Chapter 5 - Accounting Changes and Restatements, Financial Statement Notes, and Non-GAAP Metrics

True/False Questions:

[QUESTION]

1. All changes in accounting principle must be treated retrospectively.

Answer: False

Learning Objective: 05-01

Difficulty: 1 Easy

AACSB: Reflective Thinking

AICPA: FN Reporting

Blooms: Remember

Topic: Change in Accounting Principle

[QUESTION]

2. A financial analyst will carefully review company financial statements for evidence of transactions involving related parties in part because such transactions may create the risk of wealth transfer to single stockholders.

Answer: True

Learning Objective: 05-03

Difficulty: 1 Easy

AACSB: Reflective Thinking

AICPA: FN Risk Analysis

Blooms: Understand

Topic: Related-Party Transactions

[QUESTION]

3. Including non-GAAP metrics in a company’s annual report is acceptable and may provide useful information for decision makers.

Answer: True

Learning Objective: 05-04

Difficulty: 1 Easy

AACSB: Reflective Thinking

AICPA: FN Risk Analysis

Blooms: Understand

Topic: Non-GAAP metrics

[QUESTION]

4. A related party transaction occurs when a company enters a transaction with individuals or other companies that are connected in some way with it or its management.

Answer: True

Learning Objective: 05-03

Difficulty: 2 Medium

AACSB: Reflective Thinking

AICPA: BB Critical Thinking

AICPA: FN Measurement

Blooms: Understand

Topic: Related-Party Transactions

[QUESTION]

5. Events that occur after the financial statements are issued are referred to as subsequent events.

Answer: False

Feedback: Subsequent event are those events that occur after the close of the end of the fiscal period, but prior to issuing financial statements.

Learning Objective: 05-03

Difficulty: 2 Medium

AACSB: Reflective Thinking

AICPA: BB Critical Thinking

AICPA: FN Measurement

Blooms: Understand

Topic: Subsequent Events

Multiple Choice Questions:

[QUESTION]

6. Which of the following represents a change in accounting principle?

a. Adopting a new standard issued by FASB.

b. Switching from a non-GAAP method to a GAAP method.

c. Changing from one GAAP depreciation method to another GAAP method.

d. Adjusting the Cost of Goods Sold account for the difference between the inventory balance and the inventory on hand.

Answer: a

Learning Objective: 05-01

Difficulty: 2 Medium

AACSB: Reflective Thinking

AICPA: FN Reporting

Blooms: Understand

Topic: Change in Accounting Principle

[QUESTION]

7. Adoption of ASC Topic 606 related to revenue recognition represents a

a. mandatory change in accounting principle.

b. voluntary change in accounting principle.

c. mandatory change in accounting estimate.

c. voluntary change in accounting estimate.

Answer: a

Learning objective: 05-01

Difficulty: 2 Medium

AACSB: Reflective Thinking

AICPA: FN Reporting

Blooms: Understand

Topic: Change in Accounting Principle

[QUESTION]

8. Adoption of ASC Topic 842 related to leases represents a

a. mandatory change in accounting estimate.

b. voluntary change in accounting estimate.

c. mandatory change in accounting principle.

d. voluntary change in accounting principle.

Answer: c

Learning objective: 05-01

Difficulty: 2 Medium

AACSB: Reflective Thinking

AICPA: FN Reporting

Blooms: Understand

Topic: Change in Accounting Principle

[QUESTION]

9. What is the primary accounting and reporting issue arising from accounting changes?

1. The effect of the change on net income.
2. The cost associated with the accounting change.
3. The timelines or reporting of the accounting change.
4. The transition rules applying to the accounting change.

Answer: d

Learning Objective: 05-01

Difficulty: 2 Medium

AACSB: Reflective Thinking

AICPA: FN Reporting

Blooms: Understand

Topic: Change in Accounting Principle, Change in Accounting Estimate, Change in Entity

[QUESTION]

10. Which of the following characterize(s) financial statement notes?

1. They pertain to the financial statements as a whole.
2. They explain specific financial statement amounts.
3. They provide extensive additional information.
4. All of these are characteristics of financial statement notes.

Answer: d

Learning Objective: 05-03

Difficulty: 1 Easy

AACSB: Reflective Thinking

AICPA: FN Reporting

Blooms: Remember

Topic: Notes to the financial statements

[QUESTION]

11. Bertram Inc. purchased new state-of-the-art equipment. Its previously used equipment, which was recently retired, was depreciated over a useful (service) life of ten years. The firm’s accounting manager continued depreciating the new equipment over a ten-year useful life. Two years after acquisition, an audit reveals that a five to six-year useful life would have been more appropriate. Addressing this issue represents a

1. change in accounting principle.
2. change in accounting estimate.
3. change in entity.
4. correction of error.

