

In the space provided, write the word or words to either replace the question mark or answer the question.

1. Two different concepts of net income have been prominent in accounting practice and literature. The ? concept holds that in the measurement and reporting of net income, unusual and infrequently recurring gains and losses should be reported on the statement of retained earnings.

2. Two different concepts of net income have been prominent in accounting practice and literature. The practice of including extraordinary items on the income statement and thus making them an element of net income for the current period is called the ? concept of income reporting.

3. What are the two criteria, specified in APB Opinion No. 30, used to define extraordinary items?

SELF STUDY QUESTIONS

Fill in the Blank

Section 8

Module 2

In the space provided, write the word or words to either replace the question mark or answer the question.

1. APB Opinion No. 9 indicated that net income should reflect all items of profit and loss recognized during the period with the sole exception of ?.

2. Prior period adjustments are limited to (1) adjustments that result from realization of income tax benefits of preacquisition operating loss carryforwards of purchased subsidiaries, and (2) ?.

3. In class we observed that APB Opinion No. 20 discussed different types of accounting changes. What were the two types of accounting changes that we discussed in class?

Circle the letter of the best answer.

1. Reporting extraordinary items on the income statement more closely follows the concept of net income called:
 - A. current operating concept
 - B. single step
 - C. multiple step
 - D. reporting principle
 - E. all-inclusive concept

2. In order to be classified as an extraordinary item in the income statement, an event or transaction should be
 - A. infrequent and material; but it need not be unusual in nature
 - B. unusual in nature and material; but it need not be infrequent
 - C. unusual in nature, infrequent, and material
 - D. unusual in nature and infrequent; but it need not be material

3. An extraordinary item is one which
 - A. occurs infrequently and is uncontrollable in nature, but not material
 - B. occurs infrequently and is unusual in nature, but not material
 - C. is material, unusual in nature, and uncontrollable in nature
 - D. in unusual in nature, occurs infrequently, and is material
 - E. is uncontrollable in nature, occurs infrequently, and is material

4. Under which of the following conditions would hurricane damage be considered an extraordinary item for financial reporting purposes?
 - A. only if hurricanes are normal in the geographical area but do not occur frequently
 - B. under any circumstance hurricane damage should be classified as an extraordinary item
 - C. only if hurricanes occur frequently in the geographical area but have been insured against
 - D. only if hurricanes in the geographical area are unusual in nature and occur infrequently

5. A review of the December 31, 19x3 financial statements of Rhur Corporation revealed that under the caption "extraordinary losses," Rhur reported a total of \$260,000. Further analysis revealed that the \$260,000 in losses was comprised of the following items:
- Rhur recorded a loss of \$50,000 incurred in the abandonment of equipment formerly used in the business.
 - In an unusual and infrequent occurrence, a loss of \$75,000 was sustained as a result of hurricane damage to a warehouse.
 - During 19x3, several factories were shut down during a major strike by employees. Shutdown expenses totaled \$120,000.
 - Uncollectible accounts receivable of \$15,000 were written off as uncollectible.
- Ignoring income taxes, what amount of loss should Rhur report as extraordinary on its 19x3 Statement of Income?
- A. \$ 50,000
 - B. \$ 75,000
 - C. \$135,000
 - D. \$260,000
6. Ace Company, with an applicable income tax rate of 30%, reported net income of \$56,000. Included in income for the period was an extraordinary loss from flood damages of \$20,000 before deducting the related tax effect. The company's income before income taxes and extraordinary items was:
- A. \$56,000
 - B. \$76,000
 - C. \$70,000
 - D. \$62,000
 - E. none of the above
7. On July 1, 19x1, an erupting volcano destroyed Coastal Corporation's operating plant, resulting in a loss of \$1,500,000, of which only \$500,000 was covered by insurance. Coastal's income tax rate is 46%. How should this event be shown in Coastal's income statement for the year ended December 31, 19x1?
- A. as an operating loss of \$540,000, net of \$460,000 income tax
 - B. as an extraordinary loss of \$540,000, net of \$460,000 income tax
 - C. as an operating loss of \$1,000,000
 - D. as an extraordinary loss of \$1,000,000

8. How should a material, unusual event not meeting the current criteria for an extraordinary item be disclosed in the financial statements?
- A. shown as a separate item in operating revenues or expenses and supplemented by a footnote if deemed appropriate
 - B. shown in operating revenues or expenses but not shown as a separate item
 - C. shown after ordinary earnings but before extraordinary items
 - D. shown after extraordinary items net of income tax but before net earnings

Circle the letter of the best answer.

