

B EXERCISES

- 1 3 E2-1B (Usefulness, Objective of Financial Reporting)** Indicate whether the following statements about the conceptual framework are true or false. If false, provide a brief explanation supporting your position.
- (a) Accounting rule-making that relies on a body of concepts will result in useful and consistent pronouncements.
 - (b) General-purpose financial reports are most useful to company insiders in making strategic business decisions.
 - (c) Accounting standards based on individual conceptual frameworks generally will result in consistent and comparable accounting reports.
 - (d) Capital providers are the only users who benefit from general-purpose financial reporting.
 - (e) Accounting reports should be developed so that users without knowledge of economics and business can become informed about the financial results of a company.
 - (f) The objective of financial reporting is the foundation from which the other aspects of the framework logically result.
- 1 3 4 E2-2B (Usefulness, Objective of Financial Reporting, Qualitative Characteristics)** Indicate whether the following statements about the conceptual framework are true or false. If false, provide a brief explanation supporting your position.
- (a) The fundamental qualitative characteristics that make accounting information useful are relevance and verifiability.
 - (b) Relevant information has predictive value, confirmatory value, or both.
 - (c) Conservatism, a prudent reaction to uncertainty, is considered a constraint of financial reporting.
 - (d) Information that is a faithful representation is characterized as having predictive or confirmatory value.
 - (e) Comparability pertains only to the reporting of information in a similar manner for different companies.
 - (f) Verifiability is solely an enhancing characteristic for faithful representation.
 - (g) In preparing financial reports, it is assumed that users of the reports have reasonable knowledge of business and economic activities.
- 4 E2-3B (Qualitative Characteristics)** *SFAC No. 8* identifies the qualitative characteristics that make accounting information useful. Presented below are a number of questions related to these qualitative characteristics and underlying constraints.
- (a) Predictive value is an ingredient of which of the two fundamental qualities that make accounting information useful for decision-making purposes?
 - (b) Abraham Corp. switches from FIFO to average cost to FIFO over a 2-year period. Which qualitative characteristic of accounting information is not followed?
 - (c) What is the quality of information that enables users to confirm or correct prior expectations?
 - (d) What are the two fundamental qualities that make accounting information useful for decision making?
 - (e) The chairman of the SEC at one time noted, "If it becomes accepted or expected that accounting principles are determined or modified in order to secure purposes other than economic measurement, we assume a grave risk that confidence in the credibility of our financial information system will be undermined." Which qualitative characteristic of accounting information should ensure that such a situation will not occur? (Do not use reliability.)
 - (f) Identify pervasive constraint(s) developed in the conceptual framework?
 - (g) Assume that the profession permits the savings and loan industry to defer losses on investments it sells, because immediate recognition of the loss may have adverse economic consequences on the industry. Which qualitative characteristic of accounting information is not followed? (Do not use relevance or reliability.)
 - (h) Ainsworth, Inc. does not issue its first-quarter report until after the second quarter's results are reported. Which qualitative characteristic of accounting is not followed? (Do not use relevance.)
 - (i) Azuara Company has attempted to determine the replacement cost of its inventory. Three different appraisers arrive at substantially different amounts for this value. The president, nevertheless, decides to report the middle value for external reporting purposes. Which qualitative characteristic of information is lacking in these data? (Do not use reliability or representational faithfulness.)
 - (j) Aslam, Inc. is the only company in its industry to depreciate its plant assets on a straight-line basis. Which qualitative characteristic of accounting information may not be followed? (Do not use industry practices.)

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- 4 E2-4B (Qualitative Characteristics)** The qualitative characteristics that make accounting information useful for decision-making purposes are as follows.

Relevance	Timeliness	Faithful representation
Understandability	Verifiability	Comparability
Predictive value	Neutrality	Confirmatory Value
Completeness	Materiality	

Instructions

Identify the appropriate qualitative characteristic(s) to be used given the information provided below.