Answer: d

Feedback: The description of the situation suggests that the manager did not carefully consider the underlying transaction; thus, this gives rise to an error correction, rather than a change in estimate.

Learning Objective: 05-02

Difficulty: 2 Medium

AACSB: Knowledge Application

AICPA: Critical Thinking

Blooms: Apply

Topic: Reporting Error Corrections

[QUESTION]

12. Roberts Inc. acquired a controlling interest in Pernell LLC. This situation represents

1. change in accounting principle.
2. change in estimate.
3. change in entity.
4. correction of error,

Answer: c

Learning Objective: 05-01

Difficulty: 2 Medium

AACSB: Knowledge Application

AICPA: Critical Thinking

Blooms: Apply

Topic: Change in Entity

[QUESTION]

13. Accounting changes may be

1. voluntary.
2. mandatory.
3. voluntary or mandatory.
4. Predetermined.

Answer: c

Learning Objective: 05-01

Difficulty: 1 Easy

AACSB: Knowledge Application

AICPA: Critical Thinking

Blooms: Remember

Topic: Change in Accounting principle, change in Accounting Estimate, Change in Entity

[QUESTION]

14. Which of the following situations is not a change in reporting entity?

a. Issuing consolidated financial statements for the first time,

b. Disposing of one of the company’s four subsidiaries.

c. Purchasing 10% of the outstanding shares of a supplier.

d. All of these answer choices are correct.

Answer: c

Learning Objective: 05-01

Difficulty: 2 Medium

AACSB: Reflective Thinking

AICPA: FN Measurement

Blooms: Remember

Topic: Change in Entity

[QUESTION]

15. Which of the following situations does not properly state the reporting requirements when a change in reporting entity occurs?

1. Comparative financial statements for prior years must be restated to reflect the new reporting entity as if it had been inexistence during all the years presented.
2. Comparative financial statements for the prior year only must be restated to reflect the new reporting entity.
3. The effect of the change on income before extraordinary items, net income and other comprehensive income must be restated.
4. Per share amounts must be disclosed for all periods presented.

Answer: b

Learning Objective: 05-01

Difficulty: 2 Medium

AACSB: Reflective Thinking

AICPA: FN Measurement

Blooms: Remember

Topic: Change in Entity

[QUESTION]

16. When reporting a change in an accounting principle, the general rule requires that the current year’s income from continuing operations reflect

a. use of the newly adopted principle for the current year recognition.

b. use of the old principle for the current year recognition.

c. management’s choice of either the old or newly adopted principle for the current year recognition.

d. FASB’s designation of either the old or newly-adopted principle based on the item being changed.

Answer: a

Learning Objective: 05-01

Difficulty: 1 Easy

AACSB: Reflective Thinking

AICPA: FN Measurement

Blooms: Remember

Topic: Change in accounting principle

[QUESTION]

17. Non-GAAP measures typically are found

1. on the face of the financial statements.
2. in the financial statement notes.
3. in the management discussion and analysis section.
4. In the proxy statement.

Answer: c

Learning Objective: 05-04

Difficulty: 1 Easy

AACSB: Reflective Thinking

AICPA: FN Reporting

Blooms: Remember

Topic: Non-GAAP metrics

|  |
| --- |
| [QUESTION] |
| 18. Accounting treatment for changes in accounting principle are best described as: |

|  |
| --- |
| a. Changes in accounting principle that are only permitted when FASB issues a standard that revises GAAP. |
| b. Changes in accounting principle that are always accounted for using the retrospective approach which requires only a restatement of prior years’ presented financial information. |
| c. Changes in accounting principle that may require both a restatement of prior years’ financial information and the recording of a cumulative adjustment to retained earnings. |
| d. Tax effects are ignored when reporting changes in accounting principles. |
| Answer: c |
| Learning Objective: 05-01 |
| Difficulty: 2 Medium |
| AACSB: Reflective Thinking |
| AICPA: FN Measurement |
| Blooms: Understand |
| Topic: Change in accounting principle |

[QUESTION]

19. A cumulative effect of a change in an accounting principle is measured as

a. the difference between prior periods’ net income under the old method and what would have been reported if the new method had been used in the prior years.

b. the after-tax difference between prior periods’ net income under the old method and what would have been reported if the new method had been used in the prior years.

c. the difference between prior periods’ net income and current net income under the old method and what would have been reported if the new method had been used in the prior years and the current year.

d. the after-tax difference between prior periods’ net income and current net income under the old method and what would have been reported if the new method had been used in the prior years and the current year.

