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Following are multiple choice questions recently released by the AICPA. These questions were released by the AICPA with letter answers only. Our editorial board has provided the accompanying explanations.

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**1. CPA-05415**

A material overstatement in ending inventory was discovered after the year-end financial statements of a company were issued to the public. What effect did this error have on the year-end financial statements?

	<u>Current assets</u>	<u>Gross profit</u>
a.	Understated	Overstated
b.	Overstated	Overstated
c.	Understated	Understated
d.	Overstated	Understated

**ANSWER:**

Choice "b" is correct. Because inventory is a component of current assets, an overstatement of ending inventory will cause current assets to be overstated

The income statement effects of an inventory overstatement or understatement can best be seen by analyzing the cost of goods sold formula:

Beginning inventory

+ Purchases

Cost of goods available for sale

- Ending inventory

Cost of goods sold

Based on this formula, an overstatement of ending inventory will cause an understatement of cost of goods sold, which will result in an overstatement of gross profit (Sales – Cost of goods sold = Gross profit).

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

**2. CPA-05417**

Jen Co. had 200,000 shares of common stock and 20,000 shares of 10%, \$100 par value cumulative preferred stock. No dividends on common stock were declared during the year. Net income was \$2,000,000. What was Jen's basic earnings per share?

- a. \$9.00
- b. \$9.09
- c. \$10.00
- d. \$11.11

**ANSWER:**

Choice "a" is correct. When a company has cumulative preferred stock, the preferred dividends deducted from net income to derive income available to common shareholders are equal to the dividends accumulated in the period, regardless of whether they have been declared. Given this, Jen Co.'s basic EPS is calculated as follows:

$$\frac{\text{Net income} - \text{Preferred dividends}}{\text{Weighted Avg. Number of common shares outstanding}} = \frac{\$2,000,000 - \$200,000^1}{200,000} = \$9.00/\text{share}$$

<sup>1</sup> Accumulated preferred dividends = 20,000 shares x \$100 par x 10% = \$200,000

Choice "b" is incorrect. The accumulated preferred dividends of \$200,000 are subtracted from net income in the numerator to calculate EPS. The number of preferred share should not be added to the denominator when determining the weighted average number of common shares outstanding.

Choice "c" is incorrect. The preferred dividends accumulated during the period must be deducted from net income when calculating basic EPS, regardless of whether the dividends have been declared.

Choice "d" is incorrect. The accumulated preferred dividends of \$200,000 are subtracted from net income in the numerator to calculate EPS. The number of preferred share should not be subtracted from the denominator when determining the weighted average number of common shares outstanding.

**3. CPA-05418**

On December 31, year 1, Taylor, Inc. signed a binding agreement with a bank for the refinancing of an existing note payable scheduled to mature in February, year 2. The terms of the refinancing included extending the maturity date of the note by three years. On January 15, year 2, the note was refinanced. How should Taylor report the note payable in its December 31, year 1, balance sheet?

- a. A current liability.
- b. A long-term liability.
- c. A long-term note receivable.
- d. A current note receivable.

**ANSWER:**

Choice "b" is correct. A short-term obligation is excluded from current liabilities and included in noncurrent debt if the company intends to refinance it on a long-term basis and the intent is supported by either the existence of a noncancelable financing agreement or an actual refinancing prior to the issuance of the financial statements. As both of these conditions have been met, the note should be reported as a long-term liability on the December 31, year 1, balance sheet.

Choice "a" is incorrect. This note should be classified as long-term, not current, on the December 31, year 1, balance sheet because the company signed a binding refinancing agreement with the bank on December 31.

Choice "c" is incorrect. As Taylor, Inc. has an obligation to repay funds to the bank, the note would not be classified as a receivable.

Choice "d" is incorrect. As Taylor, Inc. has an obligation to repay funds to the bank, the note would not be classified as a receivable.

**4. CPA-05419**

At the end of year 1, Lane Co. held trading securities that cost \$86,000 and which had a year-end market value of \$92,000. During year 2, all of these securities were sold for \$104,500. At the end of year 2, Lane had acquired additional trading securities that cost \$73,000 and which had a year-end market value of \$71,000. What is the impact of these stock activities on Lane's year 2 income statement?

- a. Loss of \$2,000.
- b. Gain of \$10,500.
- c. Gain of \$16,500.
- d. Gain of \$18,500.

**ANSWER:**

Choice "b" is correct. Because these are trading securities, the year 2 income statement will be affected by both the realized gain from the securities sold and the unrealized loss on the securities acquired in year 2:

Realized gain on securities sold = Sales price – Carrying value = \$104,500 - 92,000 = \$12,500  
Unrealized loss in securities acquired = Year-end market value – Cost = \$71,000 – 73,000 = (2,000)  
Total income statement impact = Realized gain (loss) + Unrealized gain (loss) = \$12,500 + (2,000) = \$10,500 gain

Choice "a" is incorrect. The gain on the securities sold will affect the year 2 income statement. Realized gains and losses are always reported on the income statement in the period incurred.

Choice "c" is incorrect. Because these are trading securities, the gain on the securities sold is not equal to the difference between the sales price and the original cost of the securities. In year 1, the difference between the cost of \$86,000 and the ending fair value of \$92,000 would have been recorded on the year 1 income statement as a \$6,000 unrealized gain. Then, in year 2, the realized gain on the sale is calculated using the carrying value of \$92,000 and the sales price of \$104,500 (\$104,500 – 92,000 = \$12,500 realized gain).

Choice "d" is incorrect. Because these are trading securities, unrealized gains and losses are recorded on the income statement. Therefore, when the securities acquired in year 2 are adjusted to fair value at the end of the year, a \$2000 unrealized loss is recorded on the income statement equal to the difference between the ending market value of the securities and their original cost (\$71,000 – 73,000). Additionally, the gain on the trading securities sold is not equal to the difference between the sales price and the original cost of the securities. In year 1, the difference between the cost of \$86,000 and the ending fair value of \$92,000 would have been recorded on the year 1 income statement as a \$6,000 unrealized gain. Then, in year 2, the realized gain on the sale is calculated using the carrying value of \$92,000 and the sales price of \$104,500 (\$104,500 – 92,000 = \$12,500 realized gain).

**5. CPA-05420**

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

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

**ANSWER:**

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

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

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

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

**6. CPA-05421**

In the preparation of the statement of activities for a nongovernmental not-for-profit organization, all expenses are reported as decreases in which of the following net asset classes?

- a. Total net assets.
- b. Unrestricted net assets.
- c. Temporarily restricted net assets.
- d. Permanently restricted net assets.

**ANSWER:**

Choice "b" is correct. Expenses are reported as decreases in unrestricted net assets.

Choice "a" is incorrect. Although expenses reduce a component of total net assets, they specifically reduce unrestricted net assets.

Choice "c" is incorrect. Expenses are reported as decreases in unrestricted net assets, no expenses are recorded to reduce temporarily restricted net assets. The focus of not for profit organization financial statements is the entity taken as a whole. Fund accounting is not used. The use of temporarily restricted assets for their intended purpose is not displayed as an expenditure of temporarily restricted funds. Satisfaction of temporarily restrictions are effected by reclassifications of net assets released from restrictions to unrestricted net assets and used for the central mission of the not for profit organization.

