for 1994.

	<u>Accounts Receivable</u>	
Balance at 12-31-93	\$40,000	
Revenue - Squeeze	<u>?</u>	215,000
Subtotal	255,000	
Collections	<u>(195,000)</u>	
Balance at 12-31-94	<u>\$60,000</u>	

Note: Collections are \$200,000 less \$5,000 of unearned fees collected.

4. CPA-00542

Gray Co. was granted a patent on January 2, 1991, and appropriately capitalized \$45,000 of related costs. Gray was amortizing the patent over its estimated useful life of fifteen years. During 1994, Gray paid \$15,000 in legal costs in successfully defending an attempted infringement of the patent. After the legal action was completed, Gray sold the patent to the plaintiff for \$75,000. Gray's policy is to take no amortization in the year of disposal. In its 1994 income statement, what amount should Gray report as gain from sale of patent?

- a. \$15,000
- b. \$24,000
- c. \$27,000
- d. \$39,000

CPA-00542 Explanation

Choice "b" is correct. \$24,000 gain from sale of patent in 1994.

Original patent cost capitalized, Jan. 2, 1991	45,000
Less: 15 year s/l amortization for 3 yrs to Dec. 31, 1993: $3/15 \times \$45,000 =$	<u>(9,000)</u>
Carrying value at Dec. 31, 1993	36,000
Add: Successful legal defense costs in 1994	<u>15,000</u>
Carrying value before sale	51,000
Sales price in 1994	<u>75,000</u>
Gain from sale of patent in 1994	<u>24,000</u>

5. CPA-00548

On January 2, 2001, Paye Co. purchased Shef Co. at a cost that resulted in recognition of goodwill of \$200,000. During the first quarter of 2001, Paye spent an additional \$80,000 on expenditures designed to maintain goodwill. In its December 31, 2001, balance sheet, what amount should Paye report as goodwill?

- a. \$180,000
- b. \$280,000
- c. \$252,000
- d. \$200,000

CPA-00548 Explanation

Choice "d" is correct. \$200,000 of goodwill is capitalized as a component of the purchase of the other entity. \$80,000 is expensed since it is an internal development of goodwill and cannot be capitalized. Goodwill is not amortized; per SFAS 141 it is subject to an impairment test.

Choice "a" is incorrect. Goodwill is not amortized; per SFAS 141 it is subject to an impairment test.

Choice "b" is incorrect. The \$80,000 should not be capitalized.

Choice "c" is incorrect. The \$80,000 should not be capitalized.

6. CPA-00537

On December 31, 2000, Byte Co. had capitalized software costs of \$600,000 with an economic life of four years. Sales for 2001 were 10% of expected total sales of the software. At December 31, 2001, the software had a net realizable value of \$480,000. In its December 31, 2001 balance sheet, what amount should Byte report as net capitalized cost of computer software?

- a. \$432,000
- b. \$450,000
- c. \$480,000
- d. \$540,000

CPA-00537 Explanation

Choice "b" is correct. Amortization of capitalized software costs equals the greater of straight-line amortization or sales revenue from the software for the period ÷ total projected sales.

Dec. 31, 2000 balance	\$600,000
2001 amortization = $600,000 \div 4 =$	<u>(150,000)</u>
Dec. 31, 2001 net capitalized cost	<u>\$450,000</u>

7. CPA-00653

The **next item** is based on the following data pertaining to Pell Co.'s construction jobs, which commenced during 1992:

	<u>Project 1</u>	<u>Project 2</u>
Contract price	\$420,000	\$300,000
Costs incurred during 1992	240,000	280,000
Estimated costs to complete	120,000	40,000
Billed to customers during 1992	150,000	270,000
Received from customers during 1992	90,000	250,000

If Pell used the percentage-of-completion method, what amount of gross profit (loss) would Pell report in its 1992 income statement?

- a. \$(20,000)
- b. \$20,000
- c. \$22,500
- d. \$40,000

CPA-00653 Explanation

Choice "b" is correct. For Project 1, \$240,000 of the total costs of \$360,000 has been incurred, or 2/3 of the total costs. The contract price of \$420,000 less estimated costs of \$360,000 gives an estimated profit of \$60,000. Current profit from Project 1 is then 2/3 times \$60,000, or \$40,000. Project 2 estimates a \$20,000 loss (\$300,000 – \$280,000 – \$40,000), which is recognized immediately. ARB 45 para. 4

Choice "a" is incorrect. Under percentage-of-completion, Project 1 is 2/3 complete and the appropriate profit should be recorded.

Choice "c" is incorrect. Estimated losses are recognized in full immediately (conservatism).

Choice "d" is incorrect. Under percentage of completion, only 2/3 of Project 1 is complete, so only 2/3 of the \$60,000 profit, or \$40,000, is recognized. Project 2 expects a loss. Under conservatism, the loss is recognized in full immediately.

8. CPA-00647

The **next item** is based on the following data pertaining to Pell Co.'s construction jobs, which commenced during 1992:

	<u>Project 1</u>	<u>Project 2</u>
Contract price	\$420,000	\$300,000
Costs incurred during 1992	240,000	280,000
Estimated costs to complete	120,000	40,000
Billed to customers during 1992	150,000	270,000
Received from customers during 1992	90,000	250,000

If Pell used the completed contract method, what amount of gross profit (loss) would Pell report in its 1992 income statement?

- a. \$(20,000)
- b. \$0
- c. \$340,000
- d. \$420,000

CPA-00647 Explanation

Choice "a" is correct. Under the completed contract method, revenue is recognized when the contract is complete, however expected losses are recognized immediately in their entirety. Project 2 is estimated to have a \$20,000 loss, [$\$300,000 - \$280,000 - \$40,000 = \$20,000$ loss]. ARB 45 para. 11

Choice "b" is incorrect. Expected losses on contracts are recognized prior to job completion (conservatism).

Choice "c" is incorrect. The expected profit on Project 1 is not recognized until completion. Project 2 expects a loss.

Choice "d" is incorrect. The expected profit on Project 1 is only \$60,000 but is not recognized until complete. Project 2 expects a loss.

9. CPA-00691

Lang Co. uses the installment method of revenue recognition. The following data pertain to Lang's installment sales for the years ended December 31, 1993 and 1994:

	<u>1993</u>	<u>1994</u>
Installment receivables at year-end on 1993 sales	\$60,000	\$30,000
Installment receivables at year-end on 1994 sales	-	69,000
Installment sales	80,000	90,000
Cost of sales	40,000	60,000

What amount should Lang report as deferred gross profit in its December 31, 1994, balance sheet?

- a. \$23,000
- b. \$33,000
- c. \$38,000
- d. \$43,000

CPA-00691 Explanation

Choice "c" is correct.

Gross profit = Sales – Cost of sales

1993: [\$80,000 – \$40,000] = \$40,000

1994: [\$90,000 – \$60,000] = \$30,000

Gross profit rate = Gross profit / sales

1993: [\$40,000/\$80,000] = 50%

1994: [\$30,000/\$90,000] = 33.3%

Deferred gross profit = GP rate × AR on 1993 sales @12/31/94 = \$15,000 [50% × \$30,000]
on 1994 sales @12/31/94 = \$23,000 [33.3% × \$69,000]

Total deferred gross profit to be reported = \$38,000 [\$15,000 + \$23,000].

10. CPA-00707

Wren Co. sells equipment on installment contracts. Which of the following statements best justifies Wren's use of the cost recovery method of revenue recognition to account for these installment sales?

- a. The sales contract provides that title to the equipment only passes to the purchaser when all payments have been made.
- b. No cash payments are due until one year from the date of sale.
- c. Sales are subject to a high rate of return.
- d. There is no reasonable basis for estimating collectibility.

CPA-00707 Explanation

Choice "d" is correct. The cost recovery method is appropriate when there is no reasonable basis for estimating collectibility.

Choice "a" is incorrect. Accounting treatments are not necessarily determined by the timing of title transfer.

Choice "b" is incorrect. Since there is a presumption of cash collection, the cost recovery method would not be applicable.

Choice "c" is incorrect. If sales are subject to a high rate of return, then no sale will be recognized until returns can be determined.

11. CPA-00720

On July 1, 2000, Balt Co. exchanged a truck for 25 shares of Ace Corp.'s common stock. On that date, the truck's carrying amount was \$2,500, and its fair value was \$3,000. Also, the book value of Ace's stock was \$60 per share. On December 31, 2000, Ace had 250 shares of common stock outstanding and its book value per share was \$50. What amount should Balt report in its December 31, 2000, balance sheet as investment in Ace assuming the transaction had commercial substance?

- a. \$3,000
- b. \$2,500
- c. \$1,500
- d. \$1,250

CPA-00720 Explanation

Choice "a" is correct. \$3,000 (fair value of the truck surrendered). According to SFAS No. 153, if a nonmonetary exchange has commercial substance, the transaction is accounted for using the fair value of the asset surrendered or received, whichever is more evident. In this question, it appears that the exchange has commercial substance, as it appears to culminate the earnings process (i.e., a truck is exchanged for stock, which would appear in a business sense to have affected the expected configuration of cash). Therefore, the accounting uses the fair value of the asset surrendered or the fair value of the asset received, whichever is more evident, as the value for the exchange. The question indicates that the fair value of the truck is \$3,000 on the date of the exchange, and it does not provide the fair value of the stock (don't use the book value of the stock as an "approximation" of the fair value); therefore, the \$3,000 fair value of the truck is used for measuring the transaction.

Choice "b" is incorrect. \$2,500 is the book value of the asset surrendered. The book value of the asset surrendered is not used to account for the exchange if the fair value of the asset surrendered is more evident.

Choice "c" is incorrect. \$1,500 (25 shares × \$60) is Ace's book value of the stock on July 1, 2000. The book value of the asset received is not used to account for the exchange.

Choice "d" is incorrect. \$1,250 (25 shares × \$50) is Ace's book value of the stock at December 31, 2000. The book value of the asset received is not used to account for the exchange.

12. CPA-00721

Eagle and Falk are partners with capital balances of \$45,000 and \$25,000, respectively. They agree to admit Robb as a partner. After the assets of the partnership are revalued, Robb will have a 25% interest in capital and profits, for an investment of \$30,000. What amount should be recorded as goodwill to the original partners?

- a. \$0
- b. \$5,000
- c. \$7,500
- d. \$20,000

CPA-00721 Explanation

Choice "d" is correct, \$20,000.

Robb's investment:

25% of total capital	=	\$30,000
Calculate total capital		\$30,000/.25
Total capital	=	\$120,000

Less existing capital balances:

Eagle	\$45,000	
Falk	25,000	
Robb	30,000	
Total assets contributed		= \$100,000

Goodwill to original partners = \$ 20,000

13. CPA-04646

Eagle and Falk are partners with capital balances of \$45,000 and \$25,000, respectively. They agree to admit Robb as a partner. After the assets of the partnership are revalued, Robb will have a 25% interest in capital and profits, for an investment of \$30,000. What amount should be recorded as a bonus to the original partners?

- a. \$0
- b. \$5,000
- c. \$7,500
- d. \$20,000

CPA-04646 Explanation

Choice "b" is correct, \$5,000.

Total equity of new partnership:

Eagle	\$45,000
Falk	\$25,000
Robb	<u>\$30,000</u>
Total	<u>\$100,000</u>

Since Robb is receiving a 25% interest in the partnership, his capital account will be credited with 25% of the total equity of the new partnership, or \$25,000. The difference between his contribution of \$30,000, and his capital account balance of \$25,000, is credited to the other partners as a bonus.

14. CPA-00722

During 1994, Young and Zinc maintained average capital balances in their partnership of \$160,000 and \$100,000, respectively. The partners receive 10% interest on average capital balances, and residual profit or loss is divided equally. Partnership profit before interest was \$4,000. By what amount should Zinc's capital account change for the year?

- a. \$1,000 decrease.
- b. \$2,000 increase.
- c. \$11,000 decrease.
- d. \$12,000 increase.

CPA-00722 Explanation

Choice "a" is correct. Zinc's capital decreased by \$1,000 from \$100,000 to \$99,000.

<u>Item</u>	<u>Young</u>	<u>Zinc</u>	<u>Profit</u>
Capital	160,000	100,000	4,000
Interest	<u>16,000</u>	<u>10,000</u>	<u>(26,000)</u>
	176,000	110,000	(22,000)
Loss alloc	<u>(11,000)</u>	<u>(11,000)</u>	<u>22,000</u>
	165,000	99,000	0
Net change	<u>5,000</u>	<u>(1,000)</u>	<u>4,000</u>

Choice "b" is incorrect. If there were no interest allocation, then each capital account would increase by \$2,000 [$50\% \times \$4,000$ profit].

Choice "c" is incorrect. The \$11,000 is the loss allocation to Zinc. However, this is offset by the allocation of \$10,000 interest.

Choice "d" is incorrect. It is not possible to increase Zinc's capital by both the interest and half the profit because the interest comes "out of" the profit, resulting in a loss.

15. CPA-01258

During a period of inflation in which the amount in an asset account remains constant, which of the following occurs?

- a. A purchasing power gain, if the item is a monetary asset.
- b. A purchasing power gain, if the item is a nonmonetary asset.
- c. A purchasing power loss, if the item is a monetary asset.
- d. A purchasing power loss, if the item is a nonmonetary asset.

CPA-01258 Explanation

Choice "c" is correct. A purchasing power loss, if the item is a monetary asset.

Choice "a" is incorrect. Holding monetary liabilities (not monetary assets) during periods of inflation results in a purchasing power gain (such as a home mortgage).

Choices "b" and "d" are incorrect. Non-monetary assets (e.g., inventory) and liabilities (e.g., warranty obligations) do not result in a purchasing power gain or loss during periods of inflation because they represent current value.

16. CPA-01272

Park Co.'s wholly-owned subsidiary, Schnell Corp., maintains its accounting records in German marks. Because all of Schnell's branch offices are in Switzerland, its functional currency is the Swiss franc. Remeasurement of Schnell's 1994 financial statements resulted in a \$7,600 gain, and translation of its financial statements resulted in an \$8,100 gain. What amount should Park report as a foreign exchange gain in its income statement for the year ended December 31, 1994?

- a. \$0
- b. \$7,600
- c. \$8,100
- d. \$15,700

CPA-01272 Explanation

Choice "b" is correct, \$7,600 gain from remeasurement.

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 disposed of.

However, gains or losses from remeasuring the foreign subsidiary's financial statements from the local currency to the functional currency should be included in "income from continuing operations" of the parent company.

Note: If the question had asked "what amount should Park report as a foreign exchange gain in its "statement of income and comprehensive income," (or "statement of comprehensive income," by itself), then the answer would have been \$15,700.

17. CPA-01274

On September 22, 1994, Yumi Corp. purchased merchandise from an unaffiliated foreign company for 10,000 units of the foreign company's local currency. On that date, the spot rate was \$.55. Yumi paid the bill in full on March 20, 1995, when the spot rate was \$.65. The spot rate was \$.70 on December 31, 1994. What amount should Yumi report as a foreign currency transaction loss in its income statement for the year ended December 31, 1994?

- a. \$0
- b. \$500
- c. \$1,000
- d. \$1,500

CPA-01274 Explanation

Choice "d" is correct. On September 22, the liability denominated in dollars equals \$5,500 (10,000 units × \$.55 spot rate). On December 31, the liability denominated in dollars equals \$7,000 (10,000 units × \$.70 spot rate). At year end, the foreign currency transaction loss equals \$1,500 (\$7,000 – \$5,500). SFAS 52 para 15

Choice "a" is incorrect. Since the spot rate at year end is different from the spot rate at September 22, a foreign currency transaction gain or loss must be recognized.

Choice "b" is incorrect. Only the loss as of December 31 should be recognized.

Choice "c" is incorrect. Only the loss as of December 31 should be recognized.

1. CPA-00265

A company has adopted Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (as amended by SFAS 130). It should report the marketable equity securities that it has classified as trading at:

- Lower of cost or market, with holding gains and losses included in earnings.
- Lower of cost or market, with holding gains included in earnings only to the extent of previously recognized holding losses.
- Fair value, with holding gains included in earnings only to the extent of previously recognized holding losses.
- Fair value, with holding gains and losses included in earnings.

CPA-00265 Explanation

Choice "d" is correct. Trading securities are reported at fair value, with holding gains and losses included in earnings.

Choice "a" is incorrect. SFAS 115 eliminated the lower of cost or market valuation.

Choice "b" is incorrect. SFAS 115 eliminated the lower of cost or market valuation.

Choice "c" is incorrect. Trading securities are reported at fair value but there is no restriction on the recognition of holding gains.

2. CPA-00273

Information regarding Stone Co's available-for-sale portfolio of marketable equity securities is as follows:

Aggregate cost as of 12/31/X2	\$170,000
Market value as of 12/31/X2	148,000
Net realized gains during 20X2	30,000

At December 31, 20X1, Stone reported an unrealized loss of \$1,500 to reduce investments to market value. This was the first such adjustment made by Stone on these types of securities. According to SFAS No. 115, in its 20X2 statement of comprehensive income, what amount of unrealized loss should Stone report?

- \$30,000
- \$20,500
- \$22,000
- \$0

CPA-00273 Explanation

Choice "b" is correct. Stone must report a net cumulative loss on its Statement of Stockholders' Equity (under "Accumulated Other Comprehensive Income") of \$22,000 (\$148,000 FMV – \$170,000 Cost). Stone has already reported a \$1,500 loss as of 12/31/X1; therefore, an unrealized loss of \$20,500 (\$22,000 – \$1,500) should be reported in the Statement of Comprehensive Income (as part of other comprehensive income) for the year 20X2.

3. CPA-00284

When a parent-subsidary relationship exists, consolidated financial statements are prepared in recognition of the accounting concept of:

- a. Reliability.
- b. Materiality.
- c. Legal entity.
- d. Economic entity.

CPA-00284 Explanation

Choice "d" is correct. Reporting consolidated financial statements is consistent with the concept that the economic entity can be identified with a unit of accountability.

Choice "a" is incorrect. The concept of reliability requires that information is verifiable, neutral, and representationally faithful, but does not address the parent-subsidary relationship.

Choice "b" is incorrect. Materiality relates to the presentation and accounting treatment of specific transactions, but does not address the parent-subsidary relationship.

Choice "c" is incorrect. Consolidated financial statements reflect the economic substance of the parent-subsidary relationship, not legal form.

4. CPA-00283

Consolidated financial statements are typically prepared when one company has a controlling financial interest in another unless:

- a. The subsidiary is a finance company.
- b. The fiscal year-ends of the two companies are more than three months apart.
- c. The subsidiary is in bankruptcy.
- d. The two companies are in unrelated industries, such as manufacturing and real estate.

CPA-00283 Explanation

Choice "c" is correct. The exceptions to not consolidating a majority-owned subsidiary are when the subsidiary is in legal reorganization or bankruptcy and/or the subsidiary operates under severe foreign currency exchange restrictions, controls, or other governmentally imposed uncertainties so severe that they cast significant doubt on the parent's ability to control the subsidiary.

Choice "a" is incorrect. Consolidation of finance companies is generally required.

Choice "b" is incorrect. A difference in fiscal periods of a parent and a subsidiary does not of itself justify the exclusion of the subsidiary from consolidation.

Choice "d" is incorrect. There is no exception for nonhomogeneous operations.

5. CPA-00287

An investor uses the cost method to account for an investment in common stock. Dividends received this year exceeded the investor's share of investee's undistributed earnings since the date of investment. The amount of dividend revenue that should be reported in the investor's income statement for this year would be:

- a. The portion of the dividends received this year that were in excess of the investor's share of investee's undistributed earnings since the date of investment.
- b. The portion of the dividends received this year that were not in excess of the investor's share of investee's undistributed earnings since the date of investment.
- c. The total amount of dividends received this year.
- d. Zero.

CPA-00287 Explanation

Choice "b" is correct, the amount of dividend revenue that should be reported in the investor's income statement for this year would be the portion of the dividends received this year that were not in excess of the investor's share of investee's undistributed earnings since the date of investment.

