Chapter 5

Multiple Choice

1. One concept of income suggests that income be measured by determining the net change over time in the discounted present value of net cash flow expected to be received by the firm. Under this concept of income, which of the following, ignoring income taxes would not affect the amount of income for a period?
   a. Providing services to outsiders and investments of the funds received
   b. Production of goods or services not yet sold not yet delivered to customers or clients.
   c. Windfall gains and losses due to external causes.
   d. The method used to depreciate property, plant and equipment.

Answer d

2. The term *revenue recognition* conventionally refers to
   a. The process of identifying transactions to be recorded as revenue in an accounting period.
   b. The process of measuring and relating revenue and expenses of an enterprise for an accounting period.
   c. The earning process that gives rise to revenue realization.
   d. The process of identifying those transactions that result in an inflow of assets from customers.

Answer d

3. In the transactions approach to income determination, income is measured by subtracting the expenses resulting from specific transactions during the period from revenues of the period also resulting from transactions. Under a strict transactions approach to income measurement, which of the following would not be considered a transaction?
   a. Sale of goods on account at 20 percent markup
   b. Exchange of inventory at a regular selling price for equipment
   c. Adjustment of inventory in lower of cost or market inventory valuations when market is below cost.
   d. Payment of salaries

Answer c

4. Conventionally accountants measure income
   a. By applying a value added concept
   b. By using a transactions approach
   c. As a change in the value of owners' equity
   d. As a change in the purchasing power of owners' equity

Answer b

5. Arid Lands, Inc. is engaged in extensive exploration for water in the Caprock Desert. If upon discovery of water the corporation does not recognize any revenue from water sales until the sales exceed the costs of exploration, the basis of revenue recognition being employed is the
   a. Production basis
   b. Cash (or collection) basis
   c. Sales (or accrual) basis
   d. Sunk cost (or cost recovery) basis

Answer d

6. The installment method of recognizing revenue is not acceptable for financial reporting if
   a. The collectability of the sales price is reasonably assured
   b. The installment period is less than 12 months
   c. The method is applied to only a portion of the total
   d. Collection expenses can be reasonably predicted

Answer a

7. The principal disadvantage of using the percentage of completion method of recognizing revenue from long-term contracts is that it
   a. Is unacceptable for income tax purposes
   b. May require that intraperiod tax allocation procedures be used
   c. Gives results bases upon estimates that may be subject to considerable uncertainty
   d. Is likely to assign a small amount of revenue to a period during which much revenue was actually earned

Answer c

8. One of the basic features of financing accounting is the
   a. Direct measurement of economic resources and obligations and changes in them in terms of money and sociological and psychological impact
   b. Direct measurement of economic resources and obligations and changes in them in terms of money
   c. Direct measurement of economic resources and obligations and changes in them in terms of money and sociological impact
   d. Direct measurement of economic resources and obligations and changes in them in terms of money and psychological impact

Answer b

9. Which of the following is an argument against using historical cost in accounting?
   a. Fair values are more relevant.
   b. Historical costs are based on an exchange transaction.
   c. Historical costs are reliable.

d. Fair values are subjective

Answer d

10. The basic accounting concept that refers to the tendency of accountants to resolve uncertainty in favor of understating assets and revenues and overstating liabilities and expenses is known as
    a. the nocturne of conservatism.
    b. the materiality constraint.
    c. the substance over form principle.
    d. the industry practices constraint.

Answer a

11. Uncertainty and risks inherent in business situations should be adequately considered in financial reporting. This statement is an example of the concept of
    a. Conservatism
    b. Completeness
    c. Neutrality
    d. Representational faithfulness

Answer a

12. Determining periodic earnings and financial position depends on measuring economic resources and obligations and changes in them as these changes occur. This explanation pertains to
    a. Disclosure
    b. Accrual accounting
    c. Materiality
    d. The matching concept

Answer b

13. Under what condition is it proper to recognize revenues prior to the sale of the merchandise?
    a. When the ultimate sale of the goods is at an assured sales price
    b. When the revenue is to be reported as an installment sale
    c. When the concept of internal consistency (of amounts of revenue) must be complied with
    d. When management has a long-established policy to do so