Choice "d" is incorrect. Permanently restricted net assets account for restricted corpus whose earnings are reclassified to either temporarily restricted or unrestricted categories for use. Expenses are not recorded for permanently restricted net assets.

**7. CPA-05422**

Oak Co., a newly formed corporation, incurred the following expenditures related to land and building:

County assessment for sewer lines	\$ 2,500
Title search fees	625
Cash paid for land with a building to be demolished	135,000
Excavation for construction of basement	21,000
Removal of old building \$21,000 less salvage of \$5,000	16,000

At what amount should Oak record the land?

- a. \$138,125
- b. \$153,500
- c. \$154,125
- d. \$175,625

**ANSWER:**

Choice "c" is correct. The cost of land includes all costs to acquire the land and get it ready for use:

Cash paid for land	\$135,000
+ Title search fees	625
+ County assessment	2,500
+ Removal of building	<u>16,000</u>
Total cost of land	\$154,125

Choice "a" is incorrect. The removal of the building is necessary to get the land ready for use and must be included in the total land cost.

Choice "b" is incorrect. The title search fee is an acquisition cost that must be included in the total cost of the land.

Choice "d" is incorrect. The building excavation costs are costs incurred to construct the building that must be included in the total building cost, not the cost of the land.

**8. CPA-05423**

Paper Co. had net income of \$70,000 during the year. Dividend payment was \$10,000. The following information is available:

Mortgage repayment	\$20,000
Available-for-sale securities purchased	10,000 increase
Bonds payable—issued	50,000 increase
Inventory	40,000 increase
Accounts payable	30,000 decrease

What amount should Paper report as net cash provided by operating activities in its statement of cash flows for the year?

- a. \$0
- b. \$10,000
- c. \$20,000
- d. \$30,000

**ANSWER:**

Choice "a" is correct. The operating activities section includes cash flows from working capital (current assets and current liabilities) and other income statement items. Under the indirect method, net income is adjusted for non-cash items and increases/decrease in working capital items to arrive at net cash from operating activities. Increases in current assets and decreases in current liabilities are uses of cash, while decreases in current assets and increases in current liabilities increase cash.

Net income	\$70,000
Less: Increase in inventory	(40,000)
Less: Decrease in AP	<u>(30,000)</u>
Net cash provided by operating activities	\$ 0

Choice "b" is incorrect. The increase in available-for-sale securities decreases cash and is reported in the investing section, not the operating section, of the statement of cash flows.

Choice "c" is incorrect. The mortgage repayment is a cash outflow that is reported in the financing section.

Choice "d" is incorrect. Net income must be adjusted for the decrease in AP as well as the increase in inventory.

**9. CPA-05424**

Parker Co. amended its pension plan on January 2 of the current year. It also granted \$600,000 of unrecognized prior service costs to its employees. The employees are all active and expect to provide 2,000 service years in the future, with 350 service years this year. What is Parker's unrecognized prior service cost amortization for the year?

- a. \$0
- b. \$2,000
- c. \$105,000
- d. \$600,000

**ANSWER:**

Choice "c" is correct. Unrecognized prior service cost is amortized by assigning an equal amount to each future period of service of each employee who is active at the date of the amendment. In this problem, prior service cost will be assigned equally to each service year provided by the company's employees as follows:

$$\$600,000 \times (350/2000) = \$105,000.$$

Choice "a" is incorrect. Unrecognized prior service cost must be amortized by assigning an equal amount to each future period of service of each employee who is active at the date of the amendment.

Choice "b" is incorrect. The current period amortization of Parker's prior service cost is not equal to the expected future service hours. Unrecognized prior service cost must be amortized by assigning an equal amount to each future period of service of each employee who is active at the date of the amendment, as described above.

Choice "d" is incorrect. The company would not recognize the entire prior service cost in the current period, but would instead amortize the prior service cost by assigning an equal amount to each future period of service of each employee who is active at the date of the amendment.

**10. CPA-05425**

Entor Co. sold equipment to Pane Co. for \$50,000. The equipment had a net book amount of \$30,000. The collections were \$20,000 in the first year, \$15,000 in the next year, and \$15,000 in the last year. What is the amount of gross profit for the third year if Entor used the installment-sales accounting method for the transaction?

- a. \$0
- b. \$5,000
- c. \$6,000
- d. \$15,000

**ANSWER:**

Choice "c" is correct. When the installment sales method is used, gross profit is recognized when cash is collected. Earned gross profit is equal to cash collected multiplied by the gross profit percentage. Entor Co.'s gross profit percentage for this transaction is calculated as:

$$(\text{Sales} - \text{Cost of goods sold}) / \text{Sales} = (\$50,000 - 30,000) / \$50,000 = 40\%$$

Year 3 earned gross profit would therefore be \$6,000 (\$15,000 x 40%)

Choice "a" is incorrect. When the installment sales method is used, gross profit is recognized when cash is collected. Because \$15,000 was collected in year 3, earned gross profit will be recognized.

Choice "b" is incorrect. \$5,000 would be the year 2 earned gross profit under the cost recovery method. Year 3 earned gross profit under the installment sales method would be \$6,000, as calculated above.

Choice "d" is incorrect. The \$15,000 collected in year 3 would be recognized as earned gross profit in year 3 under the cost recovery method, not the installment sales method.

**11. CPA-05426**

Johan Co. has an intangible asset, which it estimates will have a useful life of 10 years, while Abco Co. has goodwill, which has an indefinite life. Which company should report amortization in its financial statements?

	<u>Johan</u>	<u>Abco</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

**ANSWER:**

Choice "b" is correct. Johan Co.'s intangible asset is a finite life intangible asset. Finite life intangibles are amortized over the period to be benefited. Abco Co.'s goodwill is not amortized, but is instead analyzed periodically (at least annually) for impairment.

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

**12. CPA-05427**

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

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

**ANSWER:**

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

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

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

**13. CPA-05428**

Which of the following transactions is an expenditure of a governmental unit's general fund?

- a. Contribution of enterprise fund capital by the general fund.
- b. Operating subsidy transfer from the general fund to an enterprise fund.
- c. Routine employer contributions from the general fund to a pension trust fund.
- d. Transfer from the general fund to a capital projects fund.

**ANSWER:**

Choice "c" is correct. Routine employer contributions by the general fund to the pension trust fund would be accounted for as an expenditure in the general fund.

Choice "a" is incorrect. The general fund's contribution of capital to the enterprise fund would be classified as a transfer within other financing uses, not as an expenditure.

Choice "b" is incorrect. The general fund's operating subsidy to an enterprise fund would be classified as a transfer within other financing uses, not an expenditure.

Choice "d" is incorrect. A transfer from the general fund to a capital projects fund (or any other fund) would be classified as a transfer within other financing uses, not an expenditure.

**14. CPA-05429**

In a not-for-profit organization, which of the following should be included in total expenses?

	<u>Grants to other Organizations</u>	<u>Depreciation</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

**ANSWER:**

Choice "a" is correct. Both grants to other organizations and depreciation are recorded as expenses in a not-for-profit organization.