Rule: Dividend revenue - under the cost method should be recognized to the extent of cumulative earnings since acquisition, and return of capital beyond that point.

Choice "a" is incorrect. As this will be characterized as a return of capital or liquidating dividend.

Choices "c" and "d" are incorrect. As part of the dividends will be recognized as income and part will be a return of capital.

6. CPA-00285

Plack Co. purchased 10,000 shares (2% ownership) of Ty Corp. on February 14, 2001. Plack received a stock dividend of 2,000 shares on April 30, 2001, when the market value per share was \$35. Ty paid a cash dividend of \$2 per share on December 15, 2001. In its 2001 income statement, what amount should Plack report as dividend income?

- a. \$20,000
- b. \$24,000
- c. \$90,000
- d. \$94,000

CPA-00285 Explanation

Choice "b" is correct.

$$\begin{aligned}\text{Dividend income} &= \text{Number of shares} \times \text{dividend per share} \\ &= 12,000 \times \$2 \\ &= \$24,000\end{aligned}$$

Receipt of a stock dividend is not revenue. It increases the number of shares held and decreases the cost basis per share.

7. CPA-00320

On January 2, 1993, Well Co. purchased 10% of Rea, Inc.'s outstanding common shares for \$400,000. Well is the largest single shareholder in Rea, and Well's officers are a majority on Rea's board of directors. Rea reported net income of \$500,000 for 1993, and paid dividends of \$150,000. In its December 31, 1993, balance sheet, what amount should Well report as investment in Rea?

- a. \$450,000
- b. \$435,000
- c. \$400,000
- d. \$385,000

CPA-00320 Explanation

Choice "b" is correct. Even though Well has only a 10% ownership, one can presume that Well has significant influence on Rea since it is the largest single shareholder and has a majority on Rea's board of directors. The equity method is the appropriate accounting method.

B	Beginning Investment	\$ 400,000
A	Add % Sub's Income (10% × \$500,000)	50,000
S	Subtract % Sub's dividends/withdrawals (10% × \$150,000)	<u>– 15,000</u>
E	Ending Investment	<u>\$435,000</u>

The investment account balance of \$400,000 will be increased by the \$50,000 equity in earnings (10% × \$500,000 net income) and decrease by the \$15,000 dividends received (10% × \$150,000) for a year-end balance of \$435,000.

Choice "a" is incorrect. The investment account must also be decreased for Well's share of the dividends paid by Rea.

Choice "c" is incorrect. The equity method is the correct accounting method for this investment.

Choice "d" is incorrect. The investment account must also be increased for equity in earnings of Rea.

8. CPA-00303

Band Co. uses the equity method to account for its investment in Guard, Inc. common stock. How should Band record a 2% stock dividend received from Guard?

- a. As dividend revenue at Guard's carrying value of the stock.
- b. As dividend revenue at the market value of the stock.
- c. As a reduction in the total cost of Guard stock owned.
- d. As a memorandum entry reducing the unit cost of all Guard stock owned.

CPA-00303 Explanation

Choice "d" is correct. Band should record the 2% stock dividend received from Guard with a memorandum entry that reduces the unit cost of all Guard stock owned. The total investment in Guard, Inc. will simply be spread over a larger amount of shares, thereby reducing the unit cost of all Guard stock owned.

Choices "a" and "b" are incorrect as dividend revenue is not recorded when a stock dividend of the same shares in the same company are received.

Choice "c" is incorrect. Band Co. uses the equity method to account for its investment in Guard, Inc. The initial investment (or cost) of the total Guard stock owned should not be changed simply because additional shares of stock are obtained. The total investment in Guard, Inc. will now be spread over a larger amount of shares.

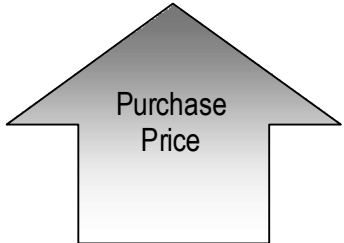
9. CPA-00289

Birk Co. purchased 30% of Sled Co.'s outstanding common stock on December 31, 2000, for \$200,000. On that date, Sled's stockholders' equity was \$500,000, and the fair value of its identifiable net assets was \$600,000. On December 31, 2000, what amount of goodwill should Birk attribute to this acquisition?

- a. \$0
- b. \$20,000
- c. \$30,000
- d. \$50,000

CPA-00289 Explanation

Choice "b" is correct. The allocation of the investment purchase price is calculated as follows:

Goodwill	Excess	=	\$200,000  Purchase Price
FV	× 30%	= \$180,000	
NBV	× 30%	= \$150,000	

Investment	\$200,000
Less: NBV (\$500,000 × 30%)	<u>(150,000)</u>
Total excess	\$ 50,000

Allocated to identifiable net assets

FV	\$600,000
NBV	<u>(500,000)</u>
	\$100,000 × 30% =
	<u>(30,000)</u>
Excess to goodwill	<u>\$20,000</u>

10. CPA-00348

Park Co. uses the equity method to account for its January 1, 1990, purchase of Tun, Inc.'s common stock. On January 1, 1990, the fair values of Tun's FIFO inventory and land exceeded their carrying amounts. How do these excesses of fair values over carrying amounts affect Park's reported equity in Tun's 1990 earnings?

	<u>Inventory excess</u>	<u>Land excess</u>
a.	Decrease	Decrease
b.	Decrease	No effect
c.	Increase	Increase
d.	Increase	No effect

CPA-00348 Explanation

Choice "b" is correct. Park would record the additional COGS associated with the undervalued beginning inventory by debiting Investment Income and crediting the Investment in Tun account. Since the difference between book value and fair market value on land is not amortized, the difference in the land value would have no effect on equity in earnings. APB 18 para. 19

11. CPA-00288

Puff Co. acquired 40% of Straw, Inc.'s voting common stock on January 2, 2001 for \$400,000. The carrying amount of Straw's net assets at the purchase date totaled \$900,000. Fair values equaled carrying amounts for all items except equipment, for which fair values exceeded carrying amounts by \$100,000. The equipment has a five-year life. During 2001, Straw reported net income of \$150,000. What amount of income from this investment should Puff report in its 2001 income statement?

- a. \$40,000
- b. \$52,000
- c. \$56,000
- d. \$60,000

CPA-00288 Explanation

Choice "b" is correct.

Undervalued Equipment $\$100,000 \times 40\%$ ownership = $\$40,000 / 5$ years = $\$8,000$

Puff's share of Straw's income:

$\$150,000 \times 40\% =$	\$60,000
Less: Excess fair value amortization	<u>(8,000)</u>
Equity method investment income	<u>\$52,000</u>

12. CPA-00324

On January 1, 1992, Point, Inc. purchased 10% of Iona Co.'s common stock. Point purchased additional shares bringing its ownership up to 40% of Iona's common stock outstanding on August 1, 1992. During October 1992, Iona declared and paid a cash dividend on all of its outstanding common stock. How much income from the Iona investment should Point's 1992 income statement report?

- a. 10% of Iona's income for January 1 to July 31, 1992, plus 40% of Iona's income for August 1 to December 31, 1992.
- b. 40% of Iona's income for August 1 to December 31, 1992 only.
- c. 40% of Iona's 1992 income.
- d. Amount equal to dividends received from Iona.

CPA-00324 Explanation

Choice "a" is correct. Once a cost method investor becomes an equity method investor, the investment account must retroactively reflect the proportionate share of investee income recognized at each percentage level investment. Thus, 10% of Iona's income from January 1 through July 31 and 40% of Iona's income from August 31 through December 31 must be reported as earnings by Point.

Choice "b" is incorrect. Since Point was an equity basis investor from August 1 through December 31, Point should recognize its share of Iona's income for the entire year at the different levels of investment during the year.

Choice "c" is incorrect. Once a cost method investor becomes an equity method investor, the investment account must retroactively reflect the proportionate share of investee income recognized at each percentage level investment.

Choice "d" is incorrect. Dividends received by a cost method investor would be recognized as income from the investment. Dividends received by an equity method investor would be a reduction of the investment account. The equity method applies to the entire year of the change so the dividends are not reported as income.

13. CPA-00430

Company J acquired all of the outstanding common stock of Company K in exchange for cash. The acquisition price exceeds the fair value of net assets acquired. How should Company J determine the amounts to be reported for the plant and equipment and long-term debt acquired from Company K?

- | | <u>Plant and equipment</u> | <u>Long-term debt</u> |
|----|----------------------------|-----------------------|
| a. | K's carrying amount | K's carrying amount |
| b. | K's carrying amount | Fair value |
| c. | Fair value | K's carrying amount |
| d. | Fair value | Fair value |

CPA-00430 Explanation

Choice "d" is correct. When the acquisition price exceeds the FMV of net assets acquired, assets and liabilities should be presented at fair value.

14. CPA-00423

Penn Corp. paid \$300,000 for the outstanding common stock of Star Co. At that time, Star had the following condensed balance sheet:

	<i>Carrying amounts</i>
Current assets	\$ 40,000
Plant and equipment, net	380,000
Liabilities	200,000
Stockholders' equity	220,000

The fair value of the plant and equipment was \$60,000 more than its recorded carrying amount. The fair values and carrying amounts were equal for all other assets and liabilities. What amount of goodwill, related to Star's acquisition, should Penn report in its consolidated balance sheet?

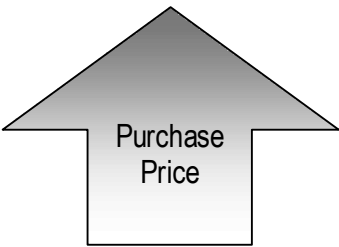
- a. \$20,000
- b. \$40,000
- c. \$60,000
- d. \$80,000

CPA-00423 Explanation

Choice "a" is correct. Goodwill is the excess of the purchase price over the fair market value of the net assets acquired.

Goodwill	Excess	=	
FV	× 100%	=	\$280,000
NBV	× 100%	=	\$220,000

\$300,000



Purchase
Price

Purchase price		\$ 300,000
FV of net assets acquired		
Current assets	\$ 40,000	
Plant and equipment		
(\$380,000 + \$60,000)	440,000	
Liabilities	(200,000)	(280,000)
Goodwill		<u>\$ 20,000</u>

15. CPA-00389

A business combination is accounted for as a purchase. Which of the following expenses related to the business combination should be included, in total, in the determination of net income of the combined corporation for the period in which the expenses are incurred?

	<u>Fees of finders and consultants</u>	<u>Registration fees for equity securities issued</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

CPA-00389 Explanation

Choice "d" is correct. Fees of finders and consultants increases the investment (asset) account. Registration fees for equity securities issued decreases additional paid in capital (stockholders equity).

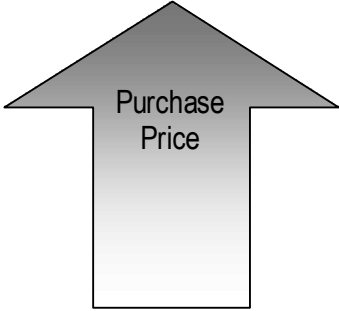
16. CPA-00391

On September 29, 1995, Wall Co. paid \$860,000 for all the issued and outstanding common stock of Hart Corp. On that date, the carrying amounts of Hart's recorded assets and liabilities were \$800,000 and \$180,000, respectively. Hart's recorded assets and liabilities had fair values of \$840,000 and \$140,000, respectively. In Wall's September 30, 1995, balance sheet, what amount should be reported as goodwill?

- a. \$20,000
- b. \$160,000
- c. \$180,000
- d. \$240,000

CPA-00391 Explanation

Choice "b" is correct. The allocation of the investment purchase price is calculated as follows:

G = Goodwill	Excess =	\$860,000 
A = FV	\$840,000 <u>(140,000)</u> <u>\$700,000</u> × 100% = \$700,000	
C A R = NBV	\$800,000 <u>(180,000)</u> <u>\$620,000</u> × 100% = \$620,000	

Investment	\$ 860,000
FV assets	\$840,000
FV liabilities	<u>(140,000)</u>
Tangible asset allocation	<u>– 700,000</u>
Goodwill	<u>\$ 160,000</u>

17. CPA-00418

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.

18. CPA-00455

Wright Corp. has several subsidiaries that are included in its consolidated financial statements. In its December 31, 1992, trial balance, Wright had the following intercompany balances before eliminations:

	<u>Debit</u>	<u>Credit</u>
Current receivable due from Main Co.	\$ 32,000	
Noncurrent receivable from Main	114,000	
Cash advance to Corn Corp.	6,000	
Cash advance from King Co.		\$15,000
Intercompany payable to King		101,000

In its December 31, 1992, consolidated balance sheet, what amount should Wright report as intercompany receivables?

- a. \$152,000
- b. \$146,000
- c. \$36,000
- d. \$0

CPA-00455 Explanation

Choice "d" is correct, \$0 reported as intercompany receivables.

Rule: 100% of all intercompany balances among members of the consolidated group are eliminated.

Note: Here's a quick way to pick up three minutes on the CPA exam, by carefully reading the question and thus avoiding calculations.

19. CPA-00448

Perez, Inc. owns 80% of Senior, Inc. During 1992, Perez sold goods with a 40% gross profit to Senior. Senior sold all of these goods in 1992. For 1992 consolidated financial statements, how should the summation of Perez and Senior income statement items be adjusted?

- a. Sales and cost of goods sold should be reduced by the intercompany sales.
- b. Sales and cost of goods sold should be reduced by 80% of the intercompany sales.
- c. Net income should be reduced by 80% of the gross profit on intercompany sales.
- d. No adjustment is necessary.

CPA-00448 Explanation

Choice "a" is correct, sales and cost of goods sold should be reduced by the intercompany sales.

Perez' sales price is Senior's purchase price. When Senior sells to an outside party, this amount becomes Senior's cost of sales. The sales price to the outsider is ok and the original cost of sales on Perez' books is ok. But, the sales and cost of sales are overstated, for a like amount, by the intercompany transaction.

Note: No balance sheet (inventory) adjustment is needed since none of the intercompany goods sold are on hand at year-end.

20. CPA-00484

On January 1, 1990, Poe Corp. sold a machine for \$900,000 to Saxe Corp., its wholly-owned subsidiary. Poe paid \$1,100,000 for this machine, which had accumulated depreciation of \$250,000. Poe estimated a \$100,000 salvage value and depreciated the machine on the straight-line method over 20 years, a policy which Saxe continued. In Poe's December 31, 1990, consolidated balance sheet, this machine should be included in cost and accumulated depreciation as:

	<u>Cost</u>	<u>Accumulated depreciation</u>
a.	\$1,100,000	\$300,000
b.	\$1,100,000	\$290,000
c.	\$900,000	\$40,000
d.	\$850,000	\$42,500

CPA-00484 Explanation

Choice "a" is correct. The effect of the intercompany sale should be eliminated. The machine should be shown on the consolidated statements at Poe's cost of \$1,100,000. Depreciation should continue as if the sale had not occurred. Depreciation for the current year is \$50,000 $[(1,100,000 - 100,000) / 20]$. Accumulated depreciation at 12/31/90 is \$300,000 $(250,000 + 50,000)$.

1. CPA-00265

A company has adopted Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (as amended by SFAS 130). It should report the marketable equity securities that it has classified as trading at:

- Lower of cost or market, with holding gains and losses included in earnings.
- Lower of cost or market, with holding gains included in earnings only to the extent of previously recognized holding losses.
- Fair value, with holding gains included in earnings only to the extent of previously recognized holding losses.
- Fair value, with holding gains and losses included in earnings.

CPA-00265 Explanation

Choice "d" is correct. Trading securities are reported at fair value, with holding gains and losses included in earnings.

Choice "a" is incorrect. SFAS 115 eliminated the lower of cost or market valuation.

Choice "b" is incorrect. SFAS 115 eliminated the lower of cost or market valuation.

Choice "c" is incorrect. Trading securities are reported at fair value but there is no restriction on the recognition of holding gains.

2. CPA-00273

Information regarding Stone Co's available-for-sale portfolio of marketable equity securities is as follows:

Aggregate cost as of 12/31/X2	\$170,000
Market value as of 12/31/X2	148,000
Net realized gains during 20X2	30,000

At December 31, 20X1, Stone reported an unrealized loss of \$1,500 to reduce investments to market value. This was the first such adjustment made by Stone on these types of securities. According to SFAS No. 115, in its 20X2 statement of comprehensive income, what amount of unrealized loss should Stone report?

- \$30,000
- \$20,500
- \$22,000
- \$0

CPA-00273 Explanation

Choice "b" is correct. Stone must report a net cumulative loss on its Statement of Stockholders' Equity (under "Accumulated Other Comprehensive Income") of \$22,000 (\$148,000 FMV – \$170,000 Cost). Stone has already reported a \$1,500 loss as of 12/31/X1; therefore, an unrealized loss of \$20,500 (\$22,000 – \$1,500) should be reported in the Statement of Comprehensive Income (as part of other comprehensive income) for the year 20X2.

3. CPA-00284

When a parent-subsidary relationship exists, consolidated financial statements are prepared in recognition of the accounting concept of:

- a. Reliability.
- b. Materiality.
- c. Legal entity.
- d. Economic entity.

CPA-00284 Explanation

Choice "d" is correct. Reporting consolidated financial statements is consistent with the concept that the economic entity can be identified with a unit of accountability.

Choice "a" is incorrect. The concept of reliability requires that information is verifiable, neutral, and representationally faithful, but does not address the parent-subsidary relationship.

Choice "b" is incorrect. Materiality relates to the presentation and accounting treatment of specific transactions, but does not address the parent-subsidary relationship.

Choice "c" is incorrect. Consolidated financial statements reflect the economic substance of the parent-subsidary relationship, not legal form.

4. CPA-00283

Consolidated financial statements are typically prepared when one company has a controlling financial interest in another unless:

- a. The subsidiary is a finance company.
- b. The fiscal year-ends of the two companies are more than three months apart.
- c. The subsidiary is in bankruptcy.
- d. The two companies are in unrelated industries, such as manufacturing and real estate.

CPA-00283 Explanation

Choice "c" is correct. The exceptions to not consolidating a majority-owned subsidiary are when the subsidiary is in legal reorganization or bankruptcy and/or the subsidiary operates under severe foreign currency exchange restrictions, controls, or other governmentally imposed uncertainties so severe that they cast significant doubt on the parent's ability to control the subsidiary.

Choice "a" is incorrect. Consolidation of finance companies is generally required.

Choice "b" is incorrect. A difference in fiscal periods of a parent and a subsidiary does not of itself justify the exclusion of the subsidiary from consolidation.

Choice "d" is incorrect. There is no exception for nonhomogeneous operations.

5. CPA-00287

An investor uses the cost method to account for an investment in common stock. Dividends received this year exceeded the investor's share of investee's undistributed earnings since the date of investment. The amount of dividend revenue that should be reported in the investor's income statement for this year would be:

- a. The portion of the dividends received this year that were in excess of the investor's share of investee's undistributed earnings since the date of investment.
- b. The portion of the dividends received this year that were not in excess of the investor's share of investee's undistributed earnings since the date of investment.
- c. The total amount of dividends received this year.
- d. Zero.

CPA-00287 Explanation

Choice "b" is correct, the amount of dividend revenue that should be reported in the investor's income statement for this year would be the portion of the dividends received this year that were not in excess of the investor's share of investee's undistributed earnings since the date of investment.

Rule: Dividend revenue - under the cost method should be recognized to the extent of cumulative earnings since acquisition, and return of capital beyond that point.

Choice "a" is incorrect. As this will be characterized as a return of capital or liquidating dividend.

Choices "c" and "d" are incorrect. As part of the dividends will be recognized as income and part will be a return of capital.

6. CPA-00285

Plack Co. purchased 10,000 shares (2% ownership) of Ty Corp. on February 14, 2001. Plack received a stock dividend of 2,000 shares on April 30, 2001, when the market value per share was \$35. Ty paid a cash dividend of \$2 per share on December 15, 2001. In its 2001 income statement, what amount should Plack report as dividend income?

