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QUESTION 1

On August 31, 1992, Harvey Co. decided to change from the FIFO periodic inventory system to the weighted average periodic inventory system. Harvey is on a calendar year basis. The cumulative effect of the change is determined:

- A. As of January 1, 1992.
- B. As of August 31, 1992.
- C. During the eight months ending August 31, 1992, by a weighted average of the purchases.
- D. During 1992 by a weighted average of the purchases.

Correct Answer: A

Choice "a" is correct, as of January 1, 1992, the beginning of the year. Rule: The cumulative effect of a change in accounting principle equals the difference between retained earnings at the beginning of period of the change and what retained earnings would have been if the change was applied to all affected prior periods, assuming comparative financial statements are not presented. If comparative statements are presented, then beginning retained earnings of the earliest year presented is adjusted for the cumulative effect of the change. We are assuming, based on the answer options given, that Harvey is not presenting comparative financial statements. Choice "b" is incorrect. The cumulative effect of the change is not determined as of the date the decision is made. Choices "c" and "d" are incorrect. The cumulative effect of the change is not determined by a weighted average.

QUESTION 2

Ocean Corp.'s comprehensive insurance policy allows its assets to be replaced at current value. The policy has a \$50,000 deductible clause. One of Ocean's waterfront warehouses