Answer: b

Learning Objective: 05-01

Difficulty: 3 Hard

AACSB: Reflective Thinking

AICPA: FN Measurement

Blooms: Understand

Topic: Change in accounting principle

[QUESTION]

20. When using the retrospective approach for a change in accounting principle, disclosure rules require that

a. prior years’ income statements presented for comparative purposes be restated to reflect use of the new principle unless it is impractical to do so.

b. all prior years’ income statements be restated to reflect use of the new principle, and include a pro forma net income figure of the previously reported income.

c. no prior years’ income statements be restated, but a pro forma net income figure be provided to reflect use of the new principle for each year presented.

d. no prior years’ income statements be restated, and no pro forma net income figures be provided.

Answer: a

Learning Objective: 05-01

Difficulty: 2 Medium

AACSB: Reflective Thinking

AICPA: FN Measurement

Blooms: Remember

Topic: Change in accounting principle

|  |
| --- |
| [QUESTION] |
| 21. Which of the following items is **not** a type of accounting change?   |  | | --- | | a. Change in accounting principles used; for example, a change from LIFO to FIFO. | | b. Change in the majority owner of the company. | | c. Change in accounting estimate; for example, a change in the useful life or salvage value of a depreciable asset. | | d. Change to consolidated financial statements from individual financial statements. | | Answer: b | | Learning Objective: 05-01 | | Difficulty: 2 Medium | | AACSB: Reflective Thinking | | AICPA: FN Measurement | | Blooms: Remember | | Topic: Change in accounting principle Change in accounting estimate, Change in entity | |

[QUESTION]

22. Mackintosh recognized warranty expense equal to five percent of net sales revenue generated on the sale of its newest product. One year after introducing the new product, Mackintosh determines that significantly fewer units than predicted were returned by customers for repair or replacement and that this justifies an accounting change. Mackintosh should account for this change

a. prospectively.

b. retrospectively.

c. by restating prior years’ financial statements.

d. ignoring the revised estimate.

Answer: a

Learning Objective: 05-01

|  |
| --- |
| Difficulty: 2 Medium |
| AACSB: Reflective Thinking |
| AICPA: FN Measurement |
| Blooms: Remember |
| Topic: Change in accounting estimate |

[QUESTION]

23. When a company changes from LIFO to another inventory method, the change is reported

a. prospectively because it is impractical to determine the effects of this change on prior years’ net income.

b. as an error correction.

c. as a change in an accounting estimate.

d. using the retrospective approach.

Answer: d

Learning Objective: 05-01

Difficulty: 2 Medium

AACSB: Reflective Thinking

AICPA: FN Measurement

Blooms: Understand

Topic: Change in accounting principle

[QUESTION]

24. When a company changes from straight-line depreciation to double-declining-balance depreciation, the change is reported

a. prospectively because it is impractical to determine the effects of this change on prior years’ net income.

b. as an error correction.

c. as a change in an accounting estimate.

d. using the retrospective approach.

Answer: c

Learning Objective: 05-01

Difficulty: 2 Medium

AACSB: Reflective Thinking

AICPA: FN Measurement

Blooms: Understand

Topic: Change in accounting estimate

[QUESTION]

25. When a company changes from any inventory method to LIFO, the change is reported

a. prospectively because it is usually impractical to determine the effects of this change on prior years’ net income.

b. as an error correction.

c. as a change in an accounting estimate.

d. using the retrospective approach.

Answer: a

Learning Objective: 05-01

Difficulty: 2 Medium

AACSB: Reflective Thinking

AICPA: FN Measurement

Blooms: Understand

Topic: Change in Accounting Principle

[QUESTION]

26. Which of the following accounting principle changes typically is reported prospectively?

a. Changing inventory method from LIFO to FIFO.

b. Changing inventory method from FIFO to LIFO.

c. Changing reporting of investments from the equity method to the fair value method.

d. Adopting ASC topic 606 on revenue recognition on the standard’s effective date.