- a. \$20,000
- b. \$24,000
- c. \$90,000
- d. \$94,000

CPA-00285 Explanation

Choice "b" is correct.

$$\begin{aligned}\text{Dividend income} &= \text{Number of shares} \times \text{dividend per share} \\ &= 12,000 \times \$2 \\ &= \$24,000\end{aligned}$$

Receipt of a stock dividend is not revenue. It increases the number of shares held and decreases the cost basis per share.

7. CPA-00320

On January 2, 1993, Well Co. purchased 10% of Rea, Inc.'s outstanding common shares for \$400,000. Well is the largest single shareholder in Rea, and Well's officers are a majority on Rea's board of directors. Rea reported net income of \$500,000 for 1993, and paid dividends of \$150,000. In its December 31, 1993, balance sheet, what amount should Well report as investment in Rea?

- a. \$450,000
- b. \$435,000
- c. \$400,000
- d. \$385,000

CPA-00320 Explanation

Choice "b" is correct. Even though Well has only a 10% ownership, one can presume that Well has significant influence on Rea since it is the largest single shareholder and has a majority on Rea's board of directors. The equity method is the appropriate accounting method.

B	Beginning Investment	\$ 400,000
A	Add % Sub's Income (10% × \$500,000)	50,000
S	Subtract % Sub's dividends/withdrawals (10% × \$150,000)	<u>– 15,000</u>
E	Ending Investment	<u>\$435,000</u>

The investment account balance of \$400,000 will be increased by the \$50,000 equity in earnings (10% × \$500,000 net income) and decrease by the \$15,000 dividends received (10% × \$150,000) for a year-end balance of \$435,000.

Choice "a" is incorrect. The investment account must also be decreased for Well's share of the dividends paid by Rea.

Choice "c" is incorrect. The equity method is the correct accounting method for this investment.

Choice "d" is incorrect. The investment account must also be increased for equity in earnings of Rea.

8. CPA-00303

Band Co. uses the equity method to account for its investment in Guard, Inc. common stock. How should Band record a 2% stock dividend received from Guard?

- a. As dividend revenue at Guard's carrying value of the stock.
- b. As dividend revenue at the market value of the stock.
- c. As a reduction in the total cost of Guard stock owned.
- d. As a memorandum entry reducing the unit cost of all Guard stock owned.

CPA-00303 Explanation

Choice "d" is correct. Band should record the 2% stock dividend received from Guard with a memorandum entry that reduces the unit cost of all Guard stock owned. The total investment in Guard, Inc. will simply be spread over a larger amount of shares, thereby reducing the unit cost of all Guard stock owned.

Choices "a" and "b" are incorrect as dividend revenue is not recorded when a stock dividend of the same shares in the same company are received.

Choice "c" is incorrect. Band Co. uses the equity method to account for its investment in Guard, Inc. The initial investment (or cost) of the total Guard stock owned should not be changed simply because additional shares of stock are obtained. The total investment in Guard, Inc. will now be spread over a larger amount of shares.

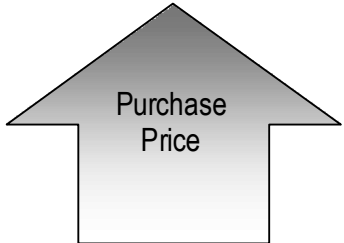
9. CPA-00289

Birk Co. purchased 30% of Sled Co.'s outstanding common stock on December 31, 2000, for \$200,000. On that date, Sled's stockholders' equity was \$500,000, and the fair value of its identifiable net assets was \$600,000. On December 31, 2000, what amount of goodwill should Birk attribute to this acquisition?

- a. \$0
- b. \$20,000
- c. \$30,000
- d. \$50,000

CPA-00289 Explanation

Choice "b" is correct. The allocation of the investment purchase price is calculated as follows:

Goodwill	Excess	=	\$200,000  Purchase Price
FV	× 30%	= \$180,000	
NBV	× 30%	= \$150,000	

Investment	\$200,000
Less: NBV (\$500,000 × 30%)	<u>(150,000)</u>
Total excess	\$ 50,000

Allocated to identifiable net assets

FV	\$600,000
NBV	<u>(500,000)</u>
	\$100,000 × 30% =
	<u>(30,000)</u>
Excess to goodwill	<u>\$20,000</u>

Class Questions

10. CPA-00348

Park Co. uses the equity method to account for its January 1, 1990, purchase of Tun, Inc.'s common stock. On January 1, 1990, the fair values of Tun's FIFO inventory and land exceeded their carrying amounts. How do these excesses of fair values over carrying amounts affect Park's reported equity in Tun's 1990 earnings?

	<u>Inventory excess</u>	<u>Land excess</u>
a.	Decrease	Decrease
b.	Decrease	No effect
c.	Increase	Increase
d.	Increase	No effect

CPA-00348 Explanation

Choice "b" is correct. Park would record the additional COGS associated with the undervalued beginning inventory by debiting Investment Income and crediting the Investment in Tun account. Since the difference between book value and fair market value on land is not amortized, the difference in the land value would have no effect on equity in earnings. APB 18 para. 19

11. CPA-00288

Puff Co. acquired 40% of Straw, Inc.'s voting common stock on January 2, 2001 for \$400,000. The carrying amount of Straw's net assets at the purchase date totaled \$900,000. Fair values equaled carrying amounts for all items except equipment, for which fair values exceeded carrying amounts by \$100,000. The equipment has a five-year life. During 2001, Straw reported net income of \$150,000. What amount of income from this investment should Puff report in its 2001 income statement?

- a. \$40,000
- b. \$52,000
- c. \$56,000
- d. \$60,000

CPA-00288 Explanation

Choice "b" is correct.

Undervalued Equipment $\$100,000 \times 40\%$ ownership = $\$40,000 / 5$ years = $\$8,000$

Puff's share of Straw's income:

$\$150,000 \times 40\% =$	\$60,000
Less: Excess fair value amortization	<u>(8,000)</u>
Equity method investment income	<u>\$52,000</u>

12. CPA-00324

On January 1, 1992, Point, Inc. purchased 10% of Iona Co.'s common stock. Point purchased additional shares bringing its ownership up to 40% of Iona's common stock outstanding on August 1, 1992. During October 1992, Iona declared and paid a cash dividend on all of its outstanding common stock. How much income from the Iona investment should Point's 1992 income statement report?

- a. 10% of Iona's income for January 1 to July 31, 1992, plus 40% of Iona's income for August 1 to December 31, 1992.
- b. 40% of Iona's income for August 1 to December 31, 1992 only.
- c. 40% of Iona's 1992 income.
- d. Amount equal to dividends received from Iona.

CPA-00324 Explanation

Choice "a" is correct. Once a cost method investor becomes an equity method investor, the investment account must retroactively reflect the proportionate share of investee income recognized at each percentage level investment. Thus, 10% of Iona's income from January 1 through July 31 and 40% of Iona's income from August 31 through December 31 must be reported as earnings by Point.

Choice "b" is incorrect. Since Point was an equity basis investor from August 1 through December 31, Point should recognize its share of Iona's income for the entire year at the different levels of investment during the year.

Choice "c" is incorrect. Once a cost method investor becomes an equity method investor, the investment account must retroactively reflect the proportionate share of investee income recognized at each percentage level investment.

Choice "d" is incorrect. Dividends received by a cost method investor would be recognized as income from the investment. Dividends received by an equity method investor would be a reduction of the investment account. The equity method applies to the entire year of the change so the dividends are not reported as income.

13. CPA-00430

Company J acquired all of the outstanding common stock of Company K in exchange for cash. The acquisition price exceeds the fair value of net assets acquired. How should Company J determine the amounts to be reported for the plant and equipment and long-term debt acquired from Company K?

- | | <u>Plant and equipment</u> | <u>Long-term debt</u> |
|----|----------------------------|-----------------------|
| a. | K's carrying amount | K's carrying amount |
| b. | K's carrying amount | Fair value |
| c. | Fair value | K's carrying amount |
| d. | Fair value | Fair value |

CPA-00430 Explanation

Choice "d" is correct. When the acquisition price exceeds the FMV of net assets acquired, assets and liabilities should be presented at fair value.

14. CPA-00423

Penn Corp. paid \$300,000 for the outstanding common stock of Star Co. At that time, Star had the following condensed balance sheet:

	<i>Carrying amounts</i>
Current assets	\$ 40,000
Plant and equipment, net	380,000
Liabilities	200,000
Stockholders' equity	220,000

The fair value of the plant and equipment was \$60,000 more than its recorded carrying amount. The fair values and carrying amounts were equal for all other assets and liabilities. What amount of goodwill, related to Star's acquisition, should Penn report in its consolidated balance sheet?

- a. \$20,000
- b. \$40,000
- c. \$60,000
- d. \$80,000

CPA-00423 Explanation

Choice "a" is correct. Goodwill is the excess of the purchase price over the fair market value of the net assets acquired.

Sub's Total (100%) Fair Value = \$300,00			
Goodwill	\$20,000	- 0 -	NCI
Identifiable Intangible Asset FV	- 0 -		
Balance Sheet FV Adjustment	\$60,000	\$300,000	Investment In Subsidiary
Book Value (CAR)	\$220,000		
	DR	CR	

Class Questions

15. CPA-00389

A business combination is accounted for as an acquisition. Which of the following expenses related to the business combination should be included, in total, in the determination of net income of the combined corporation for the period in which the expenses are incurred?

	<u>Fees of finders and consultants</u>	<u>Registration fees for equity securities issued</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

CPA-00389 Explanation

Choice "d" is correct. Fees of finders and consultants increases the investment (asset) account. Registration fees for equity securities issued decreases additional paid in capital (stockholders equity).

16. CPA-00391

On September 29, 1995, Wall Co. paid \$860,000 for all the issued and outstanding common stock of Hart Corp. On that date, the carrying amounts of Hart's recorded assets and liabilities were \$800,000 and \$180,000, respectively. Hart's recorded assets and liabilities had fair values of \$840,000 and \$140,000, respectively. In Wall's September 30, 1995, balance sheet, what amount should be reported as goodwill?

- a. \$20,000
- b. \$160,000
- c. \$180,000
- d. \$240,000

CPA-00391 Explanation

Choice "b" is correct. The allocation of the investment purchase price is calculated as follows:

Sub's Total (100%) Fair Value = \$860,000			
Goodwill	\$160,000	- 0 -	NCI
Identifiable Intangible Asset FV	- 0 -		
Balance Sheet FV Adjustment	\$80,000	\$860,000	Investment In Subsidiary
Book Value (CAR)	\$620,000		

17. CPA-00455

Wright Corp. has several subsidiaries that are included in its consolidated financial statements. In its December 31, 1992, trial balance, Wright had the following intercompany balances before eliminations:

	<u>Debit</u>	<u>Credit</u>
Current receivable due from Main Co.	\$ 32,000	
Noncurrent receivable from Main	114,000	
Cash advance to Corn Corp.	6,000	
Cash advance from King Co.		\$15,000
Intercompany payable to King		101,000

In its December 31, 1992, consolidated balance sheet, what amount should Wright report as intercompany receivables?

- a. \$152,000
- b. \$146,000
- c. \$36,000
- d. \$0

CPA-00455 Explanation

Choice "d" is correct, \$0 reported as intercompany receivables.

Rule: 100% of all intercompany balances among members of the consolidated group are eliminated.

Note: Here's a quick way to pick up three minutes on the CPA exam, by carefully reading the question and thus avoiding calculations.

18. CPA-00448

Perez, Inc. owns 80% of Senior, Inc. During 1992, Perez sold goods with a 40% gross profit to Senior. Senior sold all of these goods in 1992. For 1992 consolidated financial statements, how should the summation of Perez and Senior income statement items be adjusted?

- a. Sales and cost of goods sold should be reduced by the intercompany sales.
- b. Sales and cost of goods sold should be reduced by 80% of the intercompany sales.
- c. Net income should be reduced by 80% of the gross profit on intercompany sales.
- d. No adjustment is necessary.

CPA-00448 Explanation

Choice "a" is correct, sales and cost of goods sold should be reduced by the intercompany sales.

Perez' sales price is Senior's purchase price. When Senior sells to an outside party, this amount becomes Senior's cost of sales. The sales price to the outsider is ok and the original cost of sales on Perez' books is ok. But, the sales and cost of sales are overstated, for a like amount, by the intercompany transaction.

Note: No balance sheet (inventory) adjustment is needed since none of the intercompany goods sold are on hand at year-end.

19. CPA-00484

On January 1, 1990, Poe Corp. sold a machine for \$900,000 to Saxe Corp., its wholly-owned subsidiary. Poe paid \$1,100,000 for this machine, which had accumulated depreciation of \$250,000. Poe estimated a \$100,000 salvage value and depreciated the machine on the straight-line method over 20 years, a policy which Saxe continued. In Poe's December 31, 1990, consolidated balance sheet, this machine should be included in cost and accumulated depreciation as:

	<u>Cost</u>	<u>Accumulated depreciation</u>
a.	\$1,100,000	\$300,000
b.	\$1,100,000	\$290,000
c.	\$900,000	\$40,000
d.	\$850,000	\$42,500

CPA-00484 Explanation

Choice "a" is correct. The effect of the intercompany sale should be eliminated. The machine should be shown on the consolidated statements at Poe's cost of \$1,100,000. Depreciation should continue as if the sale had not occurred. Depreciation for the current year is \$50,000 $[(1,100,000 - 100,000) / 20]$. Accumulated depreciation at 12/31/90 is \$300,000 $(250,000 + 50,000)$.

1. CPA-00067

On Merf's April 30, 1993, balance sheet a note receivable was reported as a noncurrent asset and its accrued interest for eight months was reported as a current asset. Which of the following terms would fit Merf's note receivable?

- a. Both principal and interest amounts are payable on August 31, 1993, and August 31, 1994.
- b. Principal and interest are due December 31, 1993.
- c. Both principal and interest amounts are payable on December 31, 1993, and December 31, 1994.
- d. Principal is due August 31, 1994, and interest is due August 31, 1993, and August 31, 1994.

CPA-00067 Explanation

Choice "d" is correct, principal is due August 31, 1994 (more than one year after the balance sheet date of April 30, 1993, on which it was reported as a noncurrent asset), and interest is due August 31, 1993, (since the accrued interest for eight months was reported as a current asset due within one year of the balance sheet date), and interest is due August 31, 1994, for the one year from Sept. 1, 1993, to August 31, 1994.

Choice "a" is incorrect. Noncurrent principal at April 30, 1993 must be due after April 30, 1994.

Choice "b" is incorrect. Noncurrent principal at April 30, 1993 must be due after April 30, 1994, and current interest must be paid before April 30, 1994.

Choice "c" is incorrect. Noncurrent principal at April 30, 1993 must be due after April 30, 1994, and current interest must be paid before April 30, 1994.

2. CPA-00061

Cook Co. had the following balances at December 31, 1992:

Cash in checking account	\$350,000
Cash in money-market account	250,000
U.S. Treasury bill, purchased 12/1/92, maturing 2/28/93	800,000
U.S. Treasury bond, purchased 3/1/92, maturing 2/28/93	500,000

Cook'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 Cook report as cash and cash equivalents in its December 31, 1992, balance sheet?

- a. \$600,000
- b. \$1,150,000
- c. \$1,400,000
- d. \$1,900,000

CPA-00061 Explanation

	<i>Cash and cash equivalents</i>
Cash in checking account	\$ 350,000
Cash in money market account	250,000
U.S. treasury bill, purchased 12/1/92, maturing 2/28/93 (90 days)	800,000
U.S. treasury bond, purchased 3/1/92, maturing 2/28/93 (365 days from the date of issue is not a cash equivalent, even though it is due only 2 months from the balance sheet date.)	
Total cash and cash equivalents	<u>\$1,400,000</u>

Choice "c" is correct, \$1,400,000 cash and cash equivalents.

3. CPA-00049

Inge Co. determined that the net value of its accounts receivable at December 31, 1993, based on an aging of the receivables, was \$325,000. Additional information is as follows:

Allowance for uncollectible accounts, 1/1/93	\$30,000
Uncollectible accounts written off during 1993	18,000
Uncollectible accounts recovered during 1993	2,000
Accounts receivable at 12/31/93	350,000

For 1993, what would be Inge's uncollectible accounts expense?

- a. \$5,000
- b. \$11,000
- c. \$15,000
- d. \$21,000

CPA-00049 Explanation

Choice "b" is correct.

Allowance for uncollectible accounts:

Beginning balance	\$30,000
Uncollectible accounts written off	(18,000)
Written off accounts now collectible	2,000
Uncollectible accounts expense	<u>?</u>
Year end balance	<u>\$25,000</u>

Thus, the expense (?) equals \$11,000. Note that \$350,000 accounts receivable less the allowance for uncollectible accounts balance equals the \$325,000 net accounts receivable).

Choice "a" is incorrect. Uncollectible accounts expense is not defined as the difference between the beginning balance in the allowance for uncollectible account and the ending balance without regard for transactions during the year.

Choice "c" is incorrect. The allowance account should be credited for the \$2,000 written off accounts now collectible.

Choice "d" is incorrect. The allowance account should be credited for the \$2,000 written off accounts now collectible, and debited for the \$18,000 uncollectible accounts written off.

4. CPA-00036

At January 1, 1994, Jamin Co. had a credit balance of \$260,000 in its allowance for uncollectible accounts. Based on past experience, 2% of Jamin's credit sales have been uncollectible. During 1994, Jamin wrote off \$325,000 of uncollectible accounts. Credit sales for 1994 were \$9,000,000. In its December 31, 1994, balance sheet, what amount should Jamin report as allowance for uncollectible accounts?

- a. \$115,000
- b. \$180,000
- c. \$245,000
- d. \$440,000

CPA-00036 Explanation

Choice "a" is correct. Under the percentage of credit sales approach, uncollectible accounts expense would be debited and allowance for uncollectible accounts would be credited for \$180,000 ($2\% \times \$9,000,000$). For accounts written off, allowance for uncollectible accounts would be debited and accounts receivable would be credited for \$325,000. The December 31, 1994 allowance for uncollectible accounts balance would be \$115,000 ($\$260,000 + \$180,000 - \$325,000$).

Choice "b" is incorrect. \$180,000 is the 1994 addition to the allowance for uncollectible accounts recognized under the percentage of credit sales method. It does not represent the balance of the account at year-end.

Choice "c" is incorrect. This calculation incorrectly debits the allowance for uncollectible accounts for the \$180,000 adjustment.

Choice "d" is incorrect. This calculation does not reduce (debit) the allowance for uncollectible accounts for the \$325,000 of accounts written off.

5. CPA-00034

Gar Co. factored its receivables without recourse with Ross Bank. Gar received cash as a result of this transaction, which is best described as a:

- a. Loan from Ross collateralized by Gar's accounts receivable.
- b. Loan from Ross to be repaid by the proceeds from Gar's accounts receivable.
- c. Sale of Gar's accounts receivable to Ross, with the risk of uncollectible accounts retained by Gar.
- d. Sale of Gar's accounts receivable to Ross, with the risk of uncollectible accounts transferred to Ross.

CPA-00034 Explanation

Choice "d" is correct. Factoring receivables without recourse is a sales transaction. Factoring without recourse transfers the risk of uncollectible accounts to the buyer. SFAS 77 para. 12

Choice "a" is incorrect. Pledging receivables is the process of obtaining a loan using the receivables as collateral.

Choice "b" is incorrect. Assigning receivables is the process of obtaining a loan by transferring to the lender the debtor's right to cash collected on receivables.

Choice "c" is incorrect. Factoring receivables may be treated as a sales transaction. Factoring with recourse leaves the risk of uncollectible accounts with the seller. SFAS 77 para. 12

Class Questions

6. CPA-00059

Roth, Inc. received from a customer a one-year, \$500,000 note bearing annual interest of 8%. After holding the note for six months, Roth discounted the note at Regional Bank at an effective interest rate of 10%. What amount of cash did Roth receive from the bank?