Choice "b" is incorrect. Although partially correct in that grants to other organizations are recorded as expenses in not for profit organizations, excluding depreciation from total expenses of a not for profit organization is incorrect.

Choice "c" is incorrect. Both grants to other organizations and depreciation are recorded as expenses in a not-for-profit organization.

Choice "d" is incorrect. Although partially correct in that depreciation is recorded as an expense in not for profit organizations, excluding grants to other organizations from total expenses of a not for profit organization is incorrect.

**15. CPA-05430**

Which of the following funds of a governmental unit records depreciation?

- a. Capital projects fund.
- b. Debt service fund.
- c. Internal service fund.
- d. Special revenue fund.

**ANSWER:**

Choice "c" is correct. Internal service funds are proprietary funds that use the economic resources measurement focus that includes capitalization of assets and income determination. They use the accrual basis of accounting and recognize depreciation expense.

Choice "a" is incorrect. Capital projects funds are governmental funds that use the current financial resources measurement focus that excludes capitalization of assets. They use the modified accrual basis of accounting and do not recognize any expenditure for depreciation.

Choice "b" is incorrect. Debt service funds are governmental funds that use the current financial resources measurement focus that excludes capitalization of assets. They use the modified accrual basis of accounting and do not recognize any expenditure for depreciation.

Choice "d" is incorrect. Special revenue funds are governmental funds that use the current financial resources measurement focus that excludes capitalization of assets. They use the modified accrual basis of accounting and do not recognize any expenditure for depreciation.

**16. CPA-05431**

A county's balances in the general fund included the following:

Appropriations	\$435,000
Encumbrances	18,000
Expenditures	164,000
Vouchers payable	23,000

What is the remaining amount available for use by the county?

- a. \$230,000
- b. \$248,000
- c. \$253,000
- d. \$271,000

**ANSWER:**

Choice "c" is correct. Appropriations is a budgetary account. This account represents the governmental unit's approved spending (in this case \$435,000). Expenditures represent the actual incurring of bills, whether paid in cash or recorded as vouchers payable. Encumbrances are restrictions of the fund balance for purchase orders. Vouchers payable represent expenditures not yet paid and are included as a component of the expenditure amount. The amount of appropriations remaining is the difference between the appropriations and the funds encumbered or expended computed as follows:

<b>Budget: Appropriations</b>	\$435,000
<b>Activity: Expenditures</b>	(164,000)
<b>Encumbrances</b>	<u>(18,000)</u>
<b>Available appropriations</b>	<u>\$253,000</u>

Choice "a" is incorrect. The proposed solution reduces available appropriations by encumbrances, expenditures and vouchers payable. Vouchers payable amounts are already included in the expenditure amount.

Choice "b" is incorrect. The proposed solution reduced available appropriations by expenditures and vouchers payable. Vouchers payable amounts are already included in the expenditure amount. Appropriations must be reduced by amounts committed (encumbered) to determine the amount of available appropriations.

Choice "d" is incorrect. The proposed solution purely reduces the appropriations by expenditures and does not consider encumbered funds.

**17. CPA-005432**

Stent Co. had total assets of \$760,000, capital stock of \$150,000, and retained earnings of \$215,000. What was Stent's debt-to-equity ratio?

- a. 2.63
- b. 1.08
- c. 0.52
- d. 0.48

**ANSWER:**

Choice "b" is correct. To calculate Stent Co.'s debt-to-equity ratio, Stent's total liabilities and total equity must be derived from the facts:

$$\text{Equity} = \text{Capital stock} + \text{Retained earnings} = \$150,000 + 215,000 = \$365,000$$

$$\text{Liabilities} = \text{Assets} - \text{Equity} = \$760,000 - 365,000 = \$395,000$$

Stent's debt-to-equity ratio is then calculated as:

$$\frac{\text{Total liabilities}}{\text{Equity}} = \frac{\$395,000}{\$365,000} = 1.08$$

Choice "a" is incorrect. The denominator of the debt-to-equity ratio is total equity, not just capital stock. See the calculation above.

Choice "c" is incorrect. The debt ratio, not the debt-to-equity ratio, is equal to liabilities divided by total assets.

Choice "d" is incorrect. The debt-to-equity ratio is not equal to equity divided by total assets.

**18. CPA-05433**

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

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

**ANSWER:**

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

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

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

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

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

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

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

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

**19. CPA-05434**

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

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

**ANSWER:**

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

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

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

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

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

**20. CPA-05435**

Foley Co. is preparing the electronic spreadsheet below, to amortize the discount on its 10-year, 6%, \$100,000 bonds payable. Bonds were issued on December 31 to yield 8%. Interest is paid annually. Foley uses the effective interest method to amortize bond discounts.

	<b>A</b>	<b>B</b>	<b>C</b>	<b>D</b>	<b>E</b>
<b>1</b>	<i>Year</i>	<i>Cash paid</i>	<i>Interest expense</i>	<i>Discount amortization</i>	<i>Carrying amount</i>
<b>2</b>	1				\$86,580
<b>3</b>	2	\$6,000			

Which formula should Foley use in cell E3 to calculate the bonds' carrying amount at the end of Year 2?

- a. E2 + D3
- b. E2 - D3
- c. E2 + C3
- d. E2 - C3

**ANSWER:**

Choice "a" is correct. When the effective interest amortization method is used to amortize a bond issued at a discount, the ending carrying amount of the bond is equal to the beginning carrying amount plus the discount amortized during the current period. The carrying amount of Foley's bond at the end of Year 2 is therefore the beginning carrying amount found in cell E2 plus the Year 2 discount amortization found in cell D3.

Choice "b" is incorrect. When computing the ending carrying amount of a bond issued at a discount, the discount amortized during the current period is added to, not subtracted from, the beginning carrying amount. Amortization is subtracted when computing the ending carrying value of a bond issued at a premium.

Choice "c" is incorrect. Discount amortization, not interest expense, is added to the beginning carrying amount to determine the ending carrying amount of a bond issued at a discount.

Choice "d" is incorrect. Discount amortization, not interest expense, is added to, and not subtracted from, the beginning carrying amount to determine the ending carrying amount of a bond issued at a discount.

**21. CPA-05436**

During 2002, Fleet Co.'s trademark was licensed to Hitch Corp. for royalties of 10% of net sales of the trademarked items. Returns were estimated to be 1% of gross sales. On signing the licensing agreement, Hitch paid Fleet \$75,000 as an advance against future royalty earnings. Gross sales of the trademarked items during the year were \$600,000. What amount should Fleet report as royalty income for 2002?

- a. \$54,000
- b. \$59,400
- c. \$60,000
- d. \$75,000

**ANSWER:**

Choice "b" is correct. Fleet earns royalties based on 10% of net sales, so the first step is the calculation of net sales:

Sale	\$600,000	
Allowance for sales returns	6,000	= \$600,000 x 1%
Net Sales	\$594,000	

Net sales can then be used to calculate Fleet's royalty income:

$$\text{Net Sales} \times \text{Royalty \%} = \$594,000 \times 10\% = \$59,400$$

Choice "a" is incorrect. Sales returns are not subtracted from 10% of gross sales to calculate Fleet's royalty income.