Answers: b

Learning Objective: 05-01

Difficulty: 2 Medium

AACSB: Reflective Thinking

AICPA: FN Reporting

Blooms: Understand

Topic: Change in Accounting Principle

[QUESTION]

27. Royal, Inc. discovered that equipment purchased on January 1, 20X1 for $300,000 will not last as long as originally estimated. The firm was depreciating the equipment at the rate of $40,000 per year with an estimated salvage value of $20,000. Revised estimates on January 1, 20X4 indicate that the equipment will last a total of five years with no salvage value. How much should Royal, Inc. record as depreciation in 20X4?

a. $40,000

b. $60,000

c. $90,000

d. $120,000

Answer: c

Feedback: $300,000 – ($40,000 × 3) = $180,000 (remaining book value) ÷ 2 (remaining useful life) = $90,000

Learning Objective: 05-01

Difficulty: 2 Medium

AACSB: Knowledge Application

AICPA: FN Measurement

Blooms: Apply

Topic: Change in accounting estimate

[QUESTION]

28. Which of the following are commonly excluded from non-GAAP income-related metrics presented in 10-K or 10-Q reports?

1. Interest, taxes, depreciation, and amortization
2. Accrual related to contingent losses
3. Write-offs related to obsolete inventory
4. Salaries paid to top executives

Answer: a

Learning Objective: 05-04

Difficulty: 2 Medium

AACSB: Knowledge Application

AICPA: FN Measurement

Blooms: Apply

Topic: Non-GAAP metrics

[QUESTION]

29. When reporting a change in an accounting principle, the general rule requires that the current year’s income from continuing operations reflect

a. use of the newly adopted principle for the current year recognition.

b. use of the old principle for the current year recognition.

c. management’s choice of either the old or newly adopted principle for the current year recognition.

d. FASB’s designation of either the old or newly-adopted principle based on the item being changed.

Answer: a

Learning Objective: 05-01

Difficulty: 1 Easy

AACSB: Reflective Thinking

AICPA: FN Measurement

Blooms: Remember

Topic: Change in accounting principle

[QUESTION]

30. An increase in the useful life of equipment currently in use represents a(n)

a. change in accounting principle.

b. change in entity.

c. change in accounting estimate.

d. correction of error.

Answer: c

Learning Objective: 05-01

Difficulty: 1 Easy

AACSB: Reflective Thinking

AICPA: FN Reporting

Blooms: Understand

Topic: Change in Accounting Estimate

[QUESTION]

31. A change from the LIFO to the FIFO inventory method represents a(n)

a. change in accounting principle.

b. change in entity.

c. change in accounting estimate.

d. correction of error.

Answer: a

Learning Objective: 05-01

Difficulty: 1 Easy

AACSB: Reflective Thinking

AICPA: FN Reporting

Blooms: Understand

Topic: Change in Accounting Principle

[QUESTION]

32. Acquiring controlling interest in another company represents a(n)

a. change in accounting principle.

b. change in entity.

c. change in accounting estimate.

d. correction of error.

Answer: b

Learning Objective: 05-01

Difficulty: 1 Easy

AACSB: Reflective Thinking

AICPA: FN Reporting

Blooms: Understand

Topic: Change in Entity

[QUESTION]

33. Accounting errors or irregularities can occur for which reasons?

1. simple oversight.
2. misapplication of GAAP.
3. management exploitation of the flexibility in GAAP.
4. all of these answer choices are correct.

Answer: d

Learning Objective: 05-02

Difficulty: 2 Medium

AACSB: Reflective Thinking

AICPA: BB Critical Thinking

AICPA: FN Risk Analysis

Blooms: Remember

Topic: Reporting Error Corrections

[QUESTION]

34. Which of the following parties are responsible for the detection of errors and accounting irregularities in a company’s financial statements?

1. external auditors.
2. the SEC staff during their review process.
3. internal audit staff and audit committee of the board of directors.
4. all of these answer choices are correct.

Answer: d

Learning Objective: 05-02

Difficulty: 2 Medium

AACSB: Reflective Thinking

AICPA: FN Risk Analysis

Blooms: Understand

Topic: Reporting Error Corrections

[QUESTION]

35. Revision restatements differ from reissuance restatements in that revision restatements address misstatements

a. affecting only one prior reporting period.

b. that are less severe than those requiring reissuance restatements.

c. that increased income.

d. that decreased income.