- a. \$540,000
- b. \$523,810
- c. \$513,000
- d. \$495,238

CPA-00059 Explanation

Choice "c" is correct, \$513,000 cash proceeds received from bank.

	<i>Net proceeds at discount</i>
Face of note	\$ 500,000
Int. rate on note - 8% x 1 yr	x 8%
	<u>40,000</u>
Maturity value of note	540,000
Disc by bank - 10% x 1/2 yr	x 5%
	<u>(27,000)</u>
Proceeds from bank	<u>\$ 513,000</u>

7. CPA-00114

Bren Co.'s beginning inventory at January 1, 1993, was understated by \$26,000, and its ending inventory was overstated by \$52,000. As a result, Bren's cost of goods sold for 1993 was:

- a. Understated by \$26,000.
- b. Overstated by \$26,000.
- c. Understated by \$78,000.
- d. Overstated by \$78,000.

CPA-00114 Explanation

Choice "c" is correct. The \$26,000 understatement of beginning inventory creates an understatement of cost of goods available for sale which leads to a \$26,000 understatement of cost of goods sold. The \$52,000 overstatement of ending inventory creates a \$52,000 understatement of cost of goods sold. Thus, cost of goods sold, in total, is understated by \$78,000 (\$26,000 plus \$52,000).

Note: Amounts for beginning and ending balances and purchases are assumed.

	<u>As stated</u>	–	<u>Should be</u>	=	<u>Difference</u>
Beginning balance	\$ 0		\$ 26,000		(\$ 26,000)
Plus purchases	\$ 100,000		\$ 100,000		\$ 0
Less ending inventory	\$ 52,000		\$ 0		\$ 52,000
Cost of goods sold	\$ 48,000		\$ 126,000		(\$ 78,000)

Choice "a" is incorrect. Cost of goods sold is also understated by \$52,000 due to the overstatement of ending inventory.

Choice "b" is incorrect. The \$26,000 understatement of beginning inventory creates an understatement, rather than an overstatement, of cost of goods sold. Cost of goods sold is also understated by \$52,000 due to the overstatement of ending inventory.

Choice "d" is incorrect. Cost of goods sold is understated, rather than overstated, by \$78,000.

8. CPA-00112

Herc Co.'s inventory at December 31, 1993, was \$1,500,000 based on a physical count priced at cost, and before any necessary adjustment for the following:

- Merchandise costing \$90,000, shipped FOB shipping point from a vendor on December 30, 1993, was received and recorded on January 5, 1994.
- Goods in the shipping area were excluded from inventory although shipment was not made until January 4, 1994. The goods, billed to the customer FOB shipping point on December 30, 1993, had a cost of \$120,000.

What amount should Herc report as inventory in its December 31, 1993, balance sheet?

- a. \$1,500,000
- b. \$1,590,000
- c. \$1,620,000
- d. \$1,710,000

CPA-00112 Explanation

Choice "d" is correct. The \$90,000 inventory purchase should be included in inventory since it was shipped prior to year end and title transferred to the company at the shipping point. The unshipped goods of \$120,000 belong to the company since at year end there has been no title transfer to the buyer. Inventory includes the physical count of \$1,500,000, the inventory in transit of \$90,000, and the unshipped sale with a cost of \$120,000 for a total inventory valuation of \$1,710,000.

Choice "a" is incorrect. Adjustments to the physical inventory count should be made.

Choice "b" is incorrect. The adjustment for the cost of goods sold but not yet shipped should be made.

Choice "c" is incorrect. Adjustment to include the cost of goods purchased and in transit should be made.

9. CPA-00132

On December 1, 1992, Alt Department Store received 505 sweaters on consignment from Todd. Todd's cost for the sweaters was \$80 each, and they were priced to sell at \$100. Alt's commission on consigned goods is 10%. At December 31, 1992, 5 sweaters remained. In its December 31, 1992, balance sheet, what amount should Alt report as payable for consigned goods?

- a. \$49,000
- b. \$45,400
- c. \$45,000
- d. \$40,400

CPA-00132 Explanation

Choice "c" is correct. Consigned goods are not included in inventory by Alt and a payable is not recorded until the goods are sold. 500 sweaters were sold for \$50,000. After a 10% commission, \$45,000 is payable.

10. CPA-00092

A company decided to change its inventory valuation method from FIFO to LIFO in a period of rising prices. What was the result of the change on ending inventory and net income in the year of the change?

	<u>Ending inventory</u>	<u>Net income</u>
a.	Increase	Increase
b.	Increase	Decrease
c.	Decrease	Decrease
d.	Decrease	Increase

CPA-00092 Explanation

Choice "c" is correct. Under LIFO, ending inventory has a lower valuation than under FIFO since older, lower costs are assigned to ending inventory. Similarly, under LIFO, cost of goods sold has a higher valuation than under FIFO since recent, higher costs are assigned to goods sold. This higher cost of goods sold means that net income under LIFO decreases.

Choice "a" is incorrect. Under LIFO, older, lower costs are assigned to ending inventory and cost of goods sold has a higher valuation (since recent, higher costs are assigned to goods sold) resulting in a lower net income under LIFO compared to FIFO.

Choice "b" is incorrect. Under LIFO, ending inventory has a lower valuation than under FIFO since older, lower costs are assigned to ending inventory.

Choice "d" is incorrect. Under LIFO, cost of goods sold has a higher valuation than under FIFO since recent, higher costs are assigned to goods sold. Thus, net income under LIFO would decrease since the costs of goods sold expense is higher.

11. CPA-00134

Samm Corp. purchased a plot of land for \$100,000. The cost to raze a building on the property amounted to \$50,000 and Samm received \$10,000 from the sale of scrap materials. Samm built a new plant on the site at a total cost of \$800,000 including excavation costs of \$30,000. What amount should Samm capitalize in its land account?

- a. \$150,000
- b. \$140,000
- c. \$130,000
- d. \$100,000

CPA-00134 Explanation

Choice "b" is correct. \$140,000: The proper amount to capitalize to land, includes the cost of \$100,000 plus the cost to raze the building of \$50,000, less the sale of scrap materials of \$10,000.

Excavation costs are treated as part of the cost of the building.

12. CPA-00139

On December 1, 1991, Boyd Co. purchased a \$400,000 tract of land for a factory site. Boyd razed an old building on the property and sold the materials it salvaged from the demolition. Boyd incurred additional costs and realized salvage proceeds during December 1991 as follows:

Demolition of old building	\$50,000
Legal fees for purchase contract and recording ownership	10,000
Title guarantee insurance	12,000
Proceeds from sale of salvaged materials	8,000

In its December 31, 1991, balance sheet, Boyd should report a balance in the land account of:

- a. \$464,000
- b. \$460,000
- c. \$442,000
- d. \$422,000

CPA-00139 Explanation

Choice "a" is correct. Land costs include the costs of getting the land ready for intended use which includes razing old buildings less salvage plus title insurance and legal fees.

Land	\$400,000
Demolition	50,000
Legal fees	10,000
Title insurance	12,000
Salvaged materials	<u>(8,000)</u>
Total	<u>\$464,000</u>

Choice "b" is incorrect. Title insurance and salvaged materials proceeds are included in the cost of the land.

Choice "c" is incorrect. Legal fees and title insurance are included in the cost of the land.

Choice "d" is incorrect. Demolition cost less salvaged materials proceeds are included in the cost of the land.

13. CPA-00142

Spiro Corp. uses the sum-of-the-years'-digits method to depreciate equipment purchased in January 1996 for \$20,000. The estimated salvage value of the equipment is \$2,000 and the estimated useful life is four years. What should Spiro report as the asset's carrying amount as of December 31, 1998?

- a. \$1,800
- b. \$2,000
- c. \$3,800
- d. \$4,500

CPA-00142 Explanation

Choice "c" is correct. Spiro should report the asset's carrying value on December 31, 1998, as \$3,800.

**Base for Depreciation Using
Sum-of-the-years' Digits Method**

Purchase price	\$ 20,000
Salvage value	<u>(2,000)</u>
Base	<u>\$ 18,000</u>

Depreciation Schedule

	<u>Fraction</u>		<u>Base</u>		<u>Depreciation Expense</u>
Year 1 (1996)	4/10	×	\$18,000	=	\$ 7,200
Year 2 (1997)	3/10	×	18,000	=	5,400
Year 3 (1998)	2/10	×	18,000	=	3,600
Year 4 (1999)	<u>1/10</u>	×	18,000	=	<u>1,800</u>
	10/10				<u>\$ 18,000</u>

Calculation of the Carrying Amount

Purchase price	\$ 20,000
1996 depreciation	(7,200)
1997 depreciation	(5,400)
1998 depreciation	<u>(3,600)</u>
Carrying value at 12/31/98	<u>\$ 3,800</u>

14. CPA-00144

Rye Co. purchased a machine with a four-year estimated useful life and an estimated 10% salvage value for \$80,000 on January 1, 1992. In its income statement, what would Rye report as the depreciation expense for 1994 using the double-declining-balance method?

- a. \$9,000
- b. \$10,000
- c. \$18,000
- d. \$20,000

CPA-00144 Explanation

Choice "b" is correct. The double-declining-balance rate is 50% (2 x 25% straight-line rate). 1992 expense is \$40,000 (.5 x book value of \$80,000). 1993 expense is \$20,000 [50% x book value of \$40,000 (\$80,000 – \$40,000)]. 1994 expense is \$10,000 [50% x book value of \$20,000 (\$40,000 – \$20,000)].

Choice "a" is incorrect. Salvage value is not included in the calculation of depreciation under the double-declining-balance method.

Choice "c" is incorrect. Salvage value is not included in the calculation of depreciation under the double-declining-balance method. The double-declining-balance rate is 50% (2 x 25% straight-line rate).

Choice "d" is incorrect. The double-declining-balance rate is 50% (2 x 25% straight-line rate).

15. CPA-00151

Gei Co. determined that, due to obsolescence, equipment with an original cost of \$900,000 and accumulated depreciation at January 1, 1992, of \$420,000 had suffered permanent impairment, and as a result should have a carrying value of only \$300,000 as of the beginning of the year. In addition, the remaining useful life of the equipment was reduced from 8 years to 3. In its December 31, 1992, balance sheet, what amount should Gei report as accumulated depreciation?

- a. \$100,000
- b. \$520,000
- c. \$600,000
- d. \$700,000

CPA-00151 Explanation

Choice "d" is correct. When a permanent impairment occurs, the book value is reduced and a loss is recorded. The loss is credited to accumulated depreciation. In addition, the current year's depreciation expense should be added. The new book value is depreciated over the new life.

Accumulated depreciation, 1/1/92	\$420,000
Loss (\$900,000 – 420,000) – 300,000	180,000
Depreciation for 1992 (\$300,000 ÷ 3)	100,000
Accumulated depreciation, 12/31/92	<u>\$700,000</u>

Choice "a" is incorrect. The \$100,000 is the depreciation expense for 1992. The question asks for accumulated depreciation balance on 12/31/92.

Choice "b" is incorrect. The \$180,000 loss is added to accumulated depreciation.

Choice "c" is incorrect. The \$600,000 is the accumulated depreciation as of the date of impairment, 1/1/92. The question asks the balance on 12/31/92.

1. CPA-00394

On December 30, 1994, Chang Co. sold a machine to Door Co. in exchange for a non-interest-bearing note requiring ten annual payments of \$10,000. Door made the first payment on December 30, 1994. The market interest rate for similar notes at date of issuance was 8%. Information on present value factors is as follows:

<i>Period</i>	<i>Present value of \$1 at 8%</i>	<i>Present value of ordinary annuity of \$1 at 8%</i>
9	0.50	6.25
10	0.46	6.71

In its December 31, 1994, balance sheet, what amount should Chang report as note receivable?

- a. \$45,000
- b. \$46,000
- c. \$62,500
- d. \$67,100

CPA-00394 Explanation

Choice "c" is correct. On Dec. 31, 1994, the first payment will have been received with nine more payments to be received. Present value of this ordinary annuity of nine equal payments with a market interest rate of 8% is calculated as \$10,000 x 6.25, or \$62,500.

Choice "a" is incorrect. The note constitutes an annuity with nine payments since the first payment is made on December 31, 1994.

Choice "b" is incorrect. The note constitutes an annuity with nine payments since the first payment is made on December 31, 1994.

Choice "d" is incorrect. The annuity is for nine periods since the first payment is made on December 31, 1994.

2. CPA-00438

On January 1, 1989, Park Co. signed a 10-year operating lease for office space at \$96,000 per year. The lease included a provision for additional rent of 5% of annual company sales in excess of \$500,000. Park's sales for the year ended December 31, 1989 were \$600,000. Upon execution of the lease, Park paid \$24,000 as a bonus for the lease. Park's rent expense for the year ended December 31, 1989 is:

- a. \$98,400
- b. \$101,000
- c. \$103,400
- d. \$125,000

CPA-00438 Explanation

Choice "c" is correct. **\$103,400** rent expense for 1989.

Base rent (operating lease)	\$ 96,000
Additional rent (\$600,000 - \$500,000 = \$100,000 x 5%)	5,000
Amortization of lease bonus (\$24,000 ÷ 10 yrs.)	<u>2,400</u>
Rent expense, 1989	<u>\$103,400</u>

3. CPA-00410

Wall Co. leased office premises to Fox, Inc. for a five-year term beginning January 2, 1992. Under the terms of the operating lease, rent for the first year is \$8,000 and rent for years 2 through 5 is \$12,500 per annum. However, as an inducement to enter the lease, Wall granted Fox the first six months of the lease rent-free. In its December 31, 1992, income statement, what amount should Wall report as rental income?

- a. \$12,000
- b. \$11,600
- c. \$10,800
- d. \$8,000

CPA-00410 Explanation

Choice "c" is correct. Rental income is recorded when it is earned (accrual basis), not when the cash is received. Therefore the total rental income should be recognized ratably over the 5 years.

Rent in year 1 (1/2 of \$8,000)	\$ 4,000
Rent in years 2-5 (\$12,500 x 4)	<u>50,000</u>
Total rent	<u>\$ 54,000</u>
1992 Rent (1/5 x \$54,000)	<u>\$ 10,800</u>

Choice "a" is incorrect. Rental income is recorded when it is earned (accrual basis), not when the cash is received. Therefore the total rental income should be recognized ratably over the 5 years.

Choice "b" is incorrect. Only 1/2 of \$8,000 is received in 1992.

Choice "d" is incorrect. Rental income is recorded when it is earned (accrual basis), not when the cash is received. Therefore the total rental income should be recognized ratably over the 5 years.

4. CPA-00434

Lease A does not contain a bargain purchase option, but the lease term is equal to 90 percent of the estimated economic life of the leased property. Lease B does not transfer ownership of the property to the lessee by the end of the lease term, but the lease term is equal to 75 percent of the estimated economic life of the leased property. How should the lessee classify these leases?

<u>Lease A</u>	<u>Lease B</u>
a. Operating lease	Capital lease
b. Operating lease	Operating lease
c. Capital lease	Capital lease
d. Capital lease	Operating lease

CPA-00434 Explanation

Choice "c" is correct. **Both** leases have terms equal to or more than 75% of their estimated economic life; therefore, **both** are **capital** leases.

Rule: if any one of the following conditions is met, a lease is considered a **capital lease** and is treated as if owned by the lessee:

1. The lease transfers ownership to the lessee by the end of the lease term.
2. The lease contains a bargain purchase option.
3. The present value at the beginning of the lease term of the "minimum lease payments" equals or exceeds 90% of the fair value of the lease Property.
4. The lease term is 75% or more of the estimated economic life of the leased property.

Choice "a" is incorrect. Lease "a" is a capital lease.

Choice "b" is incorrect. Both leases "a" and "b" are capital leases.

Choice "d" is incorrect. Lease "b" is a capital lease.

5. CPA-00424

On December 31, 1990, Day Co. leased a new machine from Parr with the following pertinent information:

Lease term	6 years
Annual rental payable at beginning of each year	\$50,000
Useful life of machine	8 years
Day's incremental borrowing rate	15%
Implicit interest rate in lease (known by Day)	12%
Present value of an annuity of 1 in advance for 6 periods at 12%	4.61
Present value of an annuity of 1 in advance for 6 periods at 15 %	4.35

The lease is not renewable, and the machine reverts to Parr at the termination of the lease. The cost of the machine on Parr's accounting records is \$375,500. At the beginning of the lease term, Day should record a lease liability of:

- a. \$375,500
- b. \$230,500
- c. \$217,500
- d. \$0

CPA-00424 Explanation

Choice "b" is correct. **\$230,500** lease liability at 12-31-90.

Rule: a lease is a capital lease if its term is 75% or more of the life of the leased property. The rate to use to calculate present value is the lessor's "implicit rate" if known by the lessee and if it is lower than the lessee's incremental borrowing rate.

Lease term 6 yr = 75% and is a capital lease
 Life of machine 8 yr

Lease payment	x	PV factor at 12%	=	PV of lease
\$50,000	x	4.61	=	\$230,500 B

6. CPA-00411

On January 2, 1992, Nori Mining Co. (lessee) entered into a 5-year lease for drilling equipment. Nori accounted for the acquisition as a capital lease for \$240,000, which includes a \$10,000 bargain purchase option. At the end of the lease, Nori expects to exercise the bargain purchase option. Nori estimates that the equipment's fair value will be \$20,000 at the end of its 8-year life. Nori regularly uses straight-line depreciation on similar equipment. For the year ended December 31, 1992, what amount should Nori recognize as depreciation expense on the leased asset?

- a. \$48,000
- b. \$46,000
- c. \$30,000
- d. \$27,500

CPA-00411 Explanation

Choice "d" is correct. When a lease is capitalized because of transfer of title or bargain purchase, depreciation is based on the life of the asset, not the lease. The cost includes the bargain purchase price. Depreciation cannot be taken below the salvage value. Depreciation is:

$$(\$240,000 - 20,000) / 8 \text{ years} = \underline{\$27,500}$$

SFAS 13 para. 10, 13

Choice "a" is incorrect. The life of the asset is used when the asset is capitalized because of bargain purchase. Salvage value must also be considered.

Choice "b" is incorrect. The life of the asset is used when the asset is capitalized because of bargain purchase. Additionally, the salvage value and not the bargain purchase option is subtracted from the asset cost to determine the depreciable base.

Choice "c" is incorrect. Depreciation is computed on cost less salvage of \$20,000.

7. CPA-00397

On January 2, 1995, Marx Co. as lessee signed a five-year noncancelable equipment lease with annual payments of \$200,000 beginning December 31, 1995. Marx treated this transaction as a capital lease. The five lease payments have a present value of \$758,000 at January 2, 1995, based on interest of 10%. What amount should Marx report as interest expense for the year ended December 31, 1995?

- a. \$0
- b. \$48,400
- c. \$55,800
- d. \$75,800

CPA-00397 Explanation

Choice "d" is correct. The lease term began January 2, 1995 on a lease valued at \$758,000. The first payment of \$200,000 was made on December 31, 1995. Since the interest rate is 10% and one year has expired, Marx Co.'s interest expense is computed as 10% of \$758,000 or \$75,800. The remainder of the \$200,000 payment reduces the obligation under the lease. SFAS 13

Choice "a" is incorrect. If the first payment had been made on January 2, the amount of interest would have been \$0 because none of the lease term had elapsed. Interest accrued between January 2 and December 31, which Marx must account for.

Choice "b" is incorrect. Marx will pay 5 x \$200,000 or 1,000,000 over the life of the lease or \$1,000,000 - \$758,000 = \$242,000 total interest over the lease term. Simple interest for each of the five years would be \$242,000 / 5 or \$48,400. However, lease interest expense is computed using the effective interest method.

Choice "c" is incorrect. If the first payment had been made on January 2, the amount of interest would have been \$0 because none of the lease term had elapsed, and the lease obligation would have been reduced by the \$200,000 of the payment leaving an obligation of \$558,000. Under these circumstances the interest expense accrued between January 2 and December 31, which Marx must account for would be 10% of the reduced amount or \$55,800.