- (a) Neutrality is an ingredient of this fundamental quality of accounting information.
- (b) Ignores the economic consequences of a standard or rule.
- (c) Qualitative characteristic being employed when companies in the same industry are using the same accounting principles.
- (d) Predictive value is an ingredient of this fundamental quality of information.
- (e) Imperative for providing comparisons of a firm from period to period.
- (f) Quality of information that confirms users' earlier expectations.
- (g) Requires a high degree of consensus among individuals on a given measurement.
- (h) Four qualitative characteristics that are related to both relevance and faithful representation.
- (i) Issuance of interim reports is an example of this fundamental ingredient of relevance.
- (j) Two fundamental qualities that make accounting information useful for decision-making purposes.

- 5 E2-5B (Elements of Financial Statements)** Ten interrelated elements that are most directly related to measuring the performance and financial status of an enterprise are provided below.

Assets	Distributions to owners	Expenses
Liabilities	Comprehensive income	Gains
Equity	Revenues	Losses
Investments by owners		

Instructions

Identify the element or elements associated with the 12 items below.

- (a) Arises from income statement activities that constitute the entity's ongoing major or central operations.
- (b) Declares and pays cash dividends to owners.
- (c) Arises from peripheral or incidental transactions.
- (d) Items characterized by service potential or future economic benefit.
- (e) Increases ownership interest.
- (f) Obligation to transfer resources arising from a past transaction.
- (g) Increases in net assets in a period from nonowner sources.
- (h) Equals increase in assets less liabilities during the year, after adding distributions to owners and subtracting investments by owners.
- (i) Increases assets during a period through sale of product.
- (j) Residual interest in the assets of the enterprise after deducting its liabilities.
- (k) Includes all changes in equity during the period, except those resulting from investments by owners and distributions to owners.
- (l) Decreases assets during the period by purchasing the company's own stock.

- 6 E2-6B (Assumptions, Principles, and Constraint)** Presented below are the assumptions, principles, and constraints used in this chapter.

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|--|---------------------------------------|
| 1. Economic entity assumption | 6. Measurement principle (fair value) |
| 2. Going concern assumption | 7. Expense recognition principle |
| 3. Monetary unit assumption | 8. Full disclosure principle |
| 4. Periodicity assumption | 9. Cost - constraint |
| 5. Measurement principle (historical cost) | |

Instructions

Identify by number the accounting assumption, principle, or constraint that describes each situation below. Do not use a number more than once.

- (a) Permits the use of market value valuation in certain specific situations.
- (b) Rationale why plant assets are not reported at liquidation value. (Do not use measurement principle.)
- (c) Allocates expenses to revenues in the proper period.
- (d) Indicates that personal and business record keeping should be separately maintained.

- (e) Ensures that all relevant financial information is reported.
- (f) Indicates that market value changes subsequent to purchase are not recorded in the accounts. (Do not use measurement principle.)
- (g) Separates financial information into time periods for reporting purposes.
- (h) Assumes that the dollar is the “measuring stick” used to report on financial performance.

6 7 E2-7B (Assumptions, Principles, and Constraint) Presented below are a number of operational guidelines and practices that have developed over time.

Instructions

Select the assumption, principle, or constraint that most appropriately justifies these procedures and practices. (Do not use qualitative characteristics.)

- (a) All significant post-balance sheet events are reported.
- (b) Intangibles are capitalized and amortized over periods benefited.
- (c) Price-level changes are not recognized in the accounting records.
- (d) Brokerage firms use market value for purposes of valuation of all marketable securities.
- (e) Financial information is presented so that reasonably prudent investors will not be misled.
- (f) Lower-of-cost-or-market is used to value inventories.
- (g) Repair tools are expensed when purchased.
- (h) Each enterprise is kept as a unit distinct from its owner or owners.
- (i) All important aspects of bond indentures are presented in financial statements.
- (j) Revenue is recorded at point of sale.
- (k) A company charges its sales commission costs to expense.
- (l) An allowance for doubtful accounts is established.
- (m) Reporting must be done at defined time intervals.
- (n) Goodwill is recorded only at time of purchase.
- (o) The use of consolidated statements is justified.
- (p) All payments out of petty cash are charged to Miscellaneous Expense.
- (q) Rationale for accrual accounting is stated.