Choice "c" is incorrect. Fleet's royalty revenue should be calculated using net sales, rather than gross sales.

Choice "d" is incorrect. Royalty revenue is not equal the advance against future royalty earnings received by Fleet. Fleet's royalty revenue is equal to 10% of the net sales for the period. The advance against future royalty earnings should have been recorded as unearned revenue when received. At the end of 2002, \$15,600 (\$75,000 advance - \$59,400 royalty income earned) of the advance would remain in unearned revenue.

**22. CPA-05437**

Red Co. had \$3 million in accounts receivable recorded on its books. Red wanted to convert the \$3 million in receivables to cash in a more timely manner than waiting the 45 days for payment as indicated on its invoices. Which of the following would alter the timing of Red's cash flows for the \$3 million in receivables already recorded on its books?

- a. Change the due date of the invoice.
- b. Factor the receivables outstanding.
- c. Discount the receivables outstanding.
- d. Demand payment from customers before the due date.

**ANSWER:**

Choice "b" is correct. Factoring receivables is the process by which a company converts its receivables to cash by assigning them to a factor, either with or without recourse.

Choice "a" is incorrect. The fact that the receivables have been recorded implies that the company has already sent invoices to its customers setting the payment due date. Generally, the due date cannot be changed after the invoice has been sent, nor is changing the due date likely to speed up the overall customer payment rate.

Choice "c" is incorrect. Discounting is the process of converting notes receivable, not accounts receivable, to cash.

Choice "d" is incorrect. Demanding payment from customers before the due date is likely to anger customers, but is not likely to speed up the overall customer payment rate. The invoice sets the payment terms of the receivable.

**23. CPA-05438**

On January 1, year 1, Frost Co. entered into a two-year lease agreement with Ananz Co. to lease 10 new computers. The lease term begins on January 1, year 1 and ends on December 31, year 2. The lease agreement requires Frost to pay Ananz two annual lease payments of \$8,000. The present value of the minimum lease payments is \$13,000. Which of the following circumstances would require Frost to classify and account for the arrangement as a capital lease?

- a. The economic life of the computers is three years.
- b. The fair value of the computers on January 1, year 1 is \$14,000.
- c. Frost does **not** have the option of purchasing the computers at the end of the lease term.
- d. Ownership of the computers remains with Ananz throughout the lease term and after the lease ends.

**ANSWER:**

Choice "b" is correct. For a lessee to account for a lease as a capital lease, the terms of the lease must meet at least one of the capital lease criteria:

Ownership transfers at the end of the lease

Written option for bargain purchase

PV of minimum lease payments  $\geq$  90% of FV of leased property

Lease term  $\geq$  75% of asset useful life

If the fair value of the computers at lease inception is \$14,000 and the present value of the minimum lease payments is \$13,000, then the lease will be accounted for as a capital lease:

$$13,000/14,000 = 93\%$$

Choice "a" is incorrect. If the economic life of the computers is 3 years and the lease term is 2 years, the lease will not be accounted for as a capital lease because the lease term is only 67% of the life of the asset.

Choice "c" is incorrect. If Frost does not have the option to purchase the computers at a discount or bargain price at the end of the lease term, then the lease will not be accounted for as a capital lease.

Choice "d" is incorrect. If ownership does not transfer to Frost, then the lease will not be accounted for as a capital lease.

**24. CPA-05439**

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

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

**ANSWER:**

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

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

**25. CPA-05440**

Bain Co. entered into a 10-year lease agreement for a new piece of equipment worth \$500,000. At the end of the lease, Bain will have the option to purchase the equipment. Which of the following would require the lease to be accounted for as a capital lease?

- a. The lease includes an option to purchase stock in the company.
- b. The estimated useful life of the leased asset is 12 years.
- c. The present value of the minimum lease payments is \$400,000.
- d. The purchase option at the end of the lease is at fair market value.

**ANSWER:**

Choice "b" is correct. For a lessee to account for a lease as a capital lease, the terms of the lease must meet at least one of the capital lease criteria:

Ownership transfers at the end of the lease

Written option for bargain purchase

PV of minimum lease payments  $\geq$  90% of FV of leased property

Lease term  $\geq$  75% of asset useful life

If the lease term is 10 years and the useful life of the asset is 12 years, then the "75%" criteria is met ( $10/12 = 83\%$ ) and the lease will be accounted for as a capital lease.

Choice "a" is incorrect. An option to purchase stock in the lessor does not qualify a lease for capital lease treatment. To be accounted for as a capital lease, the lease must meet at least one of the criteria described above.

Choice "c" is incorrect. If the present value of the minimum lease payments is \$400,000 and the fair value of the equipment is \$500,000, then the lease does not meet the "90%" criteria ( $\$400,000/\$500,000 = 80\%$ ) and will not be accounted for as a capital lease.

Choice "d" is incorrect. A bargain purchase option, not a fair value purchase option, qualifies a lease for capital lease accounting.

**26. CPA-05441**

Loft Co. reviewed its inventory values for proper pricing at year end. The following summarizes two inventory items examined for the lower of cost or market:

	<u>Inventory item #1</u>	<u>Inventory item #2</u>
Original cost	\$210,000	\$400,000
Replacement cost	150,000	370,000
Net realizable value	240,000	410,000
Less profit margin	208,000	405,000

What amount should Loft include in inventory at year end, if it uses the total of the inventory to apply the lower of cost or market?

- a. \$520,000
- b. \$610,000
- c. \$613,000
- d. \$650,000

**ANSWER:**

Choice "b" is correct. If total inventory is used to apply the lower of cost or market rule, then total cost and market are calculated as follows:

Original cost	\$610,000
Replacement cost	520,000
Net realizable value	650,000
Less profit margin	613,000

Market is the middle value of the replacement cost, net realizable value (ceiling) and net realizable value less profit margin (floor). In this problem, the market value is the market floor of \$613,000. Because market is greater than the total cost of \$610,000, the inventory will be reported at cost.

Choice "a" is incorrect. This is the replacement cost, which is not used as the market value of the inventory because it is not the middle value of the replacement cost, net realizable value (ceiling) and net realizable value less profit margin (floor).

Choice "c" is incorrect. Because the \$613,000 market value is greater than the inventory cost of \$610,000, the inventory will not be reported at market.

Choice "d" is incorrect. This is the market ceiling, which is not used as the market value of this inventory because it is not the middle value of the replacement cost, net realizable value (ceiling) and net realizable value less profit margin (floor). Additionally, this amount is greater than cost and inventory must be recorded at the lower of cost or market.

**27. CPA-05442**

Baker Co. issued 100,000 shares of common stock in the current year. On October 1, Baker repurchased 20,000 shares of its common stock on the open market for \$50.00 per share. At that date, the stock's par value was \$1.00 and the average issue price was \$40.00 per share. Baker uses the cost method for treasury stock transactions. On December 1, Baker reissued the stock for \$60.00 per share. What amount should Baker report as treasury stock gain at December 31?