8. CPA-00439

Peg Co. leased equipment from Howe Corp. on July 1, 1988 for an eight-year period expiring June 30, 1996. Equal payments under the lease are \$600,000 and are due on July 1 of each year. The first payment was made on July 1, 1988. The rate of interest contemplated by Peg and Howe is 10%. The cash selling price of the equipment is \$3,520,000, and the cost of the equipment on Howe's accounting records is \$2,800,000. The lease is appropriately recorded as a sales-type lease. What is the amount of profit on the sale and interest revenue that Howe should record for the year ended December 31, 1988?

	<u>Profit on Sale</u>	<u>Interest Revenue</u>
a.	\$720,000	\$176,000
b.	\$720,000	\$146,000
c.	\$45,000	\$176,000
d.	\$45,000	\$146,000

CPA-00439 Explanation

Choice "b" is correct. **\$720,000** profit on sale and **\$146,000** interest revenue.

Rule: in a sales-type lease, any difference between the fair value of the leased asset and its carrying value is recognized as manufacturer's or dealer's profit:

Cash selling price of equipment	\$3,520,000
Less cost of equipment	<u>(2,800,000)</u>
Profit recognized on sale	<u>\$ 720,000</u>

Rule: unearned interest revenue in a sales-type lease is amortized over the period of the lease using the interest method:

PV at inception of the lease at 7/1/88	\$3,520,000
Less initial payment 7/1/88	<u>(600,000)</u>
Balance during first year	\$2,920,000
Interest rate	x 10%
Interest revenue 7/1/88 to 6/30/89 (12 mos)	<u>\$ 292,000</u>
Adjust from full year to half year	x ½ yr
Interest revenue for YE 12/31/88	<u>\$ 146,000</u>

9. CPA-00417

The following information pertains to a sale and leaseback of equipment by Mega Co. on December 31, 1991:

Sales price	\$400,000
Carrying amount	\$300,000
Monthly lease payment	\$ 3,250
Present value of lease payments	\$ 36,900
Estimated remaining life	25 years
Lease term	1 year
Implicit rate	12%

What amount of deferred gain on the sale should Mega report at December 31, 1991?

- a. \$0
- b. \$36,900
- c. \$63,100
- d. \$100,000

CPA-00417 Explanation

Choice "a" is correct. **\$0** deferred gain in the 12/31/91 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 FV of the asset sold), any gain should be recognized immediately and none deferred.

10. CPA-00458

The market price of a bond issued at a premium is equal to the present value of its principal amount:

- a. Only, at the stated interest rate.
- b. And the present value of all future interest payments, at the stated interest rate.
- c. Only, at the market (effective) interest rate.
- d. And the present value of all future interest payments, at the market (effective) interest rate.

CPA-00458 Explanation

Choice "d" is correct. To determine the market price of a bond, the present value of the principal is added to the present value of all interest payments, using the market interest rate.

Choice "a" is incorrect. The stated interest rate is used to calculate the amount of interest payment, but not the market price of the bond.

Choice "b" is incorrect. The stated interest rate is used to calculate the amount of interest payment, but not the market price of the bond.

Choice "c" is incorrect. The market interest rate is used in calculating the price of the bond; however, all the interest payments must also be taken into consideration.

11. CPA-00460

On December 1, 1995, Money Co. gave Home Co. a \$200,000, 11% loan. Money paid 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 \$4,310, beginning January 1, 1996. The repayments yield an effective interest rate of 11% at a present value of \$200,000 and 12.4% at a present value of \$194,000. What amount of income from this loan should Money report in its 1995 income statement?

- a. \$0
- b. \$1,833
- c. \$2,005
- d. \$7,833

CPA-00460 Explanation

Rule: Loan origination fees shall be deferred and recognized over the life of the loan as an adjustment of interest income (similar to the treatment of bond discount amortization).

Choice "c" is correct. \$2,005 income from this loan in 1995.

Face amount of loan	\$200,000
Nonrefundable loan origination fee	<u>(6,000)</u>
Net amount loaned	194,000
Effective interest rate (yield)	<u>12.4%</u>
	24,056
Outstanding one month (12/1/95 - 12/31/95)	<u>x 1/12</u>
Interest income for 1995	<u>\$ 2,005</u>

12. CPA-00470

On January 2, 1994, West Co. issued 9% bonds in the amount of \$500,000, which mature on January 2, 2004. The bonds were issued for \$469,500 to yield 10%. Interest is payable annually on December 31. West uses the interest method of amortizing bond discount. In its June 30, 1994, balance sheet, what amount should West report as bonds payable?

- a. \$469,500
- b. \$470,475
- c. \$471,025
- d. \$500,000

CPA-00470 Explanation

Choice "b" is correct.

I/S	B/S	
\$469,500	\$500,000	\$469,500
<u>x 10%</u>	<u>x 9%</u>	
\$ 46,950	\$ 45,000	= \$1,950 x ½ yr =
		<u>975</u>
		<u>\$470,475</u>

Choice "a" is incorrect. Amortization of the bond discount should be recorded.

Choice "c" is incorrect. The interest method should be used.

Choice "d" is incorrect. The reported valuation of the bond payable is the face value less any unamortized bond discount.

13. CPA-00463

On July 1, 1994, Eagle Corp. issued 600 of its 10%, \$1,000 bonds at 99 plus accrued interest. The bonds are dated April 1, 1994 and mature on April 1, 2004. Interest is payable semiannually on April 1 and October 1. What amount did Eagle receive from the bond issuance?

- a. \$579,000
- b. \$594,000
- c. \$600,000
- d. \$609,000

CPA-00463 Explanation

Choice "d" is correct. The cash collected equals:

Face: 600 x \$1,000	\$600,000	
Issue at:	<u>99%</u>	
Bond issue proceeds		\$594,000
Face	\$600,000	
Coupon	<u>x 10%</u>	
Annual interest	60,000	
% Year	<u>3/12</u>	
Accrued interest		<u>\$ 15,000</u>
Total cash proceeds		<u>\$609,000</u>

Choice "a" is incorrect. Accrued interest should be added rather than subtracted.

Choice "b" is incorrect. Accrued interest collected should be included.

Choice "c" is incorrect. The face value does not equal the issuance price. Accrued interest collected should be included.

14. CPA-00477

On January 31, 1992, Beau Corp. issued \$300,000 maturity value, 12% bonds for \$300,000 cash. The bonds are dated December 31, 1991, and mature on December 31, 2001. Interest will be paid semiannually on June 30 and December 31. What amount of accrued interest payable should Beau report in its September 30, 1992, balance sheet?

- a. \$27,000
- b. \$24,000
- c. \$18,000
- d. \$9,000

CPA-00477 Explanation

Choice "d" is correct. Accrued interest payable on September 30, 1992 is the interest owed since the June 30, 1992 payment.

$$\$300,000 \times 12\% \times 3/12 = \$9,000$$

Choice "a" is incorrect. The accrued interest payable on September 30 is only the amount since the June 30 payment. The \$27,000 is the interest expense through September 30 (from January 1).

Choice "b" is incorrect. The accrued interest payable on September 30 is only the amount since the June 30 payment. The \$24,000 is the interest expense from date of issue (January 31) to September 30.

Choice "c" is incorrect. The \$18,000 is the interest paid to date in 1992, but the question is interest payable at September 30.

15. CPA-00493

On March 31, 1992, Ashley, Inc.'s bondholders exchanged their convertible bonds for common stock. The carrying amount of these bonds on Ashley's books was less than the market value but greater than the par value of the common stock issued. If Ashley used the book value method of accounting for the conversion, which of the following statements correctly states an effect of this conversion?

- a. Stockholders' equity is increased.
- b. Additional paid-in capital is decreased.
- c. Retained earnings is increased.
- d. An extraordinary loss is recognized.

CPA-00493 Explanation

Choice "a" is correct. Under the book value method of exchanging convertible bonds for stock, the book value of the bonds is reallocated to the par value and the additional paid-in capital accounts of the common stock. Thus, stockholders' equity is increased.

Choice "b" is incorrect. Converting bonds to common stock either has no effect on additional paid-in capital (if the bonds' book value equaled the common stocks' par value) or increases additional paid-in capital.

Choice "c" is incorrect. Only the bond accounts and the common stock accounts are affected under the book value method of exchanging convertible bonds for common stock.

Choice "d" is incorrect. No gain or loss is recognized under the book value method.

16. CPA-00473

On December 31, 1993, Moss Co. issued \$1,000,000 of 11% bonds at 109. Each \$1,000 bond was issued with 50 detachable stock warrants, each of which entitled the bondholder to purchase one share of \$5 par common stock for \$25. Immediately after issuance, the market value of each warrant was \$4. On December 31, 1993, what amount should Moss record as discount or premium on issuance of bonds?

- a. \$40,000 premium.
- b. \$90,000 premium.
- c. \$110,000 discount.
- d. \$200,000 discount.

CPA-00473 Explanation

Choice "c" is correct.

1	DR:	Cash	\$1,090,000	
4	DR:	Discount on bond	110,000	
2	CR:	Bond payable		\$1,000,000
3	CR:	APIC--Warrants		200,000

17. CPA-00476

On March 1, 1987, Somar Co. issued 20-year bonds at a discount. By September 1, 1992, the bonds were quoted at 106 when Somar exercised its right to retire the bonds at 105. The amount is material and considered to be unusual in nature and infrequently occurring with respect to Somar Co. How should Somar report the bond retirement on its 1992 income statement?

- a. A gain in continuing operations.
- b. A loss in continuing operations.
- c. An extraordinary gain.
- d. An extraordinary loss.

CPA-00476 Explanation

Choice "d" is correct. The settlement price is greater than the face value of the debt and the face value is greater than the book value. Therefore, the settlement price is greater than the book value and a loss would be recognized on the transaction. This loss would be classified as "extraordinary" because it meets the criteria of APBO No. 30. APB 26 para. 20, SFAS 4 para. 8

18. CPA-00471

On July 31, 1993, Dome Co. issued \$1,000,000 of 10%, 15-year bonds at par and (as a typical risk-management strategy to Dome Co.) used a portion of the proceeds to call its 600 outstanding 11%, \$1,000 face value bonds, due on July 31, 2003, at 102. On that date, unamortized bond premium relating to the 11% bonds was \$65,000. In its 1993 income statement, what amount should Dome report as gain or loss from retirement of bonds?

- a. \$53,000 gain.
- b. \$0
- c. \$(65,000) loss.
- d. \$(77,000) loss.

CPA-00471 Explanation

Choice "a" is correct. A gain of \$53,000 is recognized because the \$665,000 book value of the debt (\$600,000 face value plus \$65,000 unamortized premium) is settled for \$612,000 (\$600,000 at 102). There is no accrued interest because the redemption takes place on an interest date. The proceeds from the new bond issuance are not relevant. Note that the gain is reported as part of continuing operations because the transaction is a typical risk-management strategy of the company.

Choice "b" is incorrect. The retirement price does not equal the book value, so a gain or loss must be recognized.

Choice "c" is incorrect. Gain or loss is not determined solely by the amount of unamortized premium.

Choice "d" is incorrect. The combination of the unamortized premium plus the excess of the retirement price over the bond face value is not relevant.

19. CPA-00532

The following information pertains to the transfer of real estate pursuant to a troubled debt restructuring (considered to be an extraordinary event for Knob Co.) by Knob Co. to Mene Corp. in full liquidation of Knob's liability to Mene:

Carrying amount of liability liquidated	\$150,000
Carrying amount of real estate transferred	100,000
Fair value of real estate transferred	90,000

What amount should Knob report as ordinary gain (loss) on transfer of real estate?

- a. (\$10,000)
- b. \$0
- c. \$50,000
- d. \$60,000

CPA-00532 Explanation

Choice "a" is correct. When assets are transferred in a troubled debt restructuring, the asset (real estate) is adjusted to fair value and an ordinary gain or loss is recorded.

Carrying amount	\$100,000
Fair value of real estate	<u>(90,000)</u>
Ordinary loss	<u>\$ 10,000</u>

SFAS 15 para. 13

Choice "b" is incorrect. When assets are transferred in a troubled debt restructuring, the asset (real estate) is adjusted to fair value and an ordinary gain or loss is recorded.

Choice "c" is incorrect. When assets are transferred in a troubled debt restructuring, the asset (real estate) is adjusted to fair value and an ordinary gain or loss is recorded.

Choice "d" is incorrect. The \$60,000 is the gain on the restructuring of the payable, not the gain on the transfer of real estate.

20. CPA-00528

The following information pertains to the transfer of real estate pursuant to a troubled debt restructuring (considered to be an extraordinary event for Knob Co.) by Knob Co. to Mene Corp. in full liquidation of Knob's liability to Mene:

Carrying amount of liability liquidated	\$150,000
Carrying amount of real estate transferred	100,000
Fair value of real estate transferred	90,000

What amount should Knob report as a pretax extraordinary gain (loss) on restructuring of payables?

- a. (\$10,000)
- b. \$0
- c. \$50,000
- d. \$60,000

CPA-00528 Explanation

Choice "d" is correct. When assets are transferred in a troubled debt restructuring, the asset (real estate) is adjusted to fair value and an ordinary gain or loss recorded. Then, the gain or loss on restructuring is recorded as the difference between the debt and fair value of asset transferred. This gain or loss is considered extraordinary if the related event meets the criteria of APBO No. 30 to be treated as an extraordinary item (SFAS No. 145). Otherwise, it is an ordinary gain. In this case, the gain on restructuring is considered extraordinary and is calculated as follows:

Liability	\$150,000
Fair value of real estate	<u>(90,000)</u>
Gain	<u>\$ 60,000</u>

SFAS 15 para. 13

Choice "a" is incorrect. The \$10,000 is the loss on the adjustment of real estate to fair value, not the restructuring loss.

Choice "b" is incorrect. The restructuring gain or loss is the difference between the liability and the asset's fair value and is extraordinary in this case.

Choice "c" is incorrect. The restructuring gain or loss is the difference between the liability and the asset's fair value.

1. CPA-00690

The following information pertains to Gali Co.'s defined benefit pension plan for 1994:

Fair value of plan assets, beginning of year	\$350,000
Fair value of plan assets, end of year	525,000
Employer contributions	110,000
Benefits paid	85,000

In computing pension expense, what amount should Gali use as actual return on plan assets?

- a. \$65,000
- b. \$150,000
- c. \$175,000
- d. \$260,000

CPA-00690 Explanation

Choice "b" is correct.

B	Beginning Plan Assets	\$350,000	
	+ Contributions	110,000	
A			
	+ Actual Return	150,000	Squeeze
S	– Benefits Paid	<u>< 85,000 ></u>	
E	Ending Plan Assets	<u>\$525,000</u>	

The actual return must equal \$150,000. SFAS 87 para. 23

Choice "a" is incorrect. Year-end plan assets equal beginning plan assets plus contributions less distributions plus actual return on plan assets.

Choice "c" is incorrect. Year-end plan assets equal beginning plan assets plus contributions less distributions plus actual return on plan assets.

Choice "d" is incorrect. Year-end plan assets equal beginning plan assets plus contributions less distributions plus actual return on plan assets.

2. CPA-05398

Big Books, Inc. has the following information related to its defined benefit pension plan:

December 31, 20X6:

Projected benefit obligation	\$1,500,000
Fair value of plan assets	1,200,000
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 Book's makes an annual pension plan contribution of \$200,000. The company's employees had an average remaining service life of 10 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 is the funded status of Big Book's pension plan on December 31, 20X6?

- a. \$60,000 underfunded.
- b. \$60,000 overfunded.
- c. \$300,000 underfunded.
- d. \$300,000 overfunded.

CPA-05398 Explanation

Choice "c" is correct. The funded status of the pension plan at December 31, 20X6 is computed as follows:

$$\text{Fair value of plan assets} - \text{PBO} = \$1,200,000 - 1,500,000 = \$ (300,000)$$

Because the PBO exceeds the fair value of the pension plan assets, this is an underfunded pension plan.

Choice "a" is incorrect. Although Big Books' pension plan is underfunded at 12/31/X6, this answer incorrectly uses the 20X7 PBO and fair value of plan assets to compute the 20X6 funded status.

Choice "b" is incorrect. This is the funded status of Big Books' pension plan at December 31, 20X7.

Choice "d" is incorrect. Big Books' pension plan is underfunded, not overfunded, but \$300,000 at December 31, 20X6.

3. CPA-05399

Big Books, Inc. has the following information related to its defined benefit pension plan:

December 31, 20X6:

Projected benefit obligation	\$1,500,000
Fair value of plan assets	1,200,000
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 Book's makes an annual pension plan contribution of \$200,000. The company's employees had an average remaining service life of 10 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%. The funded status of Big Books' pension plan will be reported on the December 31, 20X7 balance sheet as a:

- Current asset.
- Noncurrent asset.
- Current liability.
- Noncurrent liability.

CPA-05399 Explanation

Choice "b" is correct. Big Books' pension plan is overfunded at December 31, 20X7:

$$\text{Fair value of plan assets} - \text{PBO} = \$1,800,000 - 1,740,000 = \$60,000$$

An overfunded pension plan is reported as a noncurrent asset on the balance sheet of the sponsoring company.

Choice "a" is incorrect. Per SFAS No. 158, the funded status of a pension plan is never reported as a current asset. This is a change from previous pension accounting, which required the reporting of a current asset or a current liability.

Choice "c" is incorrect. Big Books' pension plan is overfunded in 20X7, so it would not be reported as a liability. SFAS No. 158 requires that an underfunded pension plan be reported as 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.

Choice "d" is incorrect. Big Books' pension plan is overfunded in 20X7, so it would not be reported as a liability. SFAS No. 158 requires that an underfunded pension plan be reported as 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.

4. CPA-00702

Bounty Co. provides postretirement health care benefits to employees who have completed at least 10 years service and are aged 55 years or older when retiring. Employees retiring from Bounty have a median age of 62, and no one has worked beyond age 65. Fletcher is hired at 48 years old. The attribution period for accruing Bounty's expected postretirement health care benefit obligation to Fletcher is during the period when Fletcher is aged:

- a. 48 to 65
- b. 48 to 58
- c. 55 to 65
- d. 55 to 62

CPA-00702 Explanation

Definition: The "attribution period" is the period of an employee's service to which the expected postretirement benefit obligation for that employee is assigned. Generally, the beginning of the period is the employee's date of hire (unless the plan's benefit formula grants credit only for service from a later date, in which case the beginning of the attribution period is generally the beginning of that credited service period). The end of the "attribution period" is the "full eligibility date."

Choice "b" is correct, 48 to 58. Fletcher was hired at age 48, which is the beginning of the attribution period. Full eligibility is granted by this plan to employees who completed 10 years of service and are age 55 or older; therefore, Fletcher will become fully eligible at age 58.

Choice "a" is incorrect because Fletcher becomes fully eligible at age 58 rather than age 65, according to this plan.

Choices "c" and "d" are incorrect because Fletcher was hired at age 48, which is the beginning of the "attribution period," according to this plan.

5. CPA-00703

What information should be disclosed by a company providing health care benefits to its retirees?

- I. The assumed health care cost trend rate used to measure the expected cost of benefits covered by the plan.
 - II. The accumulated postretirement benefit obligation.
- a. I and II.
 - b. I only.
 - c. II only.
 - d. Neither I nor II.

CPA-00703 Explanation

Choice "a" is correct. Actuarial assumptions and the accumulated postretirement benefit obligation must be disclosed.

6. CPA-00701

An employer's obligation for postretirement health benefits that are expected to be provided to or for an employee must be fully accrued by the date the:

- a. Employee is fully eligible for benefits.
- b. Employee retires.
- c. Benefits are utilized.
- d. Benefits are paid.

CPA-00701 Explanation

Choice "a" is correct. Postretirement health benefits are accrued in a manner similar to pension benefits. The expected postretirement health benefits must be fully accrued by the date the employee is fully eligible for the benefits. The accrual will begin when the employee is hired through the eligibility (vesting) date.

Choice "b" is incorrect. The benefits are earned prior to the employee's retirement and thus must be accrued.