Answer a

12. Which of the following is not a concept of income identified by Bedford?
    a. Psychic
    b. Real
    c. Investment
    d. Money

Answer c

13. The definition of the economic concept of income is usually attributed to which of the following economists?
    a. J. R. Hicks
    b. Paul Samuelson
    c. Ben Bernanke
    d. Adam Smith

Answer a

14. Which of the following is not an approach to determining current value**?**
    a. Replacement cost
    b. Thrift value
    c. Selling price
    d. Discounting present value

Answer b

15. Each asset—inventory, plant, equipment, and so on—would be valued based on the selling price that would be realized if the firm chose to dispose of it is the definition of which of the following current value concepts?
    a. Replacement cost
    b. Entry price
    c. Exit value
    d. Discounted present value

Answer c

16. The cost to replace assets with similar assets in a similar condition is the definition of which of the following current value concepts?
    a. Replacement cost
    b. Selling price
    c. Exit value
    d. Discounted present value

Answer a

17. Income is equal to the difference between the present value of the net assets at the end of the period and their present value at the beginning of the period, excluding the effects of investments by owners and distributions to owners is the definition of which of the following current value concepts?
    a. Replacement cost
    b. Selling price

c. Exit value
d. Discounted present value

Answer d

18. Which of the following is not a criteria outlined in SEC Staff Accounting Bulletin No. 101 for the recognition of revenue?
    a. Persuasive evidence of an arrangement exists.
    b. Delivery has not occurred.
    c. The vendor's fee is fixed or determinable.
    d. Collectability is probable.

Answer b

19. Which of the following accounting theorists called of conservatism the most influential principle of valuation in accounting?
    a. Henry Sweeney
    b. Robert Sprouse
    c. Robert Sterling
    d. Edgar Edwards

Answer c

20. The one-time overstatement of restructuring charges to reduce assets, which reduces future expenses, is the definition of which of the following earnings management techniques?
    a. Taking a bath
    b. Creative acquisition accounting
    c. Creasing "cookie jar" reserves
    d. Abusing the materiality concept

Answer a

21. Deliberately recording errors or ignoring mistakes in the financial statements under the assumption that their impact is not significant, is the definition of which of the following earnings management techniques?
    a. Taking a bath
    b. Creative acquisition accounting
    c. Creasing "cookie jar" reserves
    d. Abusing the materiality concept

Answer d

22. Overstating sales returns or warranty costs in good times and using these overstatements in bad times to reduce similar charges, is the definition of which of the following earnings management techniques?
    a. Taking a bath

b. Creative acquisition accounting
c. Creasing "cookie jar" reserves
d. Abusing the materiality concept

Answer c

Essay

1. List and three reasons why income reporting is important to our economic society.

   Alexander l lists six reasons why income reporting is important to our economic society:

   1. As the basis of one of the principal forms of taxation.
   2. In public reports as a measure of the success of a corporation's operations.
   3. As a criterion for determining the availability of dividends.
   4. By rate-regulating authorities for investigating whether those rates are fair and reasonable.
   5. As a guide to trustees charged with distributing income to a life tenant while preserving the principal for a remainderman.
   6. As a guide to management of an enterprise in the conduct of its affairs

2. Discuss the differences between the economic and accounting concepts of income.

   Economists generally agree that the objective of measuring income is to determine how much better off an entity has become during some period of time. Consequently, economists have focused on the determination of real income. The definition of the economic concept of income is usually credited to the economist J. R. Hicks, who stated:

   > The purpose of income calculation in practical affairs is to give people an indication of the amount which they can consume without impoverishing themselves. Following out this idea it would seem that we ought to define a man's income as the maximum value which he can consume during a week, and still expect to be as well off at the end of the week as he was at the beginning.

   In an attempt to overcome the measurement problems associated with using the economic concept of income, accountants originally took the position that a *transactions approach* should be used to account for assets, liabilities, revenues, and expenses. This approach relies on the presumption that the elements of financial statements should be reported when there is evidence of an outside exchange (or an "arm's-length transaction").