Answer: b

Learning Objective: 05-02

Difficulty: 2 Medium

AACSB: Reflective Thinking

MisAICPA: FN Measurement

Blooms: Remember

Topic: Reporting Error Corrections

[QUESTION]

36. Select the statement that is **not** correct regarding financial statement misstatements that require reissuance of previously issued reports.

a. Information regarding misstatements must be reported to the SEC within four days of discovery of the misstatement(s).

b. Reissuance of financial statements is required for severe misstatements of reported information.

c. All investors must be informed by the company in writing.

d. Notice of reissuance of prior period financial statements must be made in subsequent filings.

Answer: c

Learning Objective: 05-02

Difficulty: 2 Medium

AACSB: Reflective Thinking

AICPA: FN Measurement

Blooms: Remember

Topic: Reporting Error Corrections

|  |
| --- |
| [QUESTION] |
| 37. Which of the following situations may create an accounting error?   |  | | --- | | a. Simple oversight. | | b. Parties disagree on accounting for a transaction resulting in a misapplication of GAAP. | | c. Management exploits the flexibility in GAAP to inflate earnings. | | d. All of these answer choices are correct. | | Answer: d | | Learning Objective: 05-02 | | Difficulty: 1 Easy | | AACSB: Reflective Thinking | | AICPA: FN Measurement | | Blooms: Remember | | Topic: Reporting Error Corrections | |

REFERENCE: Ref. 05\_01

On December 31, 20X1, Katherine Company purchases merchandise with shipping terms FOB destination. The company’s accountant records the purchase on the day the order is placed. The merchandise is not included in the ending inventory. No additional journal entry is made when the merchandise arrives on January 5, 20X2.

[QUESTION]

REFER TO: Ref. 05\_01:

38. As a result of this error, Katherine Company’s 20X1

1. income will be overstated.
2. income will be understated.
3. ending inventory is understated.
4. ending inventory is overstated.

Answer: b

Feedback: Ending inventory is correct; however, cost of goods available for sale was overstated, causing cost of goods sold to be overstated, and income to be understated.

Learning Objective: 05-02

Difficulty: 2 Medium

AACSB: Analytical Thinking

AICPA: FN Measurement

Blooms: Analyze

Topic: Reporting Error Corrections

[QUESTION]

REFER TO: Ref. 05\_01:

39. Assume that Katherine Company discovers the error at the beginning of 20X2. What journal entry should be made to correct the prior-year error?

a. Debit Retained Earnings, Credit Inventory

b. Debit Inventory, Credit Retained Earnings

c. Debit Inventory, Credit Cost of Goods Sold

d. No journal entry is necessary

Answer: b

Learning Objective: 05-02

Difficulty: 3 Hard

AACSB: Analytical Thinking

AICPA: FN Measurement

Blooms: Apply

Topic: Reporting Error Corrections

[QUESTION]

REFER TO: Ref. 05\_01:

40. Assume that the error is not discovered. As a result of this error, Katherine Company’s 20X2:

a. income will be overstated.

b. income will be understated.

c. ending inventory is understated.

d. ending inventory is overstated.

Answer: a

Feedback: Beginning inventory is understated causing goods available for sale to be understated and income to be overstated.

Learning Objective: 05-02

Difficulty: 2 Medium

AACSB: Analytical Thinking

AICPA: FN Measurement

Blooms: Analyze

Topic: Reporting Error Corrections

[QUESTION]

REFER TO: Ref. 05\_01:

41. Assume that Katherine Company discovers the error is discovered at the beginning of 20X3. What journal entry should be made to correct the 20X1 error?

a. Debit Retained Earnings, Credit Inventory

b. Debit Inventory, Credit Retained Earnings

c. Debit Inventory, Credit Cost of Goods Sold

d. No journal entry is necessary

Answer: d

Feedback: The error has counterbalanced

Learning Objective: 05-02

Difficulty: 3 Hard

AACSB: Analytical Thinking

AICPA: FN Measurement

Blooms: Apply

Topic: Reporting Error Corrections

[QUESTION]

REFER TO: Ref. 05\_01:

42. Assume that Katherine Company discovers the error is discovered at the beginning of 20X3. What journal entry should be made to correct the 20X1 error?

a. Debit Retained Earnings, Credit Inventory

b. Debit Inventory, Credit Retained Earnings

c. Debit Inventory, Credit Cost of Goods Sold

d. No journal entry is necessary

Answer: d

Feedback: The error has counterbalanced

Learning Objective: 05-02

Difficulty: 3 Hard

AACSB: Analytical Thinking

AICPA: FN Measurement

Blooms: Apply

Topic: Reporting Error Corrections

[QUESTION]

43. All the following disclosures would appear in the Summary of Significant Accounting Policies **except**

a. inventory method.

b. depreciation method.

c. revenue recognition method.

d. financing method.