7. CPA-00704

Which of the following is **not** one of the liability reporting criteria for post-employment benefits under SFAS No. 112?

- a. The amount of the obligation can be reasonably estimated.
- b. The obligation relates to rights that vest or accumulate.
- c. The obligation depends upon whether the individual continues to be available for questions and assistance after employment ceases.
- d. The payment of the compensation is probable.

CPA-00704 Explanation

Choice "c" is correct.

Rule: All four of the following must be met in order to meet the reporting requirements for post-employment benefits:

- 1. The employer's obligation relating to the employees' rights to receive compensation for future absences is attributable to services already rendered.
- 2. The obligation relates to rights that vest or accumulate.
- 3. Payment of the compensation is probable.
- 4. The amount can be reasonable estimated.

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

8. CPA-00733

Ace Co. settled litigation on February 1, 2002 for an event that occurred during 2001. An estimated liability was determined as of December 31, 2001. This estimate was significantly less than the final settlement. The transaction is considered to be material. The financial statements for year-end 2001 have not been issued. How should the settlement be reported in Ace's year-end 2001 financial statements?

- a. Disclosure only of the settlement.
- b. Only an accrual of the settlement.
- c. Neither a disclosure nor an accrual.
- d. Both a disclosure and an accrual.

CPA-00733 Explanation

Choice "d" is correct. As of February 1, 2002, Ace Co.'s financial statements have not been issued and the actual amount of the final settlement is known. That amount should be included in Ace Co.'s December 31, 2001 financial statements and disclosed as a "subsequent event."

Choice "a" is incorrect. Since the amount of the settlement was known, it must be recorded as well as disclosed.

Choice "b" is incorrect. Whenever an accrual such as this is made, the details must be disclosed.

Choice "c" is incorrect. The general rule governing contingencies only permits no disclosure/no accrual when the outcome is "remote."

9. CPA-00736

During 1994, Haft Co. became involved in a tax dispute with the IRS. At December 31, 1994, Haft's tax advisor believed that an unfavorable outcome was probable. A reasonable estimate of additional taxes was \$200,000 but could be as much as \$300,000. After the 1994 financial statements were issued, Haft received and accepted an IRS settlement offer of \$275,000.

What amount of accrued liability should Haft have reported in its December 31, 1994 balance sheet?

- a. \$200,000
- b. \$250,000
- c. \$275,000
- d. \$300,000

CPA-00736 Explanation

Choice "a" is correct. A contingent liability which is probable and estimable must be recognized. If all amounts within a range of values are equally likely, then the lowest amount in the range is the measurement amount. The final settlement was unknown prior to the issuance of the financial statements, so a contingent liability of \$200,000 should have been recorded.

Choice "b" is incorrect. If all amounts within a range of values are equally likely, then the lowest amount in the range should be accrued.

Choice "c" is incorrect. The final settlement was unknown prior to the issuance of the financial statements.

Choice "d" is incorrect. If all amounts within a range of values are equally likely, then the lowest amount in the range should be accrued.

Financial Accounting & Reporting 6

Class Questions

10. CPA-00802

For the year ended December 31, 1993, Grim Co.'s pretax financial statement income was \$200,000 and its taxable income was \$150,000. The difference is due to the following:

Interest on municipal bonds	\$70,000
Premium expense on keyman life insurance	<u>(20,000)</u>
Total	<u>\$50,000</u>

Grim's enacted income tax rate is 30%. In its 1993 income statement, what amount should Grim report as current provision for income tax expense?

- a. \$45,000
- b. \$51,000
- c. \$60,000
- d. \$66,000

CPA-00802 Explanation

Choice "a" is correct, \$45,000 current provision for income tax expense (\$150,000 x 30%) representing the taxes to be paid for 1993.

Note: The items causing the difference between taxable income and financial statement income are permanent and will never reverse; therefore, no deferred tax is involved.

<u>TAX</u>		<u>F/S</u>
\$150,000		\$150,000
-0-	← Permanent →	70,000
<u>-0-</u>	← Permanent →	<u>(20,000)</u>
<u>\$150,000</u>		<u>\$200,000</u>
× 30%		× 30%
<u>\$45,000</u>	+ \$0 =	<u>\$45,000</u>

11. CPA-00843

Ram Corp. prepared the following reconciliation of income per books with income per tax return for the year ended December 31, 1989:

Book income before income taxes	\$750,000
Add temporary difference	
Construction contract revenue which will reverse in 1993	100,000
Deduct temporary difference	
Depreciation expense which will reverse in equal amounts in each of the next four years	<u>(400,000)</u>
Taxable income	<u>\$450,000</u>

Ram's effective income tax rate is 34% for 1989. What amount should Ram report in its 1989 income statement as the current provision for income taxes?

- a. \$34,000
- b. \$153,000
- c. \$255,000
- d. \$289,000

CPA-00843 Explanation

Choice "b" is correct.

<u>TAX</u>		<u>F/S</u>
	$\xleftarrow{\$400,000}$ $\xrightarrow{\quad}$	
	$\xleftarrow{(100,000)}$ $\xrightarrow{\quad}$	
\$450,000	\$300,000	\$750,000
× 34%	× 34%	
<u>\$153,000</u>	<u>\$102,000</u>	<u>\$255,000</u>

12. CPA-00782

Zeff Co. prepared the following reconciliation of its pretax financial statement income to taxable income for the year ended December 31, 1994, its first year of operations:

Pretax financial income	\$160,000
Nontaxable interest received on municipal securities	(5,000)
Long-term loss accrual in excess of deductible amount	10,000
Depreciation in excess of financial statement amount	<u>(25,000)</u>
Taxable income	<u>\$140,000</u>

Zeff's tax rate for 1994 is 40%.

In its 1994 income statement, what amount should Zeff report as income tax expense-current portion?

- a. \$52,000
- b. \$56,000
- c. \$62,000
- d. \$64,000

CPA-00782 Explanation

Choice "b" is correct. The current portion of the income tax expense equals \$56,000, income tax payable on taxable income [\$140,000 x 40%]. SFAS 109

Choice "a" is incorrect. The tax rate is applied to taxable income, not to pretax financial income less the permanent difference and tax depreciation in excess of accounting depreciation.

Choice "c" is incorrect. The tax rate is applied to taxable income, not to pretax financial income less the permanent difference.

Choice "d" is incorrect. The tax rate is applied to taxable income, not to pretax financial income.

<u>TAX</u>				<u>F/S</u>	
Income	\$160,000			Income	\$160,000
Muni	(5,000)	← Permanent →			-
Est. Loss	10,000	← (10,000) →			-
Excess Depr	<u>(25,000)</u>	← <u>25,000</u> →			-
	<u>\$140,000</u>	\$15,000			<u>\$160,000</u>
	<u>× 40%</u>				
	<u>\$ 56,000</u>	+	<u>\$ 6,000</u>	=	<u>\$ 62,000</u>

13. CPA-00783

Zeff Co. prepared the following reconciliation of its pretax financial statement income to taxable income for the year ended December 31, 1994, its first year of operations:

Pretax financial income	\$160,000
Nontaxable interest received on municipal securities	(5,000)
Long-term loss accrual in excess of deductible amount	10,000
Depreciation in excess of financial statement amount	<u>(25,000)</u>
Taxable income	<u>\$140,000</u>

Zeff's tax rate for 1994 is 40%.

In its December 31, 1994, balance sheet, what should Zeff report as deferred income tax liability?

- a. \$2,000
- b. \$4,000
- c. \$6,000
- d. \$8,000

CPA-00783 Explanation

Choice "c" is correct. The deferred income tax liability equals the 40% tax rate times \$15,000 future taxable amount computed as the net of the future taxable amounts [\$25,000 depreciation] and the future deductible amounts [\$10,000]. SFAS 109

<u>TAX</u>				<u>F/S</u>	
Income	\$160,000			Income	\$160,000
Muni	(5,000)	← Permanent →			-
Est. Loss	10,000	← (10,000) →			-
Excess Depr	<u>(25,000)</u>	← 25,000 →			-
	<u>\$140,000</u>	\$15,000			<u>\$160,000</u>
	× 40%				
	<u>\$ 56,000</u>	+			

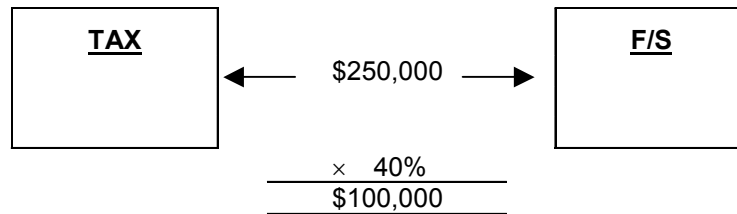
14. CPA-00785

As a result of differences between depreciation for financial reporting purposes and tax purposes, the financial reporting basis of Noor Co.'s sole depreciable asset, acquired in 1994, exceeded its tax basis by \$250,000 at December 31, 1994. This difference will reverse in future years. The enacted tax rate is 30% for 1994, and 40% for future years. Noor has no other temporary differences. In its December 31, 1994, balance sheet, how should Noor report the deferred tax effect of this difference?

- a. As an asset of \$75,000.
- b. As an asset of \$100,000.
- c. As a liability of \$75,000.
- d. As a liability of \$100,000.

CPA-00785 Explanation

Choice "d" is correct, as a deferred tax liability of \$100,000, since tax depreciation exceeds book depreciation.



15. CPA-00781

On its December 31, 1994, balance sheet, Shin Co. had income taxes payable of \$13,000 and a current deferred tax asset of \$20,000 before determining the need for a valuation account. Shin had reported a current deferred tax asset of \$15,000 at December 31, 1993. No estimated tax payments were made during 1994. At December 31, 1994, Shin determined that it was more likely than not that 10% of the deferred tax asset would not be realized. In its 1994 income statement, what amount should Shin report as total income tax expense?

- a. \$8,000
- b. \$8,500
- c. \$10,000
- d. \$13,000

CPA-00781 Explanation

Choice "c" is correct. Total income tax expense for 1994:

	<u>Tax</u> <u>Return</u> \$	← Temporary Differences →	<u>Financial</u> <u>Statement</u> \$
	× Tax Rate	× Enacted Tax Rate	
Total		\$ 20,000	
Allowance		< 2,000 >	
Net Ending		\$ 18,000	
Beginning		< 15,000 >	
	\$13,000	\$ 3,000	= \$10,000

Financial Accounting & Reporting 6

Class Questions

16. CPA-00791

Thorn Co. applies Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes. At the end of 1993, the tax effects of temporary differences were as follows:

	<i>Deferred tax assets (liabilities)</i>	<i>Related asset classification</i>
Accelerated tax depreciation	(\$75,000)	Noncurrent asset
Additional costs in inventory for tax purposes	<u>25,000</u>	Current asset
	<u><u>(\$50,000)</u></u>	

A valuation allowance was not considered necessary. Thorn anticipates that \$10,000 of the deferred tax liability will reverse in 1994. In Thorn's December 31, 1993, balance sheet, what amount should Thorn report as noncurrent deferred tax liability?

- a. \$40,000
- b. \$50,000
- c. \$65,000
- d. \$75,000

CPA-00791 Explanation

Choice "d" is correct, \$75,000 noncurrent deferred tax liability (based on classification of related asset as noncurrent).

17. CPA-00789

Mobe Co. reported the following operating income (loss) for its first three years of operations:

1992	\$ 300,000
1993	(700,000)
1994	1,200,000

For each year, there were no deferred income taxes (before 1992), and Mobe's effective income tax rate was 30%. In its 1993 income tax return, Mobe elected the two year carry back of the loss. In its 1994 income statement, what amount should Mobe report as total income tax expense?

- a. \$120,000
- b. \$150,000
- c. \$240,000
- d. \$360,000

CPA-00789 Explanation

Choice "d" is correct, \$360,000 total income tax expense for 1994.

1993

DR:	Inc. Tax Refund Rec. (\$300,000 × 30%)	\$90,000	
DR:	Deferred Tax Asset (\$400,000 × 30%)	120,000	
CR:	Income Tax Benefit		\$210,000

1994

<u>TAX</u> \$1,200,000 NOL <u>(400,000)</u> <u>\$ 800,000</u> × 30% <u>\$ 240,000</u>	Beg: \$400,000 ← (400,000) → <u>-0-</u> × 30% End: <u>-0-</u> Beg: <u>120,000</u> + <u>\$120,000</u> = <u>\$360,000</u>	<u>I/S</u> \$1,200,000 <u> </u> <u>\$1,200,000</u>
--	--	--

DR:	Income Tax Expense	\$360,000	
CR:	Income Tax Payable		\$240,000
CR:	Deferred Tax Asset		120,000

1. CPA-00929

Whether recognized or unrecognized in an entity's financial statements, disclosure of the fair values of the entity's financial instruments is required when:

- a. It is practicable to estimate those values.
- b. The entity maintains accurate cost records.
- c. Aggregated fair values are material to the entity.
- d. Individual fair values are material to the entity.

CPA-00929 Explanation

Choice "a" is correct. Fair value must be disclosed for all financial instruments for which it is practicable to estimate that VALUE, together with the related carrying amounts showing clearly whether the amounts represent assets or liabilities.

2. CPA-00943

A derivative designated as a fair value hedge must be:

- I. Specifically identified to the hedged asset, liability or unrecognized firm commitment.
 - II. Expected to be highly effective in offsetting changes in the fair value of the hedged item.
- a. I only.
 - b. II only.
 - c. Both I and II.
 - d. Neither I nor II.

CPA-00943 Explanation

Choice "c" is correct. Both I and II. A derivative may be designated and qualify as a fair value hedge if a set of criteria relating to the derivative and the hedged item are met. The most significant criteria are:

- 1. There is formal documentation of the hedging relationship between the derivative and the hedged item.
- 2. The hedge must be expected to be highly effective in offsetting changes in the fair value of the hedged item and the effectiveness is assessed at least every 3 months.
- 3. The hedged item is specifically identified.
- 4. The hedged item presents exposure to changes in fair value that could affect income.

3. CPA-00974

Selected information from the accounts of Row Co. at December 31, 1995, follows:

Total income since incorporation	\$420,000
Total cash dividends paid	130,000
Total value of property dividends distributed	30,000
Excess of proceeds over cost of Treasury stock sold, accounted for using the cost method	110,000

In its December 31, 1995, financial statements, what amount should Row report as retained earnings?

- a. \$260,000
- b. \$290,000
- c. \$370,000
- d. \$400,000

CPA-00974 Explanation

Choice "a" is correct. Look at each item given and decide how it affects retained earnings: income since incorporation equals unadjusted ending retained earnings (RE), that is, current year income is included; cash dividends is a direct deduction from RE on the date of declaration; property dividends are deducted from RE at market value on the date of declaration; the excess proceeds from the sale of Treasury stock is considered additional paid-in capital. Thus, ending RE = unadj. RE – cash dividends – property dividends = \$420,000 – \$130,000 – \$30,000 = \$260,000

Choice "b" is incorrect. This amount does not include the effect of the property dividends. Property dividends are deducted from RE at market value on the date of declaration.

Choice "c" is incorrect. This amount incorrectly includes the proceeds from the sale of the Treasury stock. The cost method of accounting for Treasury stock affects retained earnings only if the shares are sold below cost and the difference exceeds any additional paid-in capital from Treasury stock.

Choice "d" is incorrect. This amount omits property dividends and incorrectly includes the proceeds from the sale of the Treasury stock. Property dividends are deducted from RE at market value on the date of declaration. Treasury stock sold in excess of cost does *not* affect retained earnings.

4. CPA-00982

Asp Co. was organized on January 2, 1994, with 30,000 authorized shares of \$10 par common stock. During 1994 the corporation had the following capital transactions:

January 5 - Issued 20,000 shares at \$15 per share.

July 14 - Purchased 5,000 shares at \$17 per share.

December 27 - Reissued the 5,000 shares held in Treasury at \$20 per share.

Asp used the par value method to record the purchase and reissuance of the treasury shares. In its December 31, 1994, balance sheet, what amount should Asp report as additional paid-in capital?

- a. \$100,000
- b. \$125,000
- c. \$140,000
- d. \$150,000

CPA-00982 Explanation

Choice "b" is correct.

Jan. 5 ISSUED 20,000 sh, \$10 par at \$15

Dr.	Cash	300,000	
	[\$15/sh × 20,000]		
	Cr.		
	Common stock		200,000
	Cr.		
	APIC		100,000
	[\$5/sh × 20,000 sh]		

July 14 PURCHASE OF TREASURY STOCK

5,000 shares at \$17 = \$85,000

Dr.	Treasury stock	50,000	
	[\$10 par × 5,000 sh]		
Dr.	APIC	25,000	
	[\$5 orig APIC/sh 5,000 sh]		
Dr.	Retained earnings	10,000	
	[\$85,000 – 50,000 – 25,000]		
	Cr.		
	Cash		85,000

Dec 27 TREASURY STOCK REISSUANCE

5,000 sh at \$20 = \$100,000

Dr.	Cash	100,000	
	Cr.		
	Treasury stock		50,000
	[\$10 par × 5,000 sh]		
	Cr.		
	APIC		50,000
	[5,000 sh × (\$20/sh – \$10 par)]		

APIC: \$100,000 – 25,000 + 50,000 = \$125,000

Choice "a" is incorrect. APIC from the issuance of stock on Jan. 5 equals \$100,000.

Choice "c" is incorrect. APIC of \$140,000 erroneously includes the debit of \$10,000 to Retained Earnings rather than the \$25,000 debit to APIC when the treasury stock is purchased on July 14.

Choice "d" is incorrect. APIC of \$150,000 ignores the July 14 purchase of 5,000 shares of Treasury stock at \$17 per share [(\$17 purchase price – \$10 par – \$2 excess of purchase price over issue price) times 5,000 shares = \$25,000]. APIC must be reduced by \$25,000 for the July 14 purchase. The \$5 per share is the amount that originally "hit" APIC when the shares were originally issued.

5. CPA-00970

Plack Co. purchased 10,000 shares (2% ownership) of Ty Corp. on February 14, 2001. Plack received a stock dividend of 2,000 shares on April 30, 2001, when the market value per share was \$35. Ty paid a cash dividend of \$2 per share on December 15, 2001. In its 2001 income statement, what amount should Plack report as dividend income?

- a. \$20,000
- b. \$24,000
- c. \$90,000
- d. \$94,000

CPA-00970 Explanation

Choice "b" is correct.

$$\begin{aligned}\text{Dividend Income} &= \text{No. of shares} \times \text{dividend per share} \\ &= 12,000 \times \$2 \\ &= \$24,000\end{aligned}$$

Receipt of a stock dividend is not revenue. It increases the number of shares held and decreases the cost basis per share.

6. CPA-01033

On January 2, 2004, Kine Co. granted Morgan, its president, compensatory stock options to buy 1,000 shares of Kine's \$10 par common stock. The options call for a price of \$20 per share and are exercisable for 3 years following the grant date. Morgan exercised the options on December 31, 2004. The market price of the stock was \$45 on January 2, 2004, and \$70 on December 31, 2004. Using an acceptable options pricing model, Morgan determined that the fair value of the options granted was \$30,000. By what net amount should stockholders' equity increase as a result of the grant and exercise of the options?

- a. \$20,000
- b. \$30,000
- c. \$50,000
- d. \$70,000

CPA-01033 Explanation

Compensation cost should be charged to expense over the service period. In this problem, since the options are exercised in the same period as the grant date, the total compensation cost must be charged to expense in year 2004.

Jan 2, 2004 (when options granted)

	<u>DR</u>	<i>Effect on Stockholders'</i> <u>CR</u>	<u>Equity</u>
Compensation expense*	30,000		(30,000)
Paid-in capital-stock-options-outstanding		30,000	30,000

Dec 31, 2004 (when options exercised)

Cash (\$20 × 1,000)	20,000		
Paid-in capital-stock-options-outstanding	30,000		(30,000)
Common stock at par (\$10 × 1,000)		10,000	10,000
Paid in capital in excess of par (squeeze)		40,000	<u>40,000</u>
Net effect on stockholders' equity			<u>20,000</u>

Choice "a" is correct. \$20,000 increase in stockholders' equity.