   Transactions-based accounting generally requires that reported income be the result of dealings with entities external to the reporting unit and gives rise to the realization principle. The *realization principle* holds that income should be recognized when the earnings process is complete or virtually complete and an exchange transaction has taken place.

3. Discuss the three basic concepts of income as defined by Bedford.

Bedford noted that the literature usually discusses three basic concepts of income:

1. Psychic income. Which refers to the satisfaction of human wants.
2. Real income. Which refers to increases in economic wealth.
3. Money income. Which refers to increases in the monetary valuation of resources.

These three concepts are all important, but each has one or more implementation issues. The measurement of psychic income is difficult because the human wants are not quantifiable and are satisfied on various levels as an individual gains real income.

4. Discuss the difference between financial capital maintenance and physical capital maintenance.

There are two primary concepts of capital maintenance: financial capital maintenance and physical capital maintenance. *Financial capital maintenance* occurs when the financial (money) amount of enterprise net assets at the end of the period exceeds the financial amount of net assets at the beginning of the period, excluding transactions with owners. This view is transactions based. It is the traditional view of capital maintenance employed by financial accountants.

Physical capital maintenance implies that a return on capital (income) occurs when the physical productive capacity of the enterprise at the end of the period exceeds its physical productive capacity at the beginning of the period, excluding transactions with owners. This concept implies that income is recognized only after providing for the physical replacement of operating assets. Physical productive capacity at a point in time is equal to the current value of the net assets employed to generate earnings. *Current value* embodies expectations regarding the future earning power of the net assets.

The primary difference between physical capital maintenance and financial capital maintenance lies in the treatment of holding gains and losses. A holding gain or loss occurs when the value of a balance sheet item changes during an accounting period. For example, when land held by a company increases in value, a holding gain has occurred. Proponents of physical capital maintenance consider holding gains and losses as returns of capital and do not include them in income. Instead, holding gains and losses are treated as direct adjustments to equity. Conversely, under the financial capital maintenance concept, holding gains and losses are considered as returns on capital and are included in income.

5. Define the following terms:

a. Entry price

When productive capacity is measured using entry price, assets are stated at the cost to replace them with similar assets in similar condition. In order to maintain the entity's physical productive capacity, it must generate enough cash flows to provide for the physical replacement of operating assets. To determine income under this approach, revenues are matched against the current cost of replacing these assets. Consequently, income can be distributed to the owners without impairing the physical capacity to continue operating into the future. As a result, the appropriateness of using the entry value approach relies on the accounting assumption of business continuity.

b. Exit price

Determining current value using exit value requires the assessment of each asset from a disposal point of view. Each asset—inventory, plant, equipment, and so on—would be valued based on the selling price that would be realized if the firm chose to dispose of it. In determining the cash equivalent exit price, it is presumed that the asset will be sold in an orderly manner, rather than be subject to forced liquidation'
Because holding gains and losses receive immediate recognition, the exit price approach to valuation completely abandons the realization principle for the recognition of revenues. The critical event for earnings recognition purposes becomes the point of purchase rather than the point of sale.

c. Discounted present value

When using the present value of the future cash flows expected to be received from an asset (or disbursed for a liability) to determine current value each asset's discounted present value is the relevant value of the asset (or liability) that should be disclosed in the balance sheet. Under this method, income is equal to the difference between the present value of the net assets at the end of the period and their present value at the beginning of the period, excluding the effects of investments by owners and distributions to owners. This measurement process is similar to the economic concept of income because discounted present value is perhaps the closest approximation of the actual value of the assets in use —and hence may be viewed as an appropriate surrogate measure of welloffness.

6. Discuss the four types of income defined by Edwards and Bell.

The four types of income defined by Edwards and Bell are (1) current operating profit—the excess of sales revenues over the current cost of inputs used in production and sold, (2) realizable cost savings—the increases in the prices of assets held during the period, (3) realized cost savings—the difference between historical costs and the current purchase price of goods sold, and (4) realized capital gains—the excess of sales proceeds over historical costs on the disposal of long-term assets. Edwards and Bell contended that these measures are better indications of well-offness and provide users more information to analyze enterprise results.

