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Which of the following describes the appropriate reporting treatment for a change in accounting estimate?

- A. In the period of change with **no** future consideration.
- B. By reporting *pro forma* amounts for prior periods.
- C. By restating amounts reported in financial statements of prior periods.
- D. In the period of change and future periods if the change affects both. ✓**

Explanation:

Accounting changes

Type	Accounting treatment	Examples
Change in accounting principle	Retrospective	<ul style="list-style-type: none">• Inventory valuation method• Long-term contract revenue recognition (eg, over time instead of at a point in time)
Change in accounting estimate*	Prospective	<ul style="list-style-type: none">• Credit losses• Inventory obsolescence• Sales returns and allowances• Salvage values of depreciable assets• Warranty obligations
Change in reporting entity	Retrospective	<ul style="list-style-type: none">• Consolidated F/S** instead of individual F/S• Changing the specific subsidiaries presented in consolidated F/S
Error correction	Retroactive with prior period adjustment	<ul style="list-style-type: none">• Cash basis to accrual basis• Accelerated depreciation to straight line depreciation

*A change that is both a principle and estimate change is accounted for as change in accounting estimate.

**F/S = Financial statements

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Financial reporting and financial statement (F/S) preparation often require the use of estimates (eg, estimating a fixed asset's useful life). Because **estimates** are based on uncertain events, it is common for them to be **adjusted** over time as **new information** becomes available.

A **change in accounting estimate** is **applied** not to prior periods but **prospectively** (ie, moving forward in time). The change may affect **only** the **current period** (eg, writing off a receivable), or it may affect both the **current** and **future periods** (eg, determining a higher percentage of uncollectible credit sales than previously expected) (**Choice A**).

(**Choices B and C**) Changes in accounting estimates are applied prospectively, not retrospectively (ie, to prior periods). Reissuing the F/S for every accounting estimate change would be very inefficient, disregarding the need for timely reporting.

Things to remember:

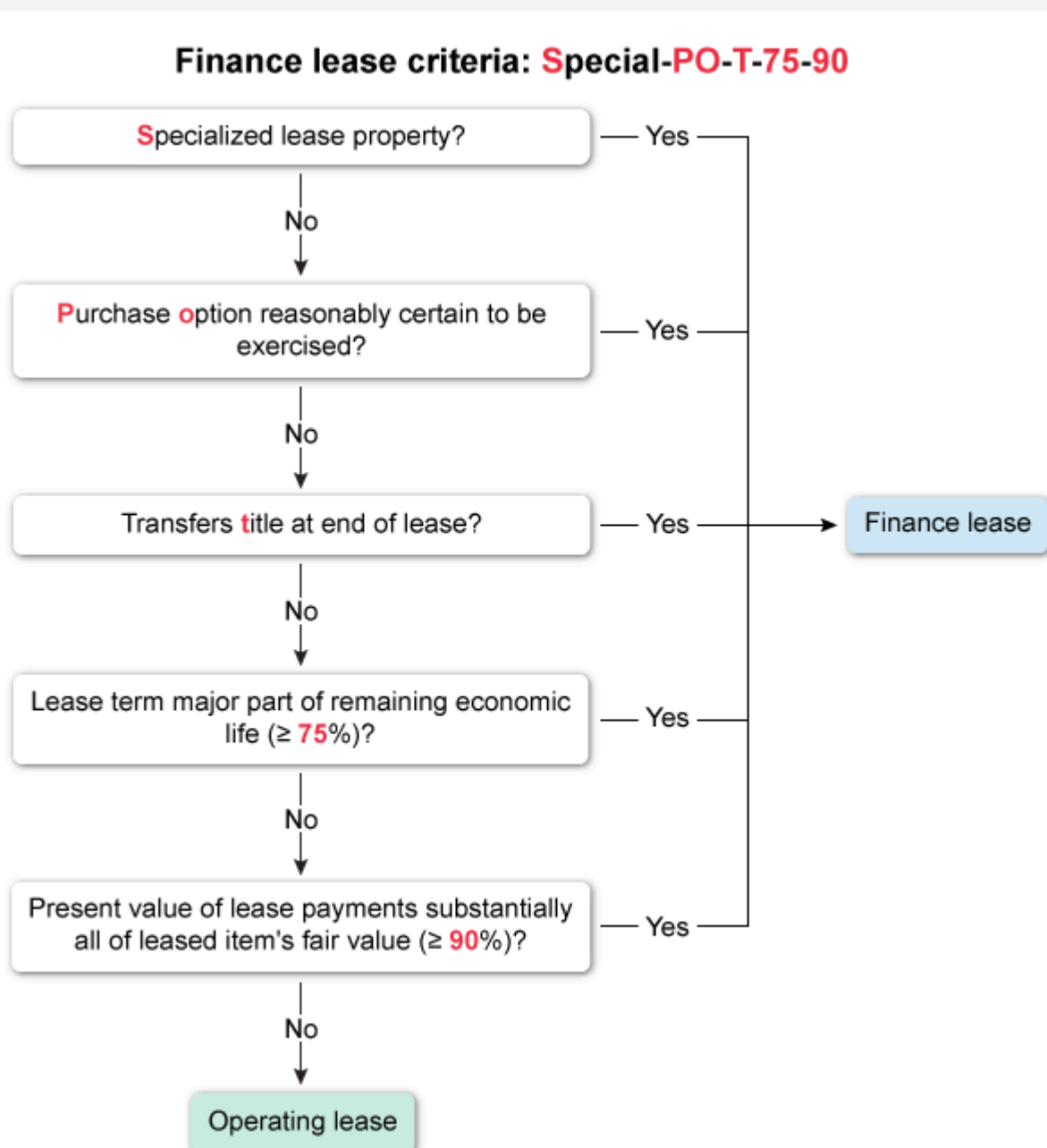
A change in accounting estimate is not applied to prior periods. It is applied prospectively (ie, moving forward) in the current period and any future periods it may affect.

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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 finance 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 calls for paying significantly higher than fair market value.

Explanation:



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A finance lease transfers the rights and risks of ownership of a leased asset from a lessor to a lessee. If the lease meets one of **five criteria** (ie, **Special-PO-T-75-90**), the

lessee accounts for the lease as a **finance lease**; if none of the criteria are met, the lease is an operating lease.

If the **lease term** is a **major part** (ie, $\geq 75\%$) of the leased asset's **remaining economic life**, it qualifies as a finance lease. In this scenario, because Bain Co. has a 10-year lease and the equipment's estimated useful life is 12 years ($10 / 12 = 83\%$), the lease will qualify as a finance lease.

(Choices A and D) A purchase option gives the lessee the right to buy the leased asset, *not stock in the company*. The option must be likely to be exercised to qualify as a finance lease. If the option exercise price is significantly higher than the asset's FMV, it is *unlikely* to be exercised.

(Choice C) If the present value of lease payments equals \$400,000, the lease is not substantially all (ie, $\geq 90\%$) of the asset's fair value ($\$400,000 / \$500,000 = 80\%$).

Things to remember:

A finance lease meets one of five criteria: leased property of a specialized nature, a purchase option that is likely to be exercised, a title that is transferred at the end of the lease, a lease term representing a major part of the asset's life, or lease payments with a present value of substantially all of the asset's fair value.

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On January 2, Year 3, Well Co. purchased 10% of Rea, Inc.'s outstanding common shares for \$400,000. Well is the largest single shareholder in Rea, and Well's officers are a majority on Rea's board of directors. Rea reported net income of \$500,000 for Year 3, and paid dividends of \$150,000. Well does not elect the fair value option to report its investment in Rea. In its December 31, Year 3, balance sheet, what amount should Well report as investment in Rea?

- A. \$385,000
- B. \$400,000
- C. **\$435,000** ✓
- D. \$450,000

Explanation:

Investor's entries under the equity method		
<i>Purchase investment</i>		
Investment in investee (cost)	XXX	
Cash		XXX
<i>Record cash dividends received</i>		
Cash	XXX	
Investment in investee		XXX
<i>Record % of investee's earnings</i>		
Investment in investee	XXX	
Equity in earnings—investee (I/S)		XXX

I/S = income statement.

The **equity method** is used to account for investments when the investor can **exercise significant influence** over the investee (ie, generally 20%–50% ownership of the investee's stock). However, the ability to exercise significant influence is a **matter of professional judgment** and considers various factors specified by accounting

standards. Therefore, it is possible to exercise significant influence with less than 20% ownership.

In this scenario, Well Co. is the largest single shareholder and occupies the most seats on the board of directors. These factors indicate that Well *has the ability* to exercise significant influence over the investee. Under the equity method, Well:

- Records the investment at cost (**Choice B**).
- Reports its pro rata share of the **investee's net income** as an **increase** in the investment (**Choice A**).
- Records **dividends** received as a **reduction** (ie, return of equity) to the investment (**Choice D**).

Accordingly, Well recognizes 10% (\$50,000) of Rea, Inc.'s (investee's) income as an increase in the investment and 10% (\$15,000) of the dividends paid by Rea as a reduction. On December 31, Year 3, Well reports the investment at **\$435,000** (\$400,000 cost + \$50,000 share of income – \$15,000 dividends).

Things to remember:

Under the equity method, the degree of influence over the investee is a matter of professional judgment and considers factors specified by accounting standards (eg, investor serving on board of directors). Therefore, it is possible to exercise significant influence with less than 20% ownership. The investment is recorded at cost, then increased by the share of investee's net income and decreased by dividends received.

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Leaf Co. purchased from Oak Co. a \$20,000, 8%, 5-year note that required five equal annual year-end payments of \$5,009. The note was discounted to yield a 9% rate to Leaf. At the date of purchase, Leaf recorded the note at its present value of \$19,485. What should be the total interest revenue earned by Leaf over the life of this note?