Answer: d

Learning Objective: 05-03

Difficulty: 2 Medium

AACSB: Reflective Thinking

AICPA: BB Critical Thinking

AICPA: FN Measurement

Blooms: Understand

Topic: Notes to financial statements

[QUESTION]

44. Notes to the financial statements typically contain all the following **except**

a. a summary of significant accounting policies.

b. disclosure of important subsequent events.

c. management’s discussion and analysis.

d. related-party transactions.

Answer: c

Learning Objective: 05-03

Difficulty: 2 Medium

AACSB: Reflective Thinking

AICPA: BB Critical Thinking

AICPA: FN Measurement

Blooms: Understand

Topic: Notes to financial statements

[QUESTION]

45. The Summary of Significant Accounting Policies

a. explains the important accounting choices the reporting entity uses to account for selected transactions and accounts.

b. does not contain an explanation of the company’s revenue recognition policies.

c. is generally a part of the equity section of the balance sheet.

d. is only required as part of a prospectus for the sale of new shares of stock.

Answer: a

Learning Objective: 05-03

Difficulty: 2 Medium

AACSB: Reflective Thinking

AICPA: BB Critical Thinking

AICPA: FN Measurement

Blooms: Understand

Topic: Summary of significant accounting policies

[QUESTION]

46. Subsequent events

a. are those significant events that occur after the financial statements are issued.

b. are subject to optional disclosure based on a recommendation from top management.

c. are required to be disclosed if they are material and likely to influence investors’ appraisal of the risk and return prospects of the reporting entity.

d. are those significant events that occur in the last quarter of the reporting period.

Answer: c

Learning Objective: 05-03

Difficulty: 1 Easy

AACSB: Reflective Thinking

AICPA: BB Critical Thinking

AICPA: FN Measurement

Blooms: Remember

Topic: Subsequent events

[QUESTION

47. A related-party transaction

a. is assumed to be an arms-length transaction.

b. can take place between subsidiaries of a common parent.

c. does not need to be disclosed in financial statements prepared under U.S. GAAP.

d. presents less risk than a similar transaction with a third party.

Answer: b

Learning Objective: 05-03

Difficulty: 2 Medium

AACSB: Reflective Thinking

AICPA: BB Critical Thinking

AICPA: FN Measurement

Blooms: Understand

Topic: Related-Party Transactions

[QUESTION]

48. Which of the following is **not** true regarding the tax note to the financial statements?

a. The tax note is never required to include any information on foreign tax rate implications.

b. The tax note can describe how financial reporting differs from tax accounting.

c. The tax note can describe how tax disputes may affect future tax payments.

d. The tax note can explain how foreign tax rates affect income tax expense.

Answer: a

Learning Objective: 05-03

Difficulty: 2 Medium

AACSB: Reflective Thinking

AICPA: BB Critical Thinking

AICPA: FN Measurement

Blooms: Understand

Topic: Notes to financial statements

[QUESTION]

49. The summary of significant accounting policies does not help explain

a. the cost flow assumptions for valuing inventory.

b. management’s assessment of the financial condition of the firm.

c. the method used for determining depreciation expense.

d. whether certain investments are accounted for using the equity method.

Answer: b

Learning Objective: 05-03

Difficulty: 2 Medium

AACSB: Reflective Thinking

AICPA: BB Critical Thinking

Blooms: Understand

Topic: Summary of significant accounting policies

[QUESTION]

50. Angela Dams purchases new equipment for $66,000 with an estimated useful (service) life of 6 years and a salvage value of $6,000. The company depreciates the equipment over six years. After two years, the company revises its estimate to total useful life of 8 years, with no change in salvage value. Depreciation for year 3 will be:

a. 10,000

b. 7,666

c. 7,500

d. 6,667

Answer: d

Feedback: Annual depreciation expense assuming 6-year life is $10,000 ((66,000-6,000)/6. Book value after two years of depreciation is $46,000 (66,000-20,000). Depreciation for years 3, 4, 5, 6, and 7 is: $6,667= (46,000-6,000)/6).