7. What conditions must be satisfied in order to recognize revenue according to *Staff Accounting Bulletin (SAB) No. 101*, "Revenue Recognition in Financial Statements?

The four conditions are:

1. Persuasive evidence of an arrangement exists.
2. Delivery has occurred.
3. The vendor's fee is fixed or determinable.
4. Collectability is probable.

8. Discuss how revenue might be recognized at various points in a company's production - sale cycle.

Companies usually recognize revenue when they sell their products or services because the sale fulfills the crucial event criterion. But recognition may be advanced or delayed due to circumstances associated with the sale. For example:

1. When production of the company's product carries over into two or more periods, the allocation of revenue to the various accounting periods is considered essential for proper reporting. In such cases a method of revenue recognition termed *percentage of completion* may be used.
2. When the company's product can be sold at a determinable price on an organized market, revenue may be realized when the goods are ready for sale.
3. In service contracts, realization should generally be connected with the performance of services, and revenue should be recognized in relation to the degree of services performed.
4. In certain circumstances, where the ultimate collectability of the revenue is in doubt, recognition is delayed until cash payment is received. The installment method and the cash recovery method are examples of delaying revenue recognition until the receipt of cash. However, the APB stated that revenue recognition should not be delayed unless ultimate collectability is so seriously doubted that an appropriate allowance for the uncollectible amount cannot be estimated.
5. In some cases, where binding contracts do not exist or rights to cancel are in evidence, the level of uncertainty may dictate that revenue recognition be delayed until the point of ratification or the passage of time. For example, some states have passed laws that allow door-to-door sales contracts to be voided within certain periods of time. In such cases, recognition should be delayed until that period has passed.

9. Discuss the matching concept.

Once a company has fulfilled its crucial event and recognized revenue, it must then identify all expenses associated with producing that revenue. This process of associating revenues with expenses is termed the *matching concept*. From a conceptual standpoint, matching revenues with the associated expenses relates efforts to accomplishments.

10. Define the following terms:

a. Holding gains

A holding gain or loss occurs when the value of a balance sheet item changes during an accounting period. For example, when land held by a company increases in value, a holding gain has occurred

b. Materiality

The concept of *materiality* has had a pervasive influence on all accounting activities despite the fact that no all-encompassing definition of the concept exists. *Accounting Research Study No. 7* originally provided the following qualitative definition:

> A statement, fact or item is material, if giving full consideration to the surrounding circumstances, as they exist at the time, it is of such a nature that its disclosure, or the method of treating it, would be likely to influence or to "make a difference" in the judgment and conduct of a reasonable person.

Later in *SFAC No. 8,* the FASB made the following statement regarding materiality:

> Information is material if omitting it or misstating it could influence decisions that users make on the basis of the financial information
> of a specific reporting entity. In other words, materiality is an entity specific aspect of relevance based on the nature or magnitude or both of the items to which the information relates in the context of an individual entity's financial report. Consequently, the Board cannot specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.

c. Conservatism

Simply stated, conservatism holds that when you are in doubt; choose the accounting alternative that will be least likely to overstate assets or income.

11. Discuss the concepts of earnings quality and earnings management including:

Earnings quality is defined as the degree of correlation between a company's accounting income and its economic income. *Earnings management* is defined as the attempt by corporate officers to influence short-term reported income.

a. Taking a bath

The one-time overstatement of restructuring charges to reduce assets, which reduces future expenses. The expectation is that the one-time loss is discounted in the marketplace by analysts and investors who will focus on future earnings.

b. Cookie jar reserves

Overstating sales returns or warranty costs in good times and using these overstatements in bad times to reduce similar charges.

c. Improper revenue recognition

Recording revenue before it is earned. It was noted that over half of the SEC's enforcement cases filed in 1999 and 2000 involved improper revenue recognition issues.