* Note: A charge to expense lowers retained earnings.

7. CPA-01200

On December 1, 20X3, Clay Co. declared and issued a 6% stock dividend on its 100,000 shares of outstanding common stock. There was no other common stock activity during 20X3. What number of shares should Clay use in determining basic earnings per share for 20X3?

- a. 100,000
- b. 100,500
- c. 103,000
- d. 106,000

7. CPA-01200

Choice "d" is correct. A 6% stock dividend equals 6,000 shares with a total of 106,000 shares outstanding after the distribution of the dividend. Stock dividends and stock splits require restatement of the shares outstanding before the stock dividend or stock split. Thus, the stock dividend would be treated as if it had occurred at the beginning of the fiscal year. SFAS 128

Choice "a" is incorrect. This calculation ignores the fact that 6,000 shares were issued due to the stock dividend.

Choice "b" is incorrect. In this calculation, the stock dividend shares are weighted for the one month in which they were outstanding. However, stock dividends are treated as if it had occurred at the beginning of the fiscal year.

Choice "c" is incorrect. Stock dividends are treated as if it had occurred at the beginning of the fiscal year.

8. CPA-01198

Ute Co. had the following capital structure during 19X3 and 19X4:

Preferred stock, \$10 par, 4% cumulative, 25,000 shares issued and outstanding	\$ 250,000
Common stock, \$5 par, 200,000 shares issued and outstanding	1,000,000

Ute reported net income of \$500,000 for the year ended December 31, 19X4. Ute paid no preferred dividends during 19X3 and paid \$16,000 in preferred dividends during 19X4. In its December 31, 19X4, income statement, what amount should Ute report as basic earnings per share?

- a. \$2.42
- b. \$2.45
- c. \$2.48
- d. \$2.50

CPA-01198 Explanation

Choice "b" is correct. \$2.45 earnings per share.

	<u>19X3</u>	<u>19X4</u>
Net income	?	\$ 500,000
Less: Cumulative preferred		
Stock dividend "requirement" (\$10 par × 25,000 shs × 4%)	<u>(10,000)</u>	<u>(10,000)</u>
Income available to common shares		490,000
Divide by average common shares O/S		÷ <u>200,000</u>
Basic earnings per common share		<u>\$ 2.45</u>

Note: Since the preferred stock dividends are cumulative, when they are declared or paid is not relevant.

Class Questions

9. CPA-01199

West Co. had earnings per share of \$15.00 for 20X2 before considering the effects of any convertible securities. No conversion or exercise of convertible securities occurred during 20X2. However, possible conversion of convertible bonds would have reduced earnings per share by \$0.75. The effect of possible exercise of common stock options would have increased earnings per share by \$0.10. What amount should West report as diluted earnings per share for 20X2?

- a. \$15.00
- b. \$14.35
- c. \$14.25
- d. \$15.10

CPA-01199 Explanation

Choice "c" is correct. \$14.25 diluted earnings per share.

	Basic EPS	Diluted EPS
EPS before the effect of any convertibles	\$15.00	\$15.00
Possible conversion of bonds	<u>—</u>	<u>(.75)</u>
Diluted earnings per share for 20X2	<u>\$15.00</u>	<u>\$14.25</u>

Note: The possible exercise of common stock options would increase EPS by \$0.10, so they are not used due to the anti-dilution rule. Each potentially dilutive security is considered separately for its dilutive effect.

10. CPA-01224

In preparing its cash flow statement for the year ended December 31, 1994, Reve Co. collected the following data:

Gain on sale of equipment	\$ (6,000)
Proceeds from sale of equipment	10,000
Purchase of A.S., Inc. bonds (par value \$200,000)	(180,000)
Amortization of bond discount	2,000
Dividends declared	(45,000)
Dividends paid	(38,000)
Proceeds from sale of Treasury stock (carrying amount \$65,000)	75,000

In its December 31, 1994, statement of cash flows, what amount should Reve report as net cash used in investing activities?

- a. \$170,000
- b. \$176,000
- c. \$188,000
- d. \$194,000

CPA-01224 Explanation

Choice "a" is correct. Investing activities include acquisitions and sales of long-term assets or investment assets. Cash used equals \$170,000 (\$180,000 paid less \$10,000 received from the sale of the equipment). SFAS 95 para. 15

11. CPA-01226

In preparing its cash flow statement for the year ended December 31, 1994, Reve Co. collected the following data:

Gain on sale of equipment	\$ (6,000)
Proceeds from sale of equipment	10,000
Purchase of A.S., Inc. bonds (par value \$200,000)	(180,000)
Amortization of bond discount	2,000
Dividends declared	(45,000)
Dividends paid	(38,000)
Proceeds from sale of Treasury stock (carrying amount \$65,000)	75,000

In its December 31, 1994, statement of cash flows, what amount should Reve report as net cash provided by financing activities?

- a. \$20,000
- b. \$27,000
- c. \$30,000

CPA-01226 Explanation

Cash provided by financing activities:

Dividends paid	(38,000)
Proceeds from sale of Treasury stock	<u>75,000</u>
Net cash provided by financing activities	<u>37,000</u>

Choice "d" is correct. \$37,000. Financing activities include obtaining resources from owners and providing them with a return on, and a return of, their investment; borrowing money and repaying amounts borrowed. Dividends paid, not dividends declared, should be included as an outflow of cash from financing activities.

1. CPA-00888

Which of the following lead(s) to the use of fund accounting by a governmental organization?

	<u>Financial Control</u>	<u>Legal Restrictions</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

CPA-00888 Explanation

Choice "a" is correct. Fund accounting enables service and mission-driven organizations to easily monitor compliance with spending purpose (restrictions), spending limits (budget and financial control), and other fiscal accountability objectives.

2. CPA-00892

Which of the following characteristics of service efforts and accomplishments is the most difficult to report for a governmental entity?

- a. Comparability.
- b. Timeliness.
- c. Consistency.
- d. Relevance.

CPA-00892 Explanation

Choice "d" is correct. Relevance means the information must bear a logical relationship with the needs for its purpose. It must also be reliable. This objective is more difficult to report than it is to adhere to consistency in the application of GAAP, which enhances comparability. Timeliness requires reports being issued early enough to facilitate timely decisions.

3. CPA-00889

In complying with GASB #34, a government will present separate fund financial statements for its governmental and proprietary funds. The purpose of this presentation is to:

- a. Demonstrate compliance with legal, regulatory or other budgetary compliance features of the government's administration of its finances.
- b. Report additional and detailed information about the primary government.
- c. Provide internal transfer pricing data regarding individual internal service funds.
- d. Document the prioritization of general revenue allocations.

CPA-00889 Explanation

Rule: Separate fund financial statements should be presented for governmental and proprietary funds to report additional and detailed information about the primary government.

Choice "b" is correct. Fund financial statements are displayed to report additional and detailed information about the primary government.

Choice "a" is incorrect. Budget comparisons are presented as required supplementary information, not in the fund financial statements.

Choice "c" is incorrect. Internal Service funds are presented in summary in the fund financial statements.

Choice "d" is incorrect. Prioritization of general revenue distributions is displayed in the Statement of Activities in the government-wide financial statements.

4. CPA-00891

The economic resources measurement focus and accrual basis of accounting would be most appropriate for which fund as used in the fund financial statements?

- a. General Fund.
- b. Permanent Fund.
- c. Internal Service Fund.
- d. Capital Projects Fund.

CPA-00891 Explanation

Choice "c" is correct. The Internal Service Fund's fund financial statement would be prepared using an economic resources measurement focus and the accrual basis of accounting. The governmental funds, which include the General Fund, Permanent Fund and Capital Projects Fund, would be prepared using the current financial resources measurement focus and the modified accrual basis of accounting.

Not "a", "b", or "d", per above.

5. CPA-00890

Which funds would most appropriately use the current financial resources measurement focus and modified accrual basis of accounting in their fund financial statements:

	<u>Governmental</u>	<u>Proprietary</u>	<u>Fiduciary</u>
a.	Yes	No	Yes
b.	No	Yes	Yes
c.	Yes	No	No
d.	Yes	Yes	Yes

CPA-00890 Explanation

Choice "c" is correct. Governmental funds use the current financial resources measurement focus and modified accrual basis of accounting in their fund financial statements. Proprietary and Fiduciary Funds use the economic resources measurement focus and accrual basis of accounting.

Not "a", "b", or "d", per above.

6. CPA-00962

Ridge Township's governing body adopted its general fund budget for the year ended July 31, 1994, comprised of estimated revenues of \$100,000 and appropriations of \$80,000. Ridge formally integrates its budget into the accounting records.

To record the appropriations of \$80,000, Ridge should:

- a. Credit appropriations control.
- b. Debit appropriations control.
- c. Credit estimated expenditures control.
- d. Debit estimated expenditures control.

CPA-00962 Explanation

Choice "a" is correct. To record the budget, the journal entry would be:

Estimated Revenues	100,000	
Appropriations		80,000
Budgetary Fund Balance		20,000

Choice "b" is incorrect. Appropriations is credited, not debited.

Choice "c" is incorrect. Estimated Expenditures Control is not an appropriate account title.

Choice "d" is incorrect. Estimated Expenditures Control is not an appropriate account title. In addition, the \$80,000 would be credited, not debited.

7. CPA-00964

Ridge Township's governing body adopted its general fund budget for the year ended July 31, 1994, comprised of estimated revenues of \$100,000 and appropriations of \$80,000. Ridge formally integrates its budget into the accounting records.

To record the \$20,000 budgeted excess of estimated revenues over appropriations, Ridge should:

- a. Credit estimated excess revenues control.
- b. Debit estimated excess revenues control.
- c. Credit budgetary fund balance.
- d. Debit budgetary fund balance.

CPA-00964 Explanation

Choice "c" is correct. To record the budget, the journal entry would be:

Estimated Revenues	100,000	
Appropriations		80,000
Budgetary Fund Balance		20,000

Choice "a" is incorrect. Estimated Excess Revenues Control is not an appropriate account title.

Choice "b" is incorrect. Estimated Excess Revenues Control is not an appropriate account title. In addition, the \$20,000 is credited, not debited.

Choice "d" is incorrect. Budgetary Fund Balance would be credited, not debited.

8. CPA-04553

The budget of a governmental unit, for which the appropriations exceed the estimated revenues, was adopted and recorded in the general ledger at the beginning of the year. During the year, expenditures and encumbrances were less than appropriations; whereas revenues equaled estimated revenues. The budgetary fund balance account is:

- a. Credited at the beginning of the year and debited at the end of the year.
- b. Credited at the beginning of the year and not changed at the end of the year.
- c. Debited at the beginning of the year and credited at the end of the year.
- d. Debited at the beginning of the year and not changed at the end of the year.

CPA-04553 Explanation

Choice "c" is correct. When appropriations exceed estimated revenues at the beginning of the year (per JE #1 below), and then expenditures and encumbrances are less than appropriations (per JE #2 below) the budgetary fund balance account is debited at the beginning of the year (per JE #1 below) and credited at the end of the year (per JE #2 below):

		<u>DR</u>	<u>CR</u>
JE #1	Estimated revenues	5,000,000	
	Budgetary fund balance	1,000,000	
	Appropriations control		6,000,000
JE #2	Estimated revenues	5,000,000	
	Appropriations control	6,000,000	
	Budgetary fund balance		1,000,000

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

9. CPA-00907

Both Curry City and the State have a general sales tax on all merchandise. Curry City's tax rate is 2 percent and the State's rate is 4 percent. Merchants are required by law to remit all sales tax collected each month to the State by the 15th of the following month. By law, the State has 45 days to process the collections and to make disbursements to the various jurisdictions for which it acts as an agent. Sales tax collected by merchants in Curry total \$450,000 in May and \$600,000 in June. Both merchants and the State make remittances in accordance with statutes. What amount of sales tax revenue for May and June is included in the June 30 year-end financial statements of the State and Curry?

	<u>State</u>	<u>Curry</u>
a. \$1,050,000	\$0	
b. \$1,050,000	\$350,000	
c. \$700,000	\$350,000	
d. \$300,000	\$150,000	

CPA-00907 Explanation

Choice "c" is correct. Under the modified accrual basis of accounting, sales tax revenue is recognized when it is measurable and available. Measurable is defined as a known amount while available is defined as collected during the period or shortly thereafter (typically within 60 days of period end). As illustrated below, the amounts collected meet the definition of measurable and available for both the State and Curry City. The allocation of the dollars is one-third (2/6) and two-thirds (4/6) of total remittances.

<u>Date</u>	<u>Tax Receipts/ Remittances</u>		<u>Merchant Sales</u>	<u>Explanation</u>
	<u>Curry City 2%</u>	<u>State 4%</u>		
May 31			7,500,000	Sales are reported (derived from question for illustration)
June 15		450,000		Taxes are received by the state from merchants by the 15th (given)
June 30			10,000,000	Sales are reported (derived from question for illustration)
July 15		600,000		Taxes are received by the state from merchants by the 15th (given)
July 30	150,000	(150,000)		State remits Curry's 2% share of May's total 6% tax in 45 days from 6/15 (given)
August 29	200,000	(200,000)		State remits Curry's 2% share of June's total 6% tax in 45 days from 7/15 (given)
August 30	_____	_____		Sixty days from 6/30 (criteria for available)
Total	<u>\$350,000</u>	<u>\$700,000</u>		

Choice "a" is incorrect. The total remittances alone do not represent the tax revenues.

Choice "b" is incorrect. The total remittances and the portion of May associated with City tax levies do not represent the tax revenues.

Choice "d" is incorrect. The collections exclusively associated with May revenues are not the total tax revenues to be recognized by the City and the State.

10. CPA-00955

When a snowplow purchased by a governmental unit is received, it should be recorded in the general fund as a(an):

- a. Encumbrance.
- b. Expenditure.
- c. Capital Asset.
- d. Appropriation.

CPA-00955 Explanation

Choice "b" is correct. Expenditures are decreases in net financial resources other than through interfund transfers. General fixed assets, such as land, buildings, and equipment, purchased with general fund resources should be recorded as expenditures in the general fund. The journal entry is:

Expenditures	XXX	
Vouchers payable		XXX

Choice "a" is incorrect. Encumbrances are recorded when resources are committed for future expenditures, not when goods and services are received.

Choice "c" is incorrect. Since the measurement focus of governmental funds is the flow of financial resources, non-financial resources and obligations are not recorded in the general fund. The snowplow should be recorded as a capital asset in the governmental activities column of the government-wide statement of net assets.

Choice "d" is incorrect. Appropriations represents the total authorized expenditures for a current fiscal period. Appropriations are recorded when the budget is formally integrated into the accounting system.

11. CPA-00940

Which account should Spring Township credit when it issues a purchase order for supplies?

- a. Appropriations control.
- b. Vouchers payable.
- c. Encumbrance control.
- d. Reserve for encumbrances.

CPA-00940 Explanation

Choice "d" is correct. A purchase order is a binding document and thus is recorded when issued. The journal entry made when a purchase order is issued is:

Encumbrances	XXX	
Reserve for Encumbrances		XXX

Choice "a" is incorrect. Appropriations control is credited when the budget is set up, not when a purchase order is issued.

Choice "b" is incorrect. Vouchers payable is credited when goods are received.

Choice "c" is incorrect. Encumbrance control is credited when goods are received and fund balance reserved for encumbrances is debited.

12. CPA-00969

Elm City issued a purchase order for supplies with an estimated cost of \$5,000. When the supplies were received, the accompanying invoice indicated an actual price of \$4,950. What amount should Elm debit (credit) to the reserve for encumbrances after the supplies and invoice were received?

- a. (\$50)
- b. \$50
- c. \$4,950
- d. \$5,000

CPA-00969 Explanation

Choice "d" is correct. After the supplies and invoice are received, Elm should debit the Reserve for Encumbrances account for the same \$5,000 estimated amount that the account was credited when the purchase order was issued. The journal entries would be:

- When the purchase order was issued -

Encumbrances (estimated)	5,000	
Reserve for Encumbrances		5,000
- When the supplies and invoice are received -

Reserve for encumbrances	5,000	
Encumbrances		5,000
Expenditures (actual)	4,950	
Vouchers payable		4,950

Choice "a" is incorrect. The Reserve for Encumbrances is debited for the same estimated amount that it was originally credited for when the purchase order was issued. Do *not* take the difference between the estimated amount and the actual amount.

Choice "b" is incorrect. The Reserve for Encumbrances is debited for the same estimated amount that it was originally credited for when the purchase order was issued. Do *not* take the difference between the estimated amount and the actual amount.

Choice "c" is incorrect. The \$4,950 is the actual invoice amount. The Reserve for Encumbrances is debited for the estimated amount.

13. CPA-00935

The revenues control account of a governmental unit is increased when:

- a. The encumbrance account is decreased.
- b. Appropriations are recorded.
- c. Property taxes are recorded.
- d. The budget is recorded.

CPA-00935 Explanation

Choice "c" is correct. When property taxes are levied, the following journal entry is made:

Property taxes receivable	XXX	
Allowance for uncollectible property taxes		XXX
Revenues		XXX

Thus, revenue control account is increased when property taxes are levied.

Choice "a" is incorrect. When the encumbrance account is decreased, the following entry is made:

Reserve for encumbrances	XXX	
Encumbrances		XXX

Thus, revenue control account is not affected.

Choice "b" is incorrect. When appropriations are recorded, the following entry is made:

Fund balance	XXX	
Appropriations		XXX

This is part of the budget entry, revenue control account is not affected.

Choice "d" is incorrect. When the budget is recorded, the following entry is made:

Estimated revenues	XXX	
Appropriations		XXX
Fund balance		XXX

This is part of the budget entry; revenue control account is not affected.

14. CPA-00908

When a purchase order is released, a commitment is made by a governmental unit to buy a computer to be manufactured to specifications for use in property tax administration. This commitment should be recorded in the general fund as a (an):

- a. Appropriation.
- b. Encumbrance.
- c. Expenditure.
- d. Fixed asset.

CPA-00908 Explanation

Choice "b" is correct. Governmental funds use modified accrual accounting. Under modified accrual accounting, the issuing of a purchase order (commitment to purchase) is recorded as:

DR	Encumbrance	\$	
CR	Reserve for encumbrance		\$

Choice "a" is incorrect. The issue of a purchase order will not impact appropriations. Appropriation accounts are adjusted upon the adoption or amendment of the budget and are closed at the end of the year.

Choice "c" is incorrect. The issue of a purchase order will not impact expenditures. Expenditure accounts are adjusted when obligations are incurred or paid and when accounts are closed at the end of a fiscal period.

Choice "d" is incorrect. The issuance of a purchase order results in an encumbrance transaction in governmental funds. In addition, fixed assets are not recorded in governmental funds.

15. CPA-00996

Which of the following funds of a governmental unit uses the same basis of accounting as the special revenue fund?

- a. Enterprise funds.
- b. Internal service funds.
- c. Private purpose fund.
- d. Permanent fund.

CPA-00996 Explanation

Choice "d" is correct. The special revenue fund is a governmental fund, which uses modified accrual accounting (revenues are record when measurable and available). The permanent fund also uses modified accrual accounting.

Choice "a" is incorrect. The enterprise fund is a proprietary fund and uses full accrual accounting.

Choice "b" is incorrect. The internal service fund is a proprietary fund and uses full accrual accounting.

Choice "c" is incorrect. The private purpose fund is a fiduciary fund and uses full accrual accounting.

16. CPA-01000

The debt service fund of a governmental unit is used to account for the accumulation of resources for, and the payment of, principal and interest in connection with a:

	<u>Fiduciary Fund</u>	<u>Proprietary Fund</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

CPA-01000 Explanation

Choice "a" is correct. The debt service fund services general debt. Both fiduciary funds and proprietary funds record their own long-term liabilities and service their own debt.