1. On January 1, 19x3, an intangible asset with a thirty-five year estimated useful life was acquired. On January 1, 19x8, a review was made of the estimated useful life, and it was determined that the intangible asset had an estimated useful life of forty-five more years. As a result of the review
 - A. the original cost at January 1, 19x3, should be amortized over a fifty-year life
 - B. the original cost at January 1, 19x3, should be amortized over the next thirty-five years
 - C. the unamortized cost at January 1, 19x8, should be amortized over the next thirty-five years
 - D. the unamortized cost at January 1, 19x8, should be amortized over the next forty years
 - E. the unamortized cost at January 1, 19x8, should be amortized over the next forty-five years

2. A company changes from the double declining balance method of depreciation for previously recorded assets to the straight line method. The cumulative effect of the change on prior periods should be reported separately as a(n)
 - A. extraordinary item
 - B. component of income after extraordinary items
 - C. component of income from ordinary operations
 - D. component of income before extraordinary items
 - E. prior period adjustment

3. Shannon Company was formed on January 1, 19x2, and used an accelerated method of depreciation on its machinery until January 1, 19x4. At that time, Shannon adopted the straight line method of depreciation for the machinery previously acquired as well as for any new machinery acquired in 19x4.

Information concerning depreciation amounts under each method is as follows:

Year	Depreciation if accelerated method used	Depreciation if straight line method used
19x2	\$400,000	\$300,000
19x3	\$530,000	\$375,000
19x4	\$600,000	\$400,000

Assume that the direct effects of this change are limited to the effect on depreciation and the related tax provisions, and that the income tax rate was 40% in each of these years. What should be reported in Shannon's income statement for the year ended December 31, 19x4, as the cumulative effect on prior years of changing to a different depreciation method?

- A. \$ 0
 B. \$153,000
 C. \$255,000
 D. \$273,000
4. The Georgia Company, which started operating in 19x1, has decided, at the urging of its auditors, to switch depreciation methods. The company had been using the straight line method but they have decided to switch to the double declining balance method starting with the year 19x4. A comparison of the results of applying each method is given below. You may assume a tax rate of 40%.

Year	<u>Annual Depreciation Expense</u>	
	Straight Line	Double Declining Balance
19x1	\$7,000	\$14,000
19x2	7,000	11,200
19x3	7,000	8,960
19x4	7,000	7,168

On the 19x4 income statement, the account entitled Cumulative Effect of Change in Depreciation Methods will show a net balance of

- A. \$ 0
 B. \$ 7,896
 C. \$ 7,997
 D. \$13,160
 E. \$13,328

5. Which of the following is characteristic of a change in an accounting estimate?
- A. it usually need not be disclosed
 - B. it does not affect the financial statements of prior periods
 - C. it should be reported through the restatement of prior financial statements
 - D. it should be reported as an adjustment in the retained earnings statement
 - E. it will never affect the financial statements of accounting periods beyond the current period
6. When it appears that there has been a failure to estimate uncollectible accounts receivable satisfactorily, resulting in an allowance balance that is clearly inadequate or excessive, an adjustment is in order. Such an adjustment should be reported
- A. in the income statement as an ordinary expense
 - B. in the income statement as an extraordinary expense, net of the related tax effects
 - C. in the retained earnings statement, as a prior period adjustment, net of the related tax effects
 - D. allocated over a reasonably short period of time, such a five years, and the effects shown as an ordinary expense in the income statement
7. The effects of a change in the estimated useful life of a depreciable asset would be:
- A. a net-of-tax adjustment shown in the income statement as “cumulative effect of a change in depreciation schedule”
 - B. a net-of-tax adjustment shown in the retained earnings statement
 - C. merely a revision of the depreciation schedule for the remaining useful life of the depreciable asset
 - D. an extraordinary item in the income statement
8. Which of the following is (are) the proper time period(s) to record a change in accounting estimate?
- A. current period and prospectively
 - B. current period and retroactively
 - C. retroactively only
 - D. current period only