Learning Objective: 05-01

Difficulty: 2 Medium

AACSB: Knowledge Application

AICPA: FN Measurement

Blooms: Apply

Topic: Change in accounting estimate

[QUESTION]

51. ASC Topic 606 on Revenue Recognition requires which transition method?

a. Full retrospective restatement

b. Modified retrospective approach

c. Full retrospective restatement or modified retrospective approach

d. Retrospective restatement or prospective approach

Answer: c

Learning Objective: 05-01

Difficulty: 1 Easy

AACSB: Reflective Thinking

AICPA: FN Reporting

Blooms: Remember

Topic: Change in Accounting Principle

Essays and Computational Problems:

[QUESTION]

52. Delta Co. began operations on January 1, 20X1. During 20X1 and 20X2, the company used the weighted-average method for its inventory costing. In 20X3, the company changed its method of inventory costing to FIFO so that its financial statements would be more comparable to those of other firms in its industry. If the FIFO method had been used, Delta’s cost of goods sold would have been $45,000 less in 20X1 and $35,000 less in 20X2. Delta’s income statements, as originally presented, appear below. Delta’s tax rate is 21%.

|  |  |  |  |
| --- | --- | --- | --- |
|  | **20X1** | **20X2** | **20X3** |
| Sales | $1,000,000 | $1,100,000 | $1,210,000 |
| Cost of goods sold | 645,000 | 695,000 | 726,000 |
| Gross profit | 355,000 | 405,000 | 484,000 |
| Selling, general and administrative expenses | 250,000 | 255,000 | 265,000 |
| Depreciation expense | 55,000 | 55,000 | 55,000 |
| Income before tax | 50,000 | 95,000 | 164,000 |
| Income tax expense | 10,500 | 19,950 | 34,440 |
| Net income | $39,500 | $75,050 | $129,560 |

**Required:**

Assume that for comparison purposes Delta presents 20X1 and 20X2 income statements in its 20X3 annual report. Revise Delta’s 20X1 and 20X2 income statements to appear as they should in the 20X3 annual report.

Answer:

|  |  |  |  |
| --- | --- | --- | --- |
|  | **20X1** | **20X2** | **20X3** |
| Sales | $1,000,000 | $1,100,000 | $1,210,000 |
| Cost of goods sold | 600,000 | 660,000 | 726,000 |
| Gross profit | 400,000 | 440,000 | 484,000 |
| Selling, general and administrative expenses | 250,000 | 255,000 | 265,000 |
| Depreciation expense | 55,000 | 55,000 | 55,000 |
| Income before taxes | 95,000 | 130,000 | 164,000 |
| Income tax expense | 19,950 | 27,300 | 34,440 |
| Net income | $75,050 | $102,700 | $129,560 |

Feedback: Adjustment to inventory = cost of goods sold as originally reported under weighted-average – cost of goods sold under FIFO = ($645,000 + $695,000) − ($600,000 + $660,000) = $80,000 over the two-year period of 20X1 and 20X2. Since pretax income—as restated for the two years—is increased by $80,000, taxes on the increase @ 21% = $16,800 total for the two years.

Learning Objective: 05-01

Difficulty: 2 Medium

AACSB: Knowledge Application

AICPA: FN Measurement

Blooms: Apply

Topic: Change in accounting principle

[QUESTION]

53. Primo Landscaping commenced its business on January 1, 20X1. On December 31, 20X1, Primo Landscaping did not record any adjusting entries with respect to the following transactions:

|  |  |
| --- | --- |
| a. | During the first year of its operations, Primo purchased supplies in the amount of $10,000 (debited to “Supplies expense”), and of this amount, $3,000 were unused as of December 31, 20X1. |
| b. | On March 15, 20X1 Primo received $36,000 for landscape maintenance services to be rendered for 24 months (beginning July 1, 20X1). This amount was credited to “Landscaping revenue.” |
| c. | The company’s fuel bill for $1,300 for the month of December 20X1 was not received until January 15, 20X2. |
| d. | The company borrowed $100,000 from First Bank on April 1, 20X1 at an interest rate of 12% per year. The principal, along with all of the interest, is due on March 30, 20X2. |
| e. | On January 17, 20X1 the company purchased a backhoe for $65,000. The backhoe is expected to last for 10,000 hours and have no salvage value. During the year, Primo operated the backhoe for 500 hours. |

**Required:**

1. Complete the table below, showing the effect of the omission of each year-end adjusting entry on assets, liabilities, and net income for 20X1. Use “OS” for overstated, “US” for understated, and “NE” for no effect.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Item Number | Effect of Omission | Assets | Liabilities | Net Income |
| a. | Direction of effect  Dollar amount of effect |  |  |  |
| b. | Direction of effect  Dollar amount of effect |  |  |  |
| c. | Direction of effect  Dollar amount of effect |  |  |  |
| d. | Direction of effect  Dollar amount of effect |  |  |  |
| e. | Direction of effect  Dollar amount of effect |  |  |  |