- a. \$0
- b. \$200,000
- c. \$400,000
- d. \$980,000

**ANSWER:**

Choice "a" is correct. Corporations are not permitted to report income statement gains and losses from treasury stock transactions. Instead, treasury stock "gains and losses" are reported as direct adjustments to stockholders' equity. Gains are recorded by crediting APIC – Treasury Stock, while losses are recorded by first reducing any existing APIC – Treasury Stock to \$0, and then debiting any additional loss to Retained Earnings.

Baker's treasury stock transactions would be recorded as follows:

10/1 – Repurchase of Treasury Stock

DR	Treasury stock	\$1,000,000	
CR	Cash		\$1,000,000

12/1 – Resell Treasury Stock

DR	Cash	\$1,200,000	
CR	Treasury stock	\$1,000,000	
CR	APIC – Treasury stock		200,000

Choice "b" is incorrect. This amount would be reported as APIC – Treasury stock on the balance sheet, not as a gain on the income statement.

Choice "c" is incorrect. The treasury stock repurchase is reported at the price paid, not the average purchase price.

Choice "d" is incorrect. The difference between the par value of the stock and the price paid to repurchase the stock is not reported as a gain.

**28. CPA-05443**

On December 31, 2002, Paxton Co. had a note payable due on August 1, 2003. On January 20, 2003, Paxton signed a financing agreement to borrow the balance of the note payable from a lending institution to refinance the note. The agreement does not expire within one year, and no violation of any provision in the financing agreement exists. On February 1, 2003, Paxton was informed by its financial advisor that the lender is not expected to be financially capable of honoring the agreement. Paxton's financial statements were issued on March 31, 2003. How should Paxton classify the note on its balance sheet at December 31, 2002?

- a. As a current liability because the financing agreement was signed after the balance sheet date.
- b. As a current liability because the lender is **not** expected to be financially capable of honoring the agreement.
- c. As a long-term liability because the agreement does **not** expire within one year.
- d. As a long-term liability because **no** violation of any provision in the financing agreement exists.

**ANSWER:**

Choice "b" is correct. A short-term obligation may be excluded from current liabilities and included in non-current debt if the company has both the intent and the ability to refinance the debt on a long-term basis, as evidenced by an actual refinancing before the issuance of the financial statements, or by the existence of a noncancelable financing agreement from a lender with the financial resources to accomplish the refinancing. Because Paxton's lender does not have the financial resources to accomplish the refinancing, the note must be reported as a current liability on its December 31, 2002 balance sheet.

Choices "a", "c", and "d" are incorrect for the reason described above.

**29. CPA-05444**

RST Charities received equities securities valued at \$100,000 as an unrestricted gift. During the year, RST received \$5,000 in dividends from these securities; at year end, the securities had a fair market value of \$110,000. By what amount did these transactions increase RST's net assets?

- a. \$100,000
- b. \$105,000
- c. \$110,000
- d. \$115,000

**ANSWER:**

Choice "d" is correct. RST's net assets increased \$115,000 during the year as a result of the contribution of equity securities, the increase in market value and the dividends received is computed as follows:

Equity security received	\$100,000
Change in market value	<u>10,000</u>
Fair market value at year end	110,000
Dividends received	<u>5,000</u>
Total	<u>\$115,000</u>

All debt securities and those equity securities that have readily determinable fair values are measured at fair value in the statement of financial position. Gains and losses on investments are reported in the statement of activities. Investment income (e.g. dividends and interest) is reported in the period earned as an increase in net assets.

Choice "a" is incorrect. The proposed solution excludes changes in market value and dividends from increases in net assets in error. Both the change in market value and the dividend would be considered as an increase in net assets.

Choice "b" is incorrect. The proposed solution excludes changes in market value from increases in net assets in error. Both the change in market value and the dividend would be considered as an increase in net assets.

Choice "c" is incorrect. The proposed solution excludes dividends from increases in net assets in error. Both the change in market value and the dividend would be considered as an increase in net assets.

**30. CPA-05445**

The Turtle Society, a nongovernmental not-for-profit organization, receives numerous contributed hours from volunteers during its busy season. Chris, a clerk at the local tax collector's office, volunteered ten hours per week for 24 weeks transferring turtle food from the port to the turtle shelter. His rate of pay at the tax office is \$10 per hour, and the prevailing wage rate for laborers is \$6.50 per hour. What amount of contribution revenue should Turtle Society record for this service?

- a. \$0
- b. \$840
- c. \$1,560
- d. \$2,400

**ANSWER:**

Choice "a" is correct. No expense would be recognized for the work performed.

Donated services should be recorded as contribution revenue and expense at fair value if the services meet the following criteria:

1. They create or enhance a non-financial asset.
2. They require specialized skills that the provider possesses and would otherwise have been purchased by the organization.

Contributed services are, therefore, only recognized SOME of the time: when the service is Specialized, Otherwise needed and Measured Easily.

Chris's work for the Turtle Society does not meet the criteria for expense recognition. The fact pattern makes a point of describing the work as being different from his normal profession and valued at an amount less than his normal wage. Chris's work is not specialized even though it is likely that it would be otherwise needed.

Choice "b" is incorrect. Chris's work for the Turtle Society is not sufficiently specialized to meet the criteria for expense recognition. The proposed response incorrectly attempts to value his volunteer labor as the difference between his compensation in an unrelated profession and the going rate for the work performed.

Choice "c" is incorrect. Chris's work for the Turtle Society is not sufficiently specialized to meet the criteria for expense recognition. The proposed response incorrectly attempts to value his volunteer labor at the going rate the unspecialized work performed.

Choice "d" is incorrect. Chris's work for the Turtle Society is not sufficiently specialized to meet the criteria for expense recognition. The proposed response incorrectly attempts to value his volunteer labor as his compensation in an unrelated profession.

**31. CPA-05446**

The following information pertains to Ceil Co., a company whose common stock trades in a public market:

Shares outstanding at 1/1	100,000
Stock dividend at 3/31	24,000
Stock issuance at 6/30	5,000

What is the weighted - average number of shares Ceil should use to calculate its basic earnings per share for the year ended December 31?

- a. 120,500
- b. 123,000
- c. 126,500
- d. 129,000

**ANSWER:**

Choice "c" is correct. When calculating the weighted-average number of shares to be used in the earnings-per-share calculation, stock dividends are treated as if they occurred at the beginning of the period. Ceil Co.'s weighted average number of shares should therefore be calculated as:

124,000 shares x 6/12 =	\$ 62,000
129,000 shares x 6/12 =	<u>64,500</u>
Weighted average	\$126,500

Choice "a" is incorrect. This weighted average calculation does not treat the stock dividend retroactively. Stock dividends must be treated as if they occurred at the beginning of the period.

Choice "b" is incorrect. This weighted average calculation treats the stock issuance as if it occurred at the beginning of the year and does not make a retroactive adjustment for the stock dividend. Stock issuances are not adjusted retroactively, but instead are time weighted for the period of the year in which the shares are outstanding. Stock dividends and stock splits must be treated retroactively.

Choice "d" is incorrect. This is the total number of shares outstanding at December 31, not the weighted average number of shares outstanding for the year.

