

B EXERCISES

(LO 4) E2-1B (Qualitative Characteristics) *SFAC No. 2* 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 primary 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 primary 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) What two overall or pervasive constraints are developed in *SFAC No. 2*?
- (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.)

(LO 4) E2-2B (Qualitative Characteristics) The qualitative characteristics that make accounting information useful for decision-making purposes are as follows.

Relevance	Timeliness	Representational faithfulness
Reliability	Verifiability	Comparability
Predictive value	Neutrality	Consistency
Feedback value		

Instructions

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

- (a) Neutrality is an ingredient of this primary 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 primary 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) Two qualitative characteristics that are related to both relevance and reliability.
- (i) Issuance of interim reports is an example of this primary ingredient of relevance.
- (j) Two primary qualities that make accounting information useful for decision-making purposes.

(LO 5) E2-3B (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		

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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.

(LO 6) E2-4B (Assumptions, Principles, and Constraints) Presented below are the assumptions, principles, and constraints used in this chapter.

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|-------------------------------|------------------------------|------------------------|
| 1. Economic entity assumption | 5. Historical cost principle | 9. Materiality |
| 2. Going concern assumption | 6. Matching principle | 10. Industry practices |
| 3. Monetary unit assumption | 7. Full disclosure principle | 11. Conservatism |
| 4. Periodicity assumption | 8. Cost-benefit relationship | |

Instructions

Identify by number the accounting assumption, principle, or constraint that describes each situation below. Do not use a letter 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 historical cost 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 revenue recognition principle.)
- (g) Anticipates all losses, but reports no gains.
- (h) Separates financial information into time periods for reporting purposes.
- (i) Assumes that the dollar is the "measuring stick" used to report on financial performance.
- (j) Requires that information significant enough to affect the decision of reasonably informed users should be disclosed. (Do not use full disclosure principle.)

(LO 6, 7) E2-5B (Assumptions, Principles, and Constraints) 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) No profits are anticipated and all possible losses are recognized.
- (n) Reporting must be done at defined time intervals.



- (o) Goodwill is recorded only at time of purchase.
- (p) The use of consolidated statements is justified.
- (q) All payments out of petty cash are charged to Miscellaneous Expense. (Do not use conservatism.)
- (r) Rationale for accrual accounting is stated.

(LO 6, 7) E2-6B (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.

(LO 7) E2-7B (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

- (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



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- (LO 7) E2-8B (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, 2007. The company made the following entry in 2006.

Accounts Receivable	61,500	
Sales		61,500

- (d) Materials were purchased on January 1, 2007, for \$120,000 and this amount was entered in the Materials account. On December 31, 2007, 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

- (LO 7) E2-9B (Full Disclosure Principle)** Presented below are a number of facts related to Palo Alto Corporation. Assume that no mention of these facts was made in the financial statements and the related notes.

Instructions

State the appropriate accounting and related disclosure necessary for each of these items.

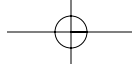
- The company reported gross profit on the income statement. Details of sales and cost of goods sold were omitted.
- The company did not consolidate financial data from one of its special purpose entity because it carried a significant amount of debt on its books.
- The company did not report the depreciation methods used in the financial statements and related notes.
- The company sold accounts receivable to a factoring company, but did not report this in the notes to the financial statements.

- (LO 6, 7) E2-10B (Assumptions, Principles, and Constraints)** 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.)

- Assets are generally valued at their transaction cost.
- Loss contingencies are recognized as soon as they can be estimated, but gain contingencies are not recognized until realized.
- Patents are capitalized and amortized over periods benefited.
- Minor assets are expensed when purchased.
- Oil and gas have unique accounting standards not applicable to firms in other industries.
- Financial results from wholly-owned subsidiaries must be consolidated with the financial statements of the parent company.
- All significant post-balance-sheet events are reported.
- Revenue is recorded when earned.
- All important aspects of hedging instruments are presented in financial statements.
- Reporting must be done at defined time intervals.



B Exercises • 5

- (LO 4) E2-11B (Qualitative Characteristics)** The chapter identifies the qualitative characteristics that make accounting information useful.

Instructions

Answer the following questions related to these qualitative characteristics and underlying constraints presented in the chapter.

- (a) What is the quality of information that enables users to form expectations?
- (b) Identify the pervasive constraint.
- (c) Einstein Corporation redefines its inventory pools to avoid a write down of inventory. Which qualitative characteristic of accounting information is not followed?
- (d) What are the two primary qualities that make accounting information useful for decision making?
- (e) Timeliness is an ingredient of which primary quality?
- (f) Which constraint is defined as a threshold for recognition?
- (g) What is the pervasive criterion for accounting information?