Answer:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Item Number | Effect of Omission | Assets | Liabilities | Net Income |
| a. | Direction of effect  Dollar amount of effect | US  $3,000 | NE | US  $3,000 |
| b. | Direction of effect  Dollar amount of effect | NE | US  $27,000 | OS  $27,000 |
| c. | Direction of effect  Dollar amount of effect | NE | US  $1,300 | OS  $1,300 |
| d. | Direction of effect  Dollar amount of effect | NE | US  $9,000 | OS  $9,000 |
| e. | Direction of effect  Dollar amount of effect | OS  $3,250 | NE | OS  $3,250 |

Feedback: a. Asset not recorded = $3,000 supplies on hand at 12/31/20X1. b. Deferred revenue not adjusted for = $1,500 per month for services to be rendered from 1/1/20X2 to 6/30/20X3. c. Fuel expense not recorded = $1,300. d. Interest expense for 9 months not accrued = $100,000 × 0.12 × 9/12 = $9,000. e. Depreciation expense not recorded = $65,000 ÷ 100,000 hours = $6.50/hour depreciation rate × 500 hours used in 20X1 = $3,250.

Learning Objective: 05-02

Difficulty: 2 Medium

AACSB: Knowledge Application

AICPA: FN Measurement

Blooms: Analyze

Topic: Reporting Error Corrections

REFERENCE: Ref. 05\_02

The following errors occurred during 20X1.

1. Inventory costing $3,000, purchased on December 29, FOB shipping point was not included in the ending inventory count. The inventory and related invoice arrived on January 2, 20X2.
2. On January 2, the cost of maintaining equipment in the amount of $40,000 was debited to the Equipment account. The company depreciates equipment over four years, with no estimated salvage value.
3. The cost of supplies purchased during the year was expensed as incurred. No adjusting entry was made for supplies costing $1,000 that were still on hand at December 31.

[QUESTION]

REFER TO: Ref. 05\_02

54. Assume that the errors were not discovered. Complete the following tables, indicating the effect on Financial Statement categories for 20X1.

Effect on 20X1 financial statement categories

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Error No. | Assets | Liabilities | Equity | Net Income |
| 1 |  |  |  |  |
| 2 |  |  |  |  |
| 3 |  |  |  |  |

Answer:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Error No. | Assets | Liabilities | Equity | Net Income |
| 1 | U  $3,000 | U  $3000 | NE | NE |
| 2 | O  $30,000 | NE | O  $30,000 | O  $30,000 |
| 3 | U  $1,000 | NE | U  $1,000 | U  $1,000 |

Feedback:

A: Effect on 20X1:

Error 1: No effect on income since both ending inventory and purchases are understated by the same amount; assets (inventory) are understated and so are liabilities (accounts payable).

Error 2: Capitalizing expenses overstates assets, equity and income. The effect is mitigated by the depreciation that was recorded.

Error 3. Supplies on hand should have been recognized as assets, reducing expenses.

Learning Objective: 05-02

Difficulty: 2 Medium

AACSB: Knowledge Application

AICPA: FN Measurement

Blooms: Analyze

Topic: Reporting Error Corrections

[QUESTION]

REFER TO: Ref. 05\_02

55. Assume that the errors were not discovered. Complete the following tables, indicating the effect on Financial Statement categories for 20X2.

Effect on 20X2 financial statement categories

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Error No. | Assets | Liabilities | Equity | Net Income |
| 1 |  |  |  |  |
| 2 |  |  |  |  |
| 3 |  |  |  |  |

Answer: Effect on 20X2 financial statement categories

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Error No. | Assets | Liabilities | Equity | Net Income |
| 1 | NE | NE | NE | NE |
| 2 | O  $20,000 | NE | O  $20,000 | U  $10,000 |
| 3 | NE | NE | NE | NE |

Feedback:

Error 1: Inventory and accounts payable were recorded when the inventory arrived, thus correcting the prior year error.

Error 2: Assets and equity continue to be overstated until the error counterbalances in year 4 (the end of the life of the asset). Income is understated because depreciation expense is recognized.

Learning Objective: 05-02

Difficulty: 2 Medium

AACSB: Knowledge Application

AICPA: FN Measurement

Blooms: Analyze

Topic: Reporting Error Corrections