**32. CPA-05447**

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

	<i>Sales to Unaffiliated Customers</i>	<i>Intersegment sales</i>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

**ANSWER:**

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

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

**33. CPA-05448**

On December 31, 1999, Key Co. received two \$10,000 non-interest-bearing notes from customers in exchange for services rendered. The note from Alpha Co., which is due in nine months, was made under customary trade terms, but the note from Omega Co., which is due in two years, was not. The market interest rate for both notes at the date of issuance is 8%. The present value of \$1 due in nine months at 8% is .944. The present value of \$1 due in two years at 8% is .857. At what amounts should these two notes receivable be reported in Key's December 31, 1999, balance sheet?

	<u>Alpha</u>	<u>Omega</u>
a.	\$9,440	\$8,570
b.	\$10,000	\$8,570
c.	\$9,440	\$10,000
d.	\$10,000	\$10,000

**ANSWER:**

Choice "b" is correct. Because the term of the Alpha note does not exceed one year, it is recorded at its face amount of \$10,000, while the two year Omega note must be reported at the present value of the obligation calculated using the market interest rate of 8%:

$$\$10,000 \times 0.857 = \$8,570$$

Choice "a" is incorrect. Because the term of the Alpha note does not exceed one year, it is recorded at its face amount of \$10,000.

Choice "c" is incorrect. Because the term of the Alpha note does not exceed one year, it is recorded at its face amount of \$10,000, while the two year Omega note must be reported at the present value of the obligation calculated using the market interest rate of 8%.

Choice "d" is incorrect. The two year Omega note must be reported at the present value of the obligation calculated using the market interest rate of 8%.

**34. CPA-05449**

Bake Co.'s trial balance included the following at December 31, 2003:

Accounts payable	\$80,000
Bonds payable, due 2004	300,000
Discount on bonds payable	15,000
Deferred income tax liability	25,000

The deferred income tax liability is not related to an asset for financial accounting purposes and is expected to reverse in 2004. What amount should be included in the current liability section of Bake's December 31, 2003, balance sheet?

- a. \$365,000
- b. \$390,000
- c. \$395,000
- d. \$420,000

**ANSWER:**

Choice "b" is correct. All of the items listed will be included in the current liabilities section of Bake's December 31, 2003 balance sheet. Accounts payable are current liabilities. The bond payable, less the discount, is classified as a current liability because it will be paid in the next operating period. The deferred tax liability is classified as current because it is not related to an asset and will reverse during the next operating period. Total current liabilities are calculated as:

Accounts payable	\$ 80,000
Bonds payable	300,000
Bond discount	(15,000)
Deferred tax liability	<u>25,000</u>
Total current liabilities	<u>\$390,000</u>

Choice "a" is incorrect. The deferred tax liability should be included in total current liabilities because it is not related to an asset and is expected to reverse in the next operating period.

Choice "c" is incorrect. The deferred tax liability should be included in total current liabilities because it is not related to an asset and is expected to reverse in the next operating period. Additionally, the discount on the bond payable should be subtracted from, not added to, total current liabilities. Bond discounts always reduce the carrying amount of the associated bonds.

Choice "d" is incorrect. The discount on the bond payable should be subtracted from, not added to, total current liabilities. Bond discounts always reduce the carrying amount of the associated bonds.

**35. CPA-05450**

Savor Co. had \$100,000 in cash-basis pretax income for 1999. At December 31, 1999, accounts receivable had increased by \$10,000 and accounts payable had decreased by \$6,000 from their December 31, 1998, balances. Compared to the accrual basis method of accounting, Savor's cash pretax income is:

- a. Higher by \$4,000.
- b. Lower by \$4,000.
- c. Higher by \$16,000.
- d. Lower by \$16,000.

**ANSWER:**

Choice "d" is correct. A \$10,000 increase in accounts receivable means that \$10,000 of the sales revenue recorded using the accrual basis during the year has not yet been paid by the customers. Under cash basis accounting, revenue is not recorded until the cash has been received, so this amount must be deducted to arrive at cash basis income.

The \$6,000 decrease in accounts payable means that total cash payments to vendors during the year exceeded the current period's accrual basis expenses. Under the cash basis, expenses are recorded when payment is made, so the \$6,000 must be deducted to arrive at cash basis income.

Total cash basis pretax income is therefore \$84,000 ( $\$100,000 - 10,000 - 6,000$ ), which is \$16,000 lower than the accrual basis pretax income of \$100,000.

Choice "a" is incorrect. The increase in accounts receivable must be subtracted from, not added to, accrual basis income to calculate cash basis income, as explained above.

Choice "b" is incorrect. The decrease in accounts payable must be subtracted from, not added to, accrual basis income to calculate cash basis income, as explained above.

Choice "c" is incorrect. Both the increase in accounts receivable and the decrease in accounts payable must be subtracted from, not added to, accrual basis income to calculate cash basis income, as explained above.

**36. CPA-05451**

Zest Co. owns 100% of Cinn, Inc. On January 2, 1999, Zest sold equipment with an original cost of \$80,000 and a carrying amount of \$48,000 to Cinn for \$72,000. Zest had been depreciating the equipment over a five-year period using straight-line depreciation with no residual value. Cinn is using straight-line depreciation over three years with no residual value. In Zest's December 31, 1999, consolidating worksheet, by what amount should depreciation expense be decreased?

- a. \$0
- b. \$8,000
- c. \$16,000
- d. \$24,000

**ANSWER:**

Choice "b" is correct. Depreciation expense should be decreased by the difference between the depreciation expense calculated by Cinn and the depreciation that would have been calculated by Zest had Zest not sold the asset in an intercompany transaction:

Depreciation expense after intercompany sale	\$24,000 = \$72,000/3
Depreciation expense if no intercompany sale	<u>16,000</u> = \$80,000/5
Difference	\$ 8,000

Note that this \$8,000 depreciation expense adjustment can also be calculated by dividing the difference between the pre-intercompany-sale asset book value and post-intercompany-sale asset book value by the useful life to be used by the new owner:

$$(\$72,000 - \$48,000) / 3 = \$8,000$$

Choice "a" is incorrect. In all intercompany sales of depreciable assets, depreciation expense must be adjusted back to what the expense would have been if the sale had not taken place. This adjustment is made at the time of consolidation.

Choice "c" is incorrect. This is the annual depreciation recorded by Zest before selling the asset to Cinn.

Choice "d" is incorrect. This is the annual depreciation recorded by Cinn after acquiring the asset from Zest.

**37. CPA-05452**

Which of the following items is an example of imposed nonexchange revenue for a governmental entity?

- a. Personal income taxes.
- b. Retail sales tax.
- c. Federal grant money.
- d. Property taxes.

**ANSWER:**

Choice "d" is correct. Imposed non-exchange transactions include taxes imposed on non exchange transactions (such as fines) or wealth (such as property taxes).

Choice "a" is incorrect. Personal income taxes are derived tax revenues that are imposed upon or derived from exchange transactions (such as income tax on taxpayer income).

Choice "b" is incorrect. Retail sales taxes are derived tax revenues that are imposed upon or derived from exchange transactions (such as sales tax on commercial sales).