6 7 E2-8B (Full Disclosure Principle) Presented below are a number of facts related to Baez, Inc. Assume that no mention of these facts was made in the financial statements and the related notes.

Instructions

Assume that you are the auditor of Baez, Inc. and that you have been asked to explain the appropriate accounting and related disclosure necessary for each of these items.

- (a) During the year, an assistant controller for the company embezzled \$15,000. Baez’s net income for the year was \$2,300,000. Neither the assistant controller nor the money has been found.
- (b) Baez has reported its ending inventory at \$2,100,000 in the financial statements. No other information related to inventories is presented in the financial statements and related notes.
- (c) The company changed its method of depreciating equipment from the double-declining balance to the straight-line method. No mention of this change was made in the financial statements.
- (d) Equipment purchases of \$170,000 were partly financed during the year through the issuance of a \$110,000 note payable. The company offset the equipment against the note payable and reported plant assets at \$60,000.
- (e) The company decided that, for the sake of conciseness, only net income should be reported on the income statement. Details as to revenues, cost of goods sold, and expenses were omitted.

7 E2-9B (Accounting Principles—Comprehensive) Presented below are a number of business transactions that occurred during the current year for Barela, Inc.

Instructions

In each of the situations, discuss the appropriateness of the journal entries in terms of generally accepted accounting principles.

- (a) The company is being sued for \$500,000 by a customer who claims damages for personal injury apparently caused by a defective product. Company attorneys feel extremely confident that the company will have no liability for damages resulting from the situation. Nevertheless, the company decides to make the following entry.

Loss from Lawsuit	500,000	
Liability for Lawsuit		500,000

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- (b) Because the general level of prices increased during the current year, Barela, Inc. determined that there was a \$16,000 understatement of depreciation expense on its equipment and decided to record it in its accounts. The following entry was made.

Depreciation Expense	16,000	
Accumulated Depreciation		16,000

- (c) Barela, Inc. has been concerned about whether intangible assets could generate cash in case of liquidation. As a consequence, goodwill arising from a purchase transaction during the current year and recorded at \$800,000 was written off as follows.

Retained Earnings	800,000	
Goodwill		800,000

- (d) Merchandise inventory that cost \$620,000 is reported on the balance sheet at \$690,000, the expected selling price less estimated selling costs. The following entry was made to record this increase in value.

Merchandise Inventory	70,000	
Revenue		70,000

- (e) The president of Barela, Inc. used his expense account to purchase a new SUV solely for personal use. The following journal entry was made.

Miscellaneous Expense	29,000	
Cash		29,000

- (f) Because of a “fire sale,” equipment obviously worth \$200,000 was acquired at a cost of \$155,000. The following entry was made.

Equipment	200,000	
Cash		155,000
Revenue		45,000

7 E2-10B (Accounting Principles—Comprehensive) Presented below is information related to Bowman, Inc.

Instructions

Comment on the appropriateness of the accounting procedures followed by Bowman, Inc.

- (a) During the year, the company purchased equipment through the issuance of common stock. The stock had a par value of \$135,000 and a fair market value of \$450,000. The fair market value of the equipment was not easily determinable. The company recorded this transaction as follows.

Equipment	135,000	
Common Stock		135,000

- (b) During the year, the company sold certain equipment for \$285,000, recognizing a gain of \$69,000. Because the controller believed that new equipment would be needed in the near future, she decided to defer the gain and amortize it over the life of any new equipment purchased.

- (c) An order for \$61,500 has been received from a customer for products on hand. This order was shipped on January 9, 2015. The company made the following entry in 2014.

Accounts Receivable	61,500	
Sales		61,500

- (d) Materials were purchased on January 1, 2014, for \$120,000 and this amount was entered in the Materials account. On December 31, 2014, the materials would have cost \$141,000, so the following entry is made.

Inventory	21,000	
Gain on Inventories		21,000

- (e) Depreciation expense on the company’s building for the year was \$60,000. Because the building was increasing in value during the year, the controller decided to charge the depreciation expense to retained earnings instead of to net income. The following entry is recorded.

Retained Earnings	60,000	
Accumulated Depreciation—Buildings		60,000