9. The estimated life of a building that has been depreciated 30 years of an originally estimated life of 50 years has been revised to a remaining life of 10 years. Based on this information and on Accounting Principle Board Opinions, the accountant should
- A. continue to depreciate the building over the original 50-year life
 - B. depreciate the remaining book value over the remaining life of the asset
 - C. adjust accumulated depreciation to its appropriate balance, through net income based on a 40-year life and then depreciate the adjusted book value as though the estimated life had always been 40 years
 - D. adjust accumulated depreciation to its appropriate balance through retained earnings, based on a 40-years life and then depreciate the adjust book value as though the estimated life had always been 40 years
10. Witte Corporation acquired machinery on January 2, 19x2. Witte was using the straight line method of depreciation with an estimated economic life of 15 years and no residual value. On January 2, 19x7, Witte estimated that the remaining economic life of the machinery is six years with no residual value. How should this change be accounted for by Witte?
- A. as a prior period adjustment and a change to an accelerated depreciation method that will compensate for underdepreciation in prior years
 - B. by an estimate of the effect of the change on each year's net income but maintaining the amount of originally determined
 - C. by a revision of future annual depreciation to equal the carrying amount on January 2, 19x7, divided by six
 - D. by a revision of future annual depreciation to equal the original cost divided by six
11. Flood Corporation purchased a machine on January 1, 19x1, for \$150,000. At the date of acquisition, the machine had an estimated useful life of 10 years with no salvage value. The machine is being depreciated on a straight line basis. On January 1, 19x6, as a result of Flood's experience with the machine, it was decided that the machine had an estimated useful life of 15 years from the date of acquisition. Assuming that the change in useful life is to be recognized, what is the amount of depreciation expense on this machine that should be charged to income in 19x6?
- A. \$ 5,000
 - B. \$ 7,500
 - C. \$10,000
 - D. \$25,000

12. Eastside Corporation purchased a machine on January 1, 19x2, for \$75,000. The machine was estimated to have a useful life of 10 years with an estimated salvage value of \$5,000. During 19x5 it became apparent that the machine would become uneconomical after December 31, 19x9, and that the machine would have no scrap value. Accumulated depreciation on this machine as of December 31, 19x4, was \$21,000. What should be the charge for depreciation in 19x5 under generally accepted accounting principles?
- A. \$ 9,375
 - B. \$10,800
 - C. \$18,375
 - D. \$21,000
13. During 19x7, Hollin Company determined, as a result of additional information, that machinery that was previously depreciated over a seven year life had a total estimated useful life of only five years. An accounting change was made in 19x7 to reflect this additional information. If the change had been made in 19x6, the allowance for accumulated depreciation would have been \$2,600,000 at December 31, 19x6, instead of \$2,100,000. As a result of this change, 19x7 depreciation expense was \$200,000 greater than it would have been if the change had not been made. Assume that the direct effects of this change are limited to the effect on depreciation and the related tax provision, and that the income tax rate was 50% in both years. What should be reported in Hollin's income statement for the year ended December 31, 19x7, as the cumulative effect on prior years of changing the estimated useful life of the machinery?"
- A. \$ 0
 - B. \$250,000
 - C. \$350,000
 - D. \$500,000
14. Bond Company purchased a machine on January 1, 19x5, for \$3,000,000. At the date of acquisition, the machine had an estimated useful life of six years with no salvage value. The machine is being depreciated on a straight line basis. On January 1, 19x8, Bond determined, as a result of additional information, that the machine had an estimated useful life of eight years from the date of acquisition with no salvage. An accounting change was made in 19x8 to reflect this additional information. Assuming that the direct effects of this change are limited to the effect on depreciation and the related tax provision, and that the income tax rate was 50% in 19x5, 19x6, 19x7 and 19x8, what should be reported in Bonds income statement for the year ended December 31, 19x8, as the cumulative effect on prior years of changing the estimated useful life of the machine?
- A. \$ 0
 - B. \$187,500
 - C. \$250,000
 - D. \$375,000