Choice "c" is incorrect. Federal grant money could be considered either a grant mandated non exchange transaction or a voluntary non exchange transaction depending on the character of the grant. It would not, however, represent imposed nonexchange revenue.

**38. CPA-05453**

Cash receipts from grants and subsidies to decrease operating deficits should be classified in which of the following sections of the statement of cash flows for governmental, not-for-profit entities?

- a. Operating.
- b. Noncapital financing.
- c. Capital and related financing.
- d. Investing.

**ANSWER:**

**Rule:** Cash flows from non capital financing activities include:

1. Proceeds or payments related to borrowing not attributable to the acquisition, construction or improvement of capital assets
2. Cash receipts or payments related to grants or subsidies not attributable to capital purposes.
3. Property taxes not designated for capital purposes
4. Cash paid to other funds (other than for interfund services)

Choice "b" is correct. Cash receipts from grants and subsidies used to decrease operating deficits (not used for capital purposes) should be classified as non capital financing activities in the statement of cash flows of a proprietary fund.

Choice "a" is incorrect. Non capital cash receipts from grants and subsidies are non capital financing activities. Operating cash flows related to receipts and disbursements related to sales of goods and services, interfund reimbursements, etc.

Choice "c" is incorrect. Non capital cash receipts from grants and subsidies are non capital financing activities. Capital and related financing activity is typically associated with cash activities related to acquisition, construction or improvement of capital assets, etc.

Choice "d" is incorrect. Non capital cash receipts from grants and subsidies are non capital financing activities. Investing activities include cash receipts and disbursements associated with the purchase and sale of equity or debt securities, etc.

**39. CPA-05454**

Baker Co. sells consumer products that are packaged in boxes. Baker offered an unbreakable glass in exchange for two box tops and \$1 as a promotion during the current year. The cost of the glass was \$2.00. Baker estimated at the end of the year that it would be probable that 50% of the box tops will be redeemed. Baker sold 100,000 boxes of the product during the current year and 40,000 box tops were redeemed during the year for the glasses. What amount should Baker accrue as an estimated liability at the end of the current year, related to the redemption of box tops?

- a. \$0
- b. \$5,000
- c. \$20,000
- d. \$25,000

**ANSWER:**

Choice "b" is correct. The cost of a premium, such as the unbreakable glass, is charged to expense during the period the related goods are sold. As this is a current year promotion, the expense should be fully recognized in the current year, with a liability recorded at year-end for premiums expected to be redeemed in the next period. This estimated liability is calculated as follows:

Total estimated box top redemptions (100,000 boxes sold x 50%)	50,000
Less: Box tops redeemed	<u>40,000</u>
Box tops to be redeemed	<u>10,000</u>
Outstanding premium claims (10,000 / 2 box tops per glass)	<u>5,000</u>
Estimated liability [5,000 claims x (\$2 cost - \$1 paid by customer)]	<u>\$5,000</u>

Choice "a" is incorrect. As this is a current year promotion, the expense should be fully recognized in the current year, with a liability recorded at year-end for premiums expected to be redeemed in the next period.

Choice "c" is incorrect. This is the cost of the premiums claimed during the current period (40,000 box tops redeemed / 2 box tops per glass x \$1 net cost per glass).

Choice "d" is incorrect. This is the estimated total cost of all premiums expected to be redeemed from this offer (100,000 boxes sold x 50% / 2 box tops per glass x \$1 net cost per glass). This amount is expensed during the current period, but a liability is recognized only for the amount of unredeemed box tops expected to be redeemed in the next period (see the calculation above).

**40. CPA-05455**

Which of the following statements is correct concerning start-up costs?

- a. Costs of start-up activities, including organization costs, should be expensed as incurred.
- b. Costs of start-up activities, including organization costs, should be capitalized and expensed only if an impairment exists.
- c. Costs of start-up activities, including organization costs, should be capitalized and amortized on a straight-line basis over the lesser of the estimated economic life of the company, or 60 months.
- d. Costs of start-up activities should be capitalized and amortized on a straight-line basis over the lesser of the estimated economic life of the company, or 60 months, while organization cost should be expensed as incurred.

**ANSWER:**

Choice "a" is correct. GAAP requires that start-up costs, including organizational costs, be expensed as incurred, without exception.

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

**41. CPA-05456**

Main, a pharmaceutical company, leased office space from Ash. Main took possession and began to use the building on July 1, 2000. Rent was due the first day of each month. Monthly lease payments escalated over the 5-year period of the lease as follows:

<u>Period</u>	<u>Lease payment</u>
July 1, 2000 - September 30, 2000	\$0 - rent abatement during move-in, construction
October 1, 2000 - June 30, 2001	17,500
July 1, 2001 - June 30, 2002	19,000
July 1, 2002 - June 30, 2003	20,500
July 1, 2003 - June 30, 2004	23,000
July 1, 2004 - June 30, 2005	24,500

What amount would Main show as deferred rent expense at December 31, 2003?

- a. \$50,658
- b. \$52,580
- c. \$68,575
- d. \$71,550

**ANSWER:**

Choice "d" is correct. Rent expense must be recognized on a straight-line basis over the life of the lease. In this lease, rent expense and the balance in the deferred rent expense account are recognized as follows:

	<u>Total Lease Payments</u>		<u>Lease Expense</u>	=	<u>Deferred Lease Exp</u>
July 1, 2000 – June 31, 2001	\$ 157,500	-	240,300	=	\$82,800
July 1, 2001 - June 30, 2002	228,000	-	240,300	=	12,300
July 1, 2002 - June 30, 2003	246,000	-	240,300	=	(5,700)
July 1, 2003 - June 30, 2004	276,000	-	240,300	=	(35,700)
July 1, 2004 - June 30, 2005	<u>294,000</u>	-	240,300	=	(53,700)
	\$1,201,500 / 60 months = \$20,025/month x 12 = \$240,300				

Deferred lease expense at December 31, 2003 is therefore:

$$\$82,800 + 12,300 + (5,700) + (35,700 \times 6/12) = \$71,550$$

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

**42. CPA-05457**

Goodwill should be tested for value impairment at which of the following levels?

- a. Each identifiable long-term asset.
- b. Each reporting unit.
- c. Each acquisition unit.
- d. Entire business as a whole.

**ANSWER:**

Choice "b" is correct. GAAP requires that goodwill be tested for impairment at the reporting unit level. The evaluation of goodwill impairment involves two major steps.

**Step 1:** Identify potential impairment by comparing the fair value of each reporting unit with its carrying amount, including goodwill.

- (1) Assign assets acquired and liabilities assumed to the various reporting units. Assign goodwill to the reporting units.
- (2) Determine the fair values of the reporting units and of the assets and liabilities of those reporting units. Fair value is determined in accordance with SFAS No. 157.
- (3) If the fair value of a reporting unit is less than its carrying amount, there is potential goodwill impairment. The impairment is assumed to be due to the reporting unit's goodwill since any impairment in the other assets of the reporting unit will already have been determined and adjusted for (**other impairments are evaluated before goodwill**).
- (4) If the fair value of a reporting unit is more than its carrying amount, there is no goodwill impairment and Step 2 is not necessary.