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

17. CPA-00997

It is inappropriate to record depreciation expense in a(an):

- a. Enterprise fund.
- b. Internal service fund.
- c. Private purpose trust fund.
- d. Capital projects fund.

CPA-00997 Explanation

Choice "d" is correct. The capital projects fund is a governmental fund. The measurement focus of governmental funds is the flow of financial resources. Since depreciation expense does not reflect the use of financial resources, it is not recorded in the capital projects fund.

Choice "a" is incorrect. An enterprise fund is a proprietary fund that uses full accrual accounting and has capital maintenance as its measurement focus. Such funds record depreciation expense.

Choice "b" is incorrect. An internal service fund is a proprietary fund that uses full accrual accounting and has capital maintenance as its measurement focus. Such funds record depreciation expense.

Choice "c" is incorrect. A private purpose trust fund is a fiduciary fund that uses full accrual accounting and has capital maintenance as its measurement focus. Such funds record depreciation expense.

18. CPA-01029

The billings for transportation services provided to other governmental units are recorded by the internal service fund as:

- a. Transportation appropriations.
- b. Operating revenues.
- c. Interfund exchanges.
- d. Inter-governmental transfers.

CPA-01029 Explanation

Choice "b" is correct. Billings for transportation services provided to other governmental units are considered quasi-external transactions and are treated as revenues by the internal service fund. The journal entry is as follows:

Due from other funds	XXX	
Operating revenues		XXX

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

19. CPA-01032

Cy City's Municipal Solid Waste Landfill Enterprise Fund was established when a new landfill was opened January 3, 1994. The landfill is expected to close December 31, 2015. Cy's 1994 expenses would include a portion of which of the year 2016 expected disbursements?

- I. Cost of a final cover to be applied to the landfill.
- II. Cost of equipment to be installed to monitor methane gas buildup.
- a. I only.
- b. II only.
- c. Both I and II.
- d. Neither I nor II.

CPA-01032 Explanation

Choice "c" is correct. Municipal Solid Waste Landfills (MSWLF) owners and operators are required to incur a variety of costs to provide for protection of the environment both during the period of landfill operations and during the postclosure period. The estimated total current cost of MSWLF closure and postclosure care, based upon applicable federal state or local laws or regulations should include:

- a. Cost of equipment expected to be installed and facilities expected to be constructed near or after the date that the MSWLF stops accepting solid waste and during the post closure period. This equipment should be limited to items that, once installed or constructed, will be exclusively used for the MSWLF. This may include gas monitoring and collection systems.
- b. Cost of final cover (capping) expected to be applied near or after the date that the MSWLF stops accepting solid waste.

20. CPA-01040

A state government had the following activities:

- I. State-operated lottery \$10,000,000
- II. State-operated hospital 3,000,000

Which of the above activities should be most likely accounted for in an enterprise fund?

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

CPA-01040 Explanation

Choice "d" is correct. An enterprise fund is used to account for the provision of goods and services 1) that are financed mainly by user charges, or 2) for which the determination of periodic income is appropriate. Both a state-operated lottery and a state-operated hospital are financed mainly by user charges. In addition, the determination of periodic income might be useful for both activities.

21. CPA-01067

Fish Road property owners in Sea County are responsible for special assessment debt that arose from a storm sewer project. If the property owners default, Sea has no obligation regarding debt service, although it does bill property owners for assessments and uses the monies it collects to pay debt holders. What fund type should Sea use to account for these collection and servicing activities?

- a. Agency.
- b. Debt service.
- c. Private purpose funds.
- d. Capital projects.

CPA-01067 Explanation

Choice "a" is correct. The debt service transactions of a special assessment issue for which the government is not obligated in any manner should be reported in an agency fund rather than a debt service fund to reflect the fact that the government's duties are limited to acting as an agent for the assessed property owners and bondholders.

Choice "b" is incorrect. The debt service fund would service the debt for special assessments where the government is obligated in some manner, which is not the case here.

Choice "c" is incorrect. Expendable trust funds would not be used for special assessment projects.

Choice "d" is incorrect. The capital project fund would account for the project inflows and outflows where the government is obligated in some manner, which is not the case here.

22. CPA-01082

Arlen City's accounts contained the following cash balances at December 31, 1992:

Under the Forfeiture Act-cash confiscated from illegal activities; disbursements can be used only for law enforcement activities	\$300,000
Sales taxes collected by Arlen to be distributed to other governmental units	500,000

What amount of cash should Arlen report in its private purpose trust funds at December 31, 1992?

- a. \$0
- b. \$300,000
- c. \$500,000
- d. \$800,000

CPA-01082 Explanation

Choice "a" is correct. The \$300,000 should be reported in a special revenue fund since the government is agreeing to accept cash and spend it in a specified way and the \$500,000 belongs in an agency fund. Escheat property held for individuals, private organizations, or another government should be reported in a private trust fund, or in the governmental or proprietary fund in which otherwise reported.

Choice "b" is incorrect. The \$300,000 results from the government's agreement to accept resources and to spend them in a specified way (i.e. law enforcement activities). This is an example of a special revenue fund.

Choice "c" is incorrect. The \$500,000 belongs in an agency fund since Arlen is collecting sales taxes to be remitted to other governmental units.

Choice "d" is incorrect. The \$500,000 belongs in an agency fund since Arlen is collecting sales taxes to be remitted to other governmental units.

1. CPA-00975

The statement of activities of the government-wide financial statements is designed primarily to provide information to assess which of the following?

- a. Operational accountability.
- b. Financial accountability.
- c. Fiscal accountability.
- d. Functional accountability.

CPA-00975 Explanation

Rule: The focus of government-wide financial statements is the government's responsibility to report the extent to which they have met their operating objectives efficiently and effectively, using all resources available for that purpose, and the extent to which they can continue to meet their objectives for the future.

Choice "a" is correct. Government-wide financial statements focus on operational accountability per above rule.

Choice "b" is incorrect. Although all financial statements serve to demonstrate financial accountability is some way, the government-wide financial statements most specifically focus on operational accountability.

Choice "c" is incorrect. Fund financial statements focus on fiscal accountability. Fund financial statement accountability objectives complement government-wide financial statement accountability objectives.

Choice "d" is incorrect. Functional accountability is a distracter.

2. CPA-00995

Which of the following statements about the statistical section of the Comprehensive Annual Financial Report (CAFR) of a governmental unit is true?

- a. Statistical tables may not cover more than two fiscal years.
- b. Statistical tables may not include non-accounting information.
- c. The statistical section is not part of the basic financial statements.
- d. The statistical section is an integral part of the basic financial statements.

CPA-00995 Explanation

Choice "c" is correct. A comprehensive annual financial report is divided into three sections: an introductory section, the basic financial statements and the statistical section. The statistical section, definition is not part of the basic financial statements.

Choice "a" is incorrect. Statistical tables generally provide ten years of historical financial information. There is no limitation with regard to presenting two years or less of data.

Choice "b" is incorrect. Statistical tables include a variety of accounting and non-accounting data including property values, tax rates on overlapping governments, demographic statistics, etc.

Choice "d" is incorrect. The statistical tables are not viewed as an integral part of the basic financial statements.

3. CPA-01141

South City School District has a separately elected governing body that administers the public school system. The district's budget is subject to the approval of the city council. The district's financial activity should be reported in the City's financial statements by:

- a. Blending only.
- b. Discrete presentation.
- c. Inclusion as a footnote only.
- d. Either blending or inclusion as a footnote.

CPA-01141 Explanation

Choice "b" is correct. South City 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 substantively the same as the City because it is a legally separate entity, 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 South City 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 substantively the same as the City and the school district does not exclusively service or benefit the City itself.

Choice "c" is incorrect. South City 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 substantively 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. In this response, the word *only* made this response incorrect.

Choice "d" is incorrect. Since South City 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 substantively the same as the City and the school district does not exclusively service or benefit the City itself.

4. CPA-01044

A municipality preparing its basic financial statements and required supplementary information in accordance with GASB #34 would introduce the basic financial statements and provide analytical overview of the government's financial statements in:

- a. A section titled Management's Discussion and Analysis only in the event that the basic financial statements are issued in connection with a public bond offering.
- b. A section titled Management's Discussion and Analysis included as part of the city's required supplementary information following the financial statements.
- c. A section titled Management's Discussion and Analysis included as part of the city's optional supplementary information immediately following the notes to the financial statements but before the required supplementary information.
- d. A section titled Management's Discussion and Analysis included as part of the city's required supplementary information before the basic financial statements.

CPA-01044 Explanation

Choice "d" is correct. Management's Discussion and Analysis is a required component of the required supplementary information preceding the basic financial statements for general-purpose governments.

Choice "a" is incorrect. Preparation of Management's Discussion and Analysis is not limited to instances in which a government issues publicly offered debt.

Choice "b" is incorrect. Management's Discussion and Analysis is considered to be required supplementary information but is placed before the basic financial statements.

Choice "c" is incorrect. Management's Discussion and Analysis is not optional, it is mandatory.

5. CPA-01171

The portion of special assessment debt maturing in 5 years, to be repaid from general resources of the government, should be reported in the:

- a. General fund.
- b. Government-wide statement of net assets.
- c. Agency fund.
- d. Capital projects fund.

CPA-01171 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.

6. CPA-00960

Tree City reported a \$1,500 net increase in fund balance for governmental funds. During the year, Tree purchased general capital assets of \$9,000 and recorded depreciation expense of \$3,000. What amount should Tree report as the change in net assets for governmental activities?

- a. (\$4,500)
- b. \$1,500
- c. \$7,500
- d. \$10,500

CPA-00960 Explanation

Choice "c" 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	\$1,500
O Capital O utlay	9,000
(net of depreciation)	(3,000)
E Expenditures Principal Payments on Debt - Proceeds from New Debt	0
S Internal S ervice Fund Net Income	<u>0</u>
Change in Net Assets in government-wide financial statements	<u>\$7,500</u>

Choice "a" is incorrect. Capital outlay is added back to the change in fund balance and depreciation is subtracted as per above.

Choice "b" 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 "d" is incorrect. The change in fund balance reconciles to the change in net assets as a result of not only adding back the capital outlay expenditure but also from subtraction of the depreciation expense not included in governmental fund financial statements.

7. CPA-00989

Dogwood City's water enterprise fund received interest of \$10,000 on long-term investments. How should this amount be reported on the Statement of Cash Flows?

- a. Operating activities.
- b. Non-capital financing activities.
- c. Capital and related financing activities.
- d. Investing activities.

CPA-00989 Explanation

Choice "d" is correct. Cash receipts associated with interest income are reported as investing activities for purposes of enterprise fund Statement of Cash Flow reporting.

Choice "a" is incorrect. Although cash receipts associated with interest income are frequently classified as operating activities for purposes of commercial Statement of Cash Flow reporting, enterprise funds report these cash inflows as investing activities.

Choice "b" is incorrect. Non-capital financing activities anticipate the cash flows associated with borrowing and lending related to sustaining operations.

Choice "c" is incorrect. Capital financing activities anticipate the cash flows associated with borrowing and lending related to long-lived assets.

8. CPA-00980

According to GASB 34, *Basic Financial Statements-and Management's Discussion and Analysis-for State and Local Governments*, certain budgetary schedules are required supplementary information. What is the minimum budgetary information required to be reported in those schedules?

- a. A schedule of unfavorable variances at the functional level.
- b. A schedule showing the final appropriations budget and actual expenditures on a budgetary basis.
- c. A schedule showing the original budget, the final appropriations budget, and actual inflows, outflows, and balances on a budgetary basis.
- d. A schedule showing the proposed budget, the approved budget, the final amended budget, actual inflows and outflows on a budgetary basis, and variances between budget and actual.

CPA-00980 Explanation

Rule: Budgetary comparison schedules should be prepared for the general fund and each major special revenue fund, which requires a budget and display the original budget, final appropriations budget, and actual inflows, outflows, and balances on a budgetary basis.

Choice "c" is correct. The minimum budgetary information presented in governmental financial statements, typically as required supplementary information, would include the schedule described in the rule above.

Choice "a" is incorrect. Presentations of variances are optional.

Choice "b" is incorrect. Budgetary presentation must display original as well as final amended budgets in comparison to each other as well as actual results displayed on a budgetary basis.

Choice "d" is incorrect. Budgetary presentations need not include originally proposed budgets, only the originally approved budgets along with other items as described in the rule. In addition, variance presentations are optional.

9. CPA-01222

Pharm, a non-governmental not-for-profit organization, is preparing its year-end financial statements. Which of the following statements is required?

- a. Statement of changes in financial position.
- b. Statement of cash flows.
- c. Statement of changes in fund balance.
- d. Statement of revenue, expenses and changes in fund balance.

CPA-01222 Explanation

Rule: Not-for-profit corporations are required to produce the following financial statements:

- Statement of Financial Position
- Statement of Activities
- Statement of Cash Flows

Not-for-profit corporations are generally encouraged, but not required, to produce a Statement of Functional Expenses. Voluntary Health and Welfare organizations, a subset of all not-for-profit entities, are required to present a Statement of Functional Expenses.

Choice "b" is correct. Not-for-profit organizations are required to present a statement of cash flows along with other financial statements, as described in the rule above.

Choice "a" is incorrect. The Statement of Changes in Financial Position is no longer used by not-for-profit corporations.

Choice "c" is incorrect. Not-for-profits do not account of fund balances in financial statements issued for external use and therefore do not produce a Statement of Changes in Fund Balance.

Choice "d" is incorrect. Not-for-profits do not account of fund balances in financial statements issued for external use and therefore do not produce a Statement of Revenues, Expenses and Changes in Fund Balance.

10. CPA-01220

Stanton College, a not-for-profit organization, received a building with no donor stipulations as to its use. Stanton does not have an accounting policy implying a time restriction on donated assets. What type of net assets should be increased when the building was received?

- I. Unrestricted.
- II. Temporarily restricted.
- III. Permanently restricted.

- a. I only.
- b. II only.
- c. III only.
- d. II or III.

CPA-01220 Explanation

Choice "a" is correct. Assets received by a not-for-profit organization that are not restricted either permanently or temporarily as regards to purpose, time or acquisition are classified as unrestricted. Long-lived assets would be recognized as unrestricted unless there was an accounting policy relative to time restrictions. Accounting policies implying time restrictions would result in classification of the asset as temporarily restricted and releasing the asset from restriction as it depreciates.

Choice "b" is incorrect. Classification of assets as temporarily restricted account for donor imposed restrictions that can be satisfied as to purpose, timing or asset acquisition requirements. Absent these requirements or an accounting policy implying a time restriction, the contribution of assets is classified as unrestricted.

Choice "c" is incorrect. Classification of assets as permanently restricted account for permanent donor imposed restrictions that can never be satisfied. Typically a corpus or principal is donated and permanently restricted and the income from the asset is either temporarily restricted or is unrestricted. The building received by Stanton College is not subject to any such restriction.

Choice "d" is incorrect. Classification of a contribution as temporary OR permanent is usually impossible and, in any case, is inappropriate in this case.

11. CPA-01255

The Jackson Foundation, a not-for-profit organization, received contributions in 1996 as follows:

- Unrestricted cash contributions of \$500,000.
- Cash contributions of \$200,000 to be restricted to acquisition of property.

Jackson's statement of cash flows should include which of the following amounts?

	<i>Operating activities</i>	<i>Investing activities</i>	<i>Financing activities</i>
a.	\$700,000	\$0	\$0
b.	\$500,000	\$200,000	\$0
c.	\$500,000	\$0	\$200,000
d.	\$0	\$500,000	\$200,000

CPA-01255 Explanation

Choice "c" is correct. The unrestricted cash contributions totaling \$500,000 are reported as increases in operating activities in the statement of cash flows. The \$200,000 restricted cash contributions are reported as increases in financing activities since the restriction is the acquisition of property, not general operations.

12. CPA-01212

State University received two contributions during the year that must be used to provide scholarships. Contribution A for \$10,000 was collected during the year, and \$8,000 was spent on scholarships. Contribution B is a pledge for \$30,000 to be received next fiscal year. What amount of contribution revenue should the university report in its statement of activities?

- a. \$8,000
- b. \$10,000
- c. \$38,000
- d. \$40,000

CPA-01212 Explanation

Rule: Cash contributions and unconditional pledges are recognized as contribution revenue in the year in which the cash or pledge is received.

Choice "d" is correct. State University would account for cash contributions and pledged contributions as contribution revenue in the year the collection or pledge was made. Note that the question asks for "contribution" revenue without reference to classification.

	<u>Total</u>
Contribution A	\$10,000
Contribution B	<u>30,000</u>
Total	<u>\$40,000</u>

Choice "a" is incorrect. The \$8,000 in contributions represents only the extent to which money has been expended in accordance with restrictions.

Choice "b" is incorrect. The \$10,000 in contributions excludes the pledge receivable of \$30,000.

Choice "c" is incorrect. The combination of expended contributions and the uncollected pledges is incorrect.

13. CPA-01225

During 1997, Jones Foundation received the following support:

A cash contribution of \$875,000 to be used at the board of directors' discretion;

A promise to contribute \$500,000 in 1998 from a supporter who has made similar contributions in prior periods;

Contributed legal services with a value of \$100,000, which Jones would have otherwise purchased.

At what amounts would Jones classify and record these transactions?

<i>Unrestricted</i> <i>revenue</i>	<i>Temporarily restricted</i> <i>revenue</i>
a. \$1,375,000	\$0
b. \$875,000	\$500,000
c. \$975,000	\$0
d. \$975,000	\$500,000

CPA-01225 Explanation

Choice "d" is correct. Board discretionary funds are unrestricted. Contributed services are unrestricted. To be restricted, the donation must be restricted by the donors, creditors, grantors or laws or regulations. A promise to contribute is restricted until conditions (collection) or eligibility requirements (date, etc.) have been satisfied. Classification of revenues is computed as follows:

	<i><u>Unrestricted</u></i>	<i><u>Temporary Restricted</u></i>
Cash Contribution	875,000	—
Promise to Contribute	—	500,000
Donated Services	<u>100,000</u>	<u>—</u>
	<u>975,000</u>	<u>500,000</u>

14. CPA-01229

At the beginning of the year, the Baker Fund, a non-governmental not-for-profit corporation, received a \$125,000 contribution restricted to youth activity programs. During the year, youth activities generated revenues of \$89,000 and had program expenses of \$95,000. What amount should Baker report as net assets released from restrictions for the current year?

- a. \$0
- b. \$6,000
- c. \$95,000
- d. \$125,000

CPA-01229 Explanation

Choice "c" is correct. Restricted donations are released from restriction when conditions or eligibility requirements have been satisfied. The Baker Fund has complied and satisfied the restriction on \$95,000, by spending the money on program expenses.

15. CPA-01257

In its fiscal year ended June 30, 1995, Barr College, a large private institution, received \$100,000 designated by the donor for scholarships for superior students. On July 26, 1995, Barr selected the students and awarded the scholarships. How should the July 26 transaction be reported in Barr's statement of activities for the year ended June 30, 1996?

- a. As both an increase and a decrease of \$100,000 in unrestricted net assets.
- b. As a decrease only in unrestricted net assets.
- c. By footnote disclosure only.
- d. Not reported.

CPA-01257 Explanation

Choice "a" is correct. The tuition fees from students should be recognized as revenue (an increase in unrestricted net assets), while scholarships to the students are considered expenses, or a reduction in unrestricted net assets. The exchange transaction of providing credit hours for tuition is usually recognized at gross revenue, with reductions in tuition being recognized as expenses.

16. CPA-01287

In April 1995, Delta Hospital purchased medicines from Field Pharmaceutical Co. at a cost of \$5,000. However, Field notified Delta that the invoice was being canceled and that the medicines were being donated to Delta. Delta should record this donation of medicines as:

- a. A memorandum entry only.
- b. A \$5,000 credit to non-operating expenses.
- c. A \$5,000 credit to operating expenses.
- d. Other operating revenue.

CPA-01287 Explanation

Choice "d" is correct. Donations of medicines are included as other operating revenue at the fair value of the medicine, since the medicine constitutes part of the ongoing major operation of the hospital.