15. Edwards Company purchased a machine on January 1, 19x5, for \$3,000,000. At the time of acquisition, the machine had an estimated useful life of six years with no salvage value. The machine is being depreciated on a straight line basis. On January 1, 19x8, Edwards determined, as a result of additional information, that the machine had an estimated useful life of eight years from the date of acquisition with no salvage. An accounting change was made in 19x8 to reflect this additional information. What is the amount of depreciation expense on this machine that should be charged in Edwards' income statement for the year ended December 31, 19x8?
- A. \$100,000
 - B. \$300,000
 - C. \$375,000
 - D. \$500,000
16. Evergreen Company purchased a patent on January 1, 19x2, for \$178,500. The patent was being amortized over its remaining legal life of 15 years expiring on January 1, 19x17. During 19x5 Evergreen determined that the economic benefits of the patent would not last longer than ten years from the date of acquisition. What amount should be charged to patent amortization expense for the year ended December 31, 19x5?
- A. \$10,500
 - B. \$17,850
 - C. \$20,400
 - D. \$35,700
17. APB Opinion No. 9 indicated that net income should reflect all items of profit and loss recognized during the period with the sole exception of
- A. accounting errors
 - B. extraordinary items
 - C. prior period adjustment
 - D. immaterial items
 - E. amounts arising as a result of changes in accounting principle
18. Which of the following items would be reported as a prior period adjustment?
- A. the company wrote off one million dollars of inventory that was considered obsolete
 - B. additional depreciation on factory machinery because of an inaccurate estimate of the useful life of the depreciable asset
 - C. an earthquake destroyed a warehouse that had a book value of \$200,000. Earthquakes are rare in this geographical area.
 - D. effects of the adjustment made because a piece of equipment with a useful life of five years was erroneously expensed when it was purchased two years ago
 - E. all of the above

19. If financial statements for a single year are presented, a prior period adjustment recognized in the current year:
- A. affects income before extraordinary items of the current year
 - B. is shown as an adjustment of the beginning balance of retained earnings in the statement of retained earnings for the current year
 - C. is included in the income statement after extraordinary items for the current year
 - D. is included as an extraordinary item in the income statement for the current year
20. Which of the following events would be accounted for as a prior period adjustment?
- A. change in the depreciable lives of fixed assets
 - B. change in amount of opening retained earnings balance due to an error in a prior period
 - C. change in the method of computing depreciation of fixed assets
 - D. correction in current period due to overestimation of prior periods uncollectible accounts expense
21. Which one of the following types of losses is excluded from the determination of net income in income statements?
- A. material losses resulting from transactions in the company's investments account
 - B. material losses resulting from unusual sales of assets not acquired for resale
 - C. material losses resulting from the write-off of intangibles
 - D. material losses resulting from correction of errors related to prior periods
 - E. none of the above
22. Which of the following items will not appear in the statement of retained earnings?
- A. net loss
 - B. prior period adjustment
 - C. change in accounting principle, net of taxes
 - D. dividends
 - E. none of the above

23. Tundra Corporation made a very large arithmetical error in the preparation of its year-end financial statements by improper placement of a decimal point in the calculation of depreciation. The error caused the net income to be reported at almost double the proper amount. Correction of the error when discovered in the following year should be treated as:
- A. an increase in depreciation expense for the year in which the error is discovered
 - B. a component of income for the year in which the error is discovered, but separately listed on the income statement and fully explained in a note to the financial statements
 - C. an extraordinary item for the year in which the error was made
 - D. a prior period adjustment
 - E. none of the above
24. Which type of accounting change should always be accounted for in current and future periods?
- A. change from straight line depreciation to an accelerated depreciation method
 - B. change in the estimated useful life of a depreciable asset
 - C. a prior year mathematical error associated with the calculation of depreciation expense
 - D. none of the above
25. According to APB Opinion No. 20, a change from the sum of the years' digits depreciation method to the straight line depreciation method should be accounted for as a
- A. change in accounting principle
 - B. change in an estimate
 - C. accounting error
 - D. prior period adjustment
 - E. none of the above
26. Prior period adjustments directly affect the
- A. net income for the period
 - B. retained earnings account through the period's net income
 - C. retained earnings account
 - D. extraordinary gains and losses of the period when the prior period adjustment is made
 - E. none of the above
27. An example of an item which should be reported as a prior period adjustment is the
- A. collection of previously written off accounts receivable
 - B. payment of taxes resulting from examination of prior year income tax returns
 - C. correction of error in financial statements of a prior year
 - D. receipt of insurance proceeds for damage to building sustained in a prior year

28. The 19x5 financial statements of Bice Company reported net income for the year ended December 31, 19x5 of \$2,000,000. On July 1, 19x6, subsequent to the issuance of the 19x5 financial statements, Bice changed from an accounting principle that is not generally accepted to one that is generally accepted. If the generally accepted accounting principle had been used in 19x5, net income for the year ended December 31, 19x5, would have been decreased \$1,000,000. On August 1, 19x6, Bice discovered a mathematical error relating to its 19x5 financial statements. If this error had been discovered in 19x5, net income for the year ended December 31, 19x5, would have been increased \$500,000. What amount, if any, should be included in net income for the year ended December 31, 19x6, because of the items noted above?
- A. \$0
 - B. \$500,000 increase
 - C. \$500,000 decrease
 - D. \$1,000,000 decrease
 - E. \$1,000,000 increase

Circle the letter of the best answer.