**Step 2:** Measure the amount of goodwill impairment loss by comparing the implied fair value of the reporting unit's goodwill with the carrying amount of that goodwill.

- (1) Allocate the fair value of the reporting unit to all assets and liabilities of the unit. Any fair value that cannot be assigned to specific assets and liabilities is the implied goodwill of the reporting unit.
- (2) Compare the implied fair value of the goodwill to the carrying value of the goodwill. If the implied fair value of the goodwill is less than its carrying amount, recognize a goodwill impairment loss. Once the goodwill impairment loss has been fully recognized, it cannot be reversed.

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

**43. CPA-05458**

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

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

**ANSWER:**

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

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

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

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

**44. CPA-05459**

On January 1 ten years ago, Andrew Co. created a subsidiary for the purpose of buying an oil tanker depot at a cost of \$1,500,000. Andrew expected to operate the depot for 10 years, at which time it is legally required to dismantle the depot and remove underground storage tanks. It was estimated that it would cost \$150,000 to dismantle the depot and remove the tanks at the end of the depot's useful life. However, the actual cost to demolish and dismantle the depot and remove the tanks in the tenth year is \$155,000.

What amount of expense related to the demolition of the depot and the removal of the tanks should Andrew recognize in its financial statements in year 10?

- a. None, recognized in prior years.
- b. \$5,000 expense.
- c. \$150,000 expense.
- d. \$155,000 expense.

**ANSWER:**

Choice "b" is correct. An asset retirement obligation (ARO) must be recognized at the time the oil tanker is purchased to reflect Andrew's legal obligation to dismantle the depot and remove the underground storage tanks. The ARO would be recorded at the present value of the expected obligation by debiting the oil tanker depot asset and crediting asset retirement obligation liability. Over the 10 year life of the oil tanker depot, accretion expense would be recorded so that at the end of the 10 years, the ARO liability is equal to the undiscounted total expected cost of \$150,000. When the actual demolition and removal costs are incurred in year 10, the following JE would be recorded:

DR	ARO liability	150,000	
DR	Demolition expense	5,000	
CR		Cash/AP	155,000

Choice "a" is incorrect. Because the actual demolition and retirement costs exceed the ARO, additional expense must be recorded in year 10, as described above.

Choice "c" is incorrect. This is the amount of the ARO, not the demolition expense recognized in year 10. This amount has already been recognized in expense over the 10 years through both depreciation and accretion expense.

Choice "d" is incorrect. This is the total cost paid for demolition and removal, not the expense recognized in year 10. Only \$5,000 of this cost is recognized as demolition expense in year 10. \$150,000 of this amount has already been recognized in expense over the 10 years through both depreciation and accretion expense.

**45. CPA-05460**

The controller of Peabody, Inc. has been asked to present an analysis of accounts receivable collections at the upcoming staff meeting. The following information is used:

	<u>12/31, year 2</u>	<u>12/31, year 1</u>
Accounts receivable	\$100,000	\$130,000
Allowance, doubtful accounts	(20,000)	(40,000)
Sales	400,000	200,000
Cost of goods sold	350,000	70,000

What is the receivables turnover ratio as of December 31, year 2?

- a. 5.0
- b. 4.7
- c. 3.5
- d. 0.6

**ANSWER:**

Choice "b" is correct. To calculate AR turnover, average net receivables must first be calculated:

$$\text{Average net receivables} = [(\$100,000 - \$20,000) + (\$130,000 - \$40,000)]/2 = \$85,000$$

Accounts receivable turnover is then calculated as:

$$\text{AR Turnover} = \text{Net Credit Sales} / \text{Average net receivables} = 400,000 / 85,000 = 4.7$$

Choice "a" is incorrect. AR turnover is calculated using average net receivables, not 12/31, year 2 net receivables. Whenever a ratio combines balance sheet and income statement items, the average of the balance sheet item should be used.

Choice "c" is incorrect. AR turnover should be calculated using net receivables, not gross receivables.

Choice "d" is incorrect. This answer is not reasonable given the facts and the AR turnover formula.

**46. CPA-05461**

Which of the following is generally associated with the terms of convertible debt securities?

- a. An interest rate that is lower than nonconvertible debt.
- b. An initial conversion price that is less than the market value of the common stock at time of issuance.
- c. A noncallable feature.
- d. A feature to subordinate the security to nonconvertible debt.

**ANSWER:**

Choice "a" is correct. The interest rate on convertible debt is generally lower than nonconvertible debt because of the value of the conversion feature.

Choice "b" is incorrect. The conversion price is generally greater than the market value of the common stock at the time of issuance.

Choice "c" is incorrect. This is not a typical feature of convertible debt securities.

Choice "d" is incorrect. Convertible debt is not typically subordinate to nonconvertible debt.

**47. CPA-05462**

During the current year, Ace Co. amortized a bond discount. Ace prepares its statement of cash flows using the indirect method. In which section of the statement should Ace report the amortization of the bond discount?

- a. Financing activities.
- b. Operating activities.
- c. Investing activities.
- d. Supplemental disclosures.

**ANSWER:**

Choice "b" is correct. When the indirect method is used, net income must be adjusted for all income statement items that do not affect operating cash receipts and disbursements. When a bond interest payment is made, the following journal entry is recorded:

DR	Interest expense
CR	Cash
CR	Bond discount amortization

Interest expense exceeds the cash interest payment by the amount of the bond discount amortization. The bond discount amortization must therefore be added back to net income so that operating activities reflect only the cash paid for interest.

Choice "a" is incorrect. Although arising from debt, which is a financing activity, bond discount amortization is reported in operating activities because it is related to interest expense, which is an income statement (operating activities) item.

Choice "c" is incorrect. Bond discount amortization is not related to investments and is therefore not reported in investing activities.

Choice "d" is incorrect. Bond discount amortization is reported in operating activities when the indirect method is used for the reasons described above.

**48. CPA-05463**

Beach Co. determined that the decline in the fair market value (FMV) of an investment was below the amortized cost and permanent in nature. The investment was classified as available-for-sale on Beach's books. The controller would properly record the decrease in FMV by including it in which of the following?

- a. Other comprehensive income section of the income statement only.
- b. Earnings section of the income statement and writing down the cost basis to FMV.
- c. Extraordinary items section of the income statement, net of tax, and writing down the cost basis to FMV.
- d. Other comprehensive income section of the income statement, and writing down the cost basis to FMV.

**ANSWER:**

Choice "b" is correct. When an available-for-sale security is determined to be impaired because of a permanent decline in fair value below cost, the asset must be written down to the lower fair value by recording a loss that is recognized on the income statement.

Choice "a" is incorrect. The impairment of an available-for-sale security must be recorded on the income statement. Only gains and non-permanent losses on available-for-sale securities are reported in other comprehensive income.

Choice "c" is incorrect. The impairment of an available-for-sale security is reported as a component of income from continuing operations and is not considered an extraordinary item.

Choice "d" is incorrect. The impairment of an available-for-sale security must be recorded on the income statement. Only gains and non-permanent losses on available-for-sale securities are reported in other comprehensive income.

**49. CPA-05464**

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

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

**ANSWER:**

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

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

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

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