A. \$5,045

B. **\$5,560** ✓

C. \$8,000

D. \$9,000

Explanation:

Recording purchased notes receivable		
Notes receivable (face value)	20,000	
Discount on notes receivable		515
Cash		19,485
Calculation of total interest		
Future value (5 payments of \$5,009)		\$25,045
<u>Less: face value</u>		<u>(20,000)</u>
Subtotal		\$5,045
<u>Add: total amortization of discount</u>		<u>515</u>
Total interest revenue		<u>\$5,560</u>

In general, when a company records a loan or note receivable (N/R), the **net proceeds** are equal to the **present value** of the **future payments** to be received. Due to market conditions, the amount paid for a purchased loan may not equal face value.

When proceeds are **below face** value, the market rate exceeds the stated rate, resulting in a discount. If proceeds are **above face** value, the difference is a premium. The discount or premium is recognized in a valuation account. In accordance with the matching principle and accrual accounting, the discount or premium is amortized (using the effective interest rate method) as interest revenue over the life of the N/R. The

amortization of a **discount increases** interest **revenue**; amortization of a premium decreases interest revenue.

Leaf Co. purchases a \$20,000 face value N/R with a net present value of \$19,485, indicating there is \$515 discount. The \$515 will be amortized as additional interest revenue. Because the future value of the N/R is \$25,045 ($\$5,009 \times 5$ payments), Leaf will earn interest revenue of \$5,045 ($\$25,045 - \$20,000$) (**Choice A**). Therefore, the total interest revenue is **\$5,560** ($\$5,045 + \515).

Note: A shortcut to determine total interest is the difference between the future and present values ($\$25,045 - \$19,485 = \$5,560$).

(Choices C and D) Interest of \$8,000 and \$9,000 incorrectly use the stated and discount rates and ignore any discount.

Things to remember:

In general, when a company records a notes receivable, the net proceeds are equal to the present value of the future payments to be received. When proceeds are below face value, the market rate exceeds the stated rate, resulting in a discount. The discount is amortized over the life of the note as additional interest revenue.

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Brock Corp. reports operating expenses in two categories: (1) selling, and (2) general and administrative. The adjusted trial balance at December 31, year 1, included the following expense and loss accounts:

Accounting and legal fees	\$120,000
Advertising	150,000
Freight-out	80,000
Interest	70,000
Loss on sale of long-term investment	30,000
Officers' salaries	225,000
Rent for office space	220,000
Sales salaries and commissions	140,000

One-half of the rented premises is occupied by the sales department.

Brock's total selling expenses for year 1 are

A. \$480,000 ✓

B. \$400,000

C. \$370,000

D. \$360,000

Explanation:

(Choice A) The requirement is to compute the amount of expenses to be included in selling expenses for year 1. Advertising (\$150,000) and sales salaries and commissions (\$140,000) are clearly selling expenses, as is the rent for the office space occupied by the sales department ($\$220,000 \times 1/2 = \$110,000$). Additionally, freight-out (\$80,000) is a selling expense because shipping the goods **from** the point of sale to the customer is the final effort in the selling process. The total selling expense is, therefore, \$480,000 ($\$150,000 + \$140,000 + \$110,000 + \$80,000$). The remaining expenses given are general and administrative expenses, except for interest and the loss on sale of long-term investment, which are nonoperating items (other expenses and losses).

(Choice B) The requirement is to compute the amount of expenses to be included in selling expenses for year 1. Advertising (\$150,000) and sales salaries and commissions (\$140,000) are clearly selling expenses, as is the rent for the office space occupied by the sales department ($\$220,000 \times 1/2 = \$110,000$). Additionally, freight-out (\$80,000) is a selling expense because shipping the goods **from** the point of sale to the customer is the final effort in the selling process. The total selling expense is, therefore, \$480,000

(\$150,000 + \$140,000 + \$110,000 + \$80,000). The remaining expenses given are general and administrative expenses, except for interest and the loss on sale of long-term investment, which are nonoperating items (other expenses and losses).

(Choice C) The requirement is to compute the amount of expenses to be included in selling expenses for year 1. Advertising (\$150,000) and sales salaries and commissions (\$140,000) are clearly selling expenses, as is the rent for the office space occupied by the sales department ($\$220,000 \times 1/2 = \$110,000$). Additionally, freight-out (\$80,000) is a selling expense because shipping the goods **from** the point of sale to the customer is the final effort in the selling process. The total selling expense is, therefore, \$480,000 (\$150,000 + \$140,000 + \$110,000 + \$80,000). The remaining expenses given are general and administrative expenses, except for interest and the loss on sale of long-term investment, which are nonoperating items (other expenses and losses).

(Choice D) The requirement is to compute the amount of expenses to be included in selling expenses for year 1. Advertising (\$150,000) and sales salaries and commissions (\$140,000) are clearly selling expenses, as is the rent for the office space occupied by the sales department ($\$220,000 \times 1/2 = \$110,000$). Additionally, freight-out (\$80,000) is a selling expense because shipping the goods **from** the point of sale to the customer is the final effort in the selling process. The total selling expense is, therefore, \$480,000 (\$150,000 + \$140,000 + \$110,000 + \$80,000). The remaining expenses given are general and administrative expenses, except for interest and the loss on sale of long-term investment, which are nonoperating items (other expenses and losses).