1. Intraperiod tax allocation:
 - A. involves the allocation of income taxes between current and future periods
 - B. arises because certain revenues and expenses appear in the financial statements either before or after they are included in the income tax return
 - C. arises because items included in the determination of taxable income may be presented in different parts of the financial statements
 - D. all of the above are correct

2. Which of the following is not affected by tax allocation within a period?
 - A. income before extraordinary items
 - B. extraordinary items
 - C. adjustments of prior periods
 - D. operating revenues

3. Intraperiod income tax allocation in corporate financial statements can best be justified by which of the following accounting concepts or principles?
 - A. comparability
 - B. matching
 - C. realization
 - D. verifiability

4. Income tax allocation consists of procedures intended to cause
 - A. tax expense shown in the income statement to bear a normal relation to the net income before tax reported in the income statement
 - B. tax expense shown in the income statement to bear a normal relation to the tax liability for the current year
 - C. tax liability shown in the balance sheet to bear a normal relation to the net income before tax reported in the income statement
 - D. actual tax payments to be evenly distributed over a period of time

Circle the letter of the best answer.

1. Reporting on per share data in income statements must disclose amounts for
 - A. income before extraordinary items
 - B. extraordinary items, if any (less any applicable tax consequences)
 - C. net income -- the total of A and B
 - D. income before extraordinary items and net income
 - E. none of the above

2. ABC Corporation had 40,000 common stock shares outstanding from January 1, 19x1, through August 1, 19x1, on which date 20,000 additional shares were issued as a 50% stock dividend. If no extraordinary items existed and net income was \$220,000, the calculated earnings per share as of December 31, 19x1 (rounded to the nearest cent) would be
 - A. \$3.67
 - B. \$4.26
 - C. \$4.55
 - D. \$5.50

1. Briefly explain the difference between the all-inclusive and the current operating concepts of income. Also list two major criticisms of the current operating concept of income.
2. What are the major arguments supporting the use of the current operating concept of income reporting?
3. What are the major arguments supporting the use of the all-inclusive concept of income reporting?
4. How are items that are either unusual or infrequent, but not both, reported on the income statement?

1. The various types of accounting change may significantly affect the presentation of both financial position and results of operations for an accounting period and the trends shown in comparative financial statements and historical summaries.
 - a. Describe a change in accounting principle and how it should be reported in the income statement of the period of change.
 - b. Describe a change in accounting estimate and how it should be reported in the income statement of the period of change.
2. How would a change in an accounting principle be reflected in the financial statements?
3. How would a change in an accounting estimate be reflected in the financial statements?
4. How would a change due to an accounting error in a prior period be reflected in the financial statements?
5. Sometimes a business entity may change its method of accounting for certain items. The change may be classified as a change in accounting principle, a change in accounting estimate, or a change due to a correction of a prior period error.

Listed below are two independent, unrelated sets of facts relating to accounting changes.

Situation I -- A company determines that the depreciable lives of its fixed assets are presently too long to fairly match the cost of the fixed assets with the revenue produced. The company decided at the beginning of the current year to reduce the depreciable lives of all of its existing assets by five years.

Situation II -- A company decides in January 19x8 to adopt the double declining balance method of depreciation for plant equipment. The declining balance method will be used for new acquisitions as well as for previously acquired plant equipment for which depreciation had been provided on the straight line basis.

For each of the situations described above, provide the information indicated below. complete your discussion of each situation before going on to the next situation.

- a. type of accounting change
- b. manner of reporting the change under current generally accepted accounting principles including a discussion, where applicable, of how amounts are computed.
- c. effect of the change on the statement of financial position and earnings statement.

SELF STUDY QUESTIONS

Section 8

Essay

Module 4

1. What effect would a stock dividend have upon the calculation of earnings per share?
2. What effect would a stock split have upon the calculation of earnings per share?
3. How would the existence of an extraordinary item on the income statement affect the presentation of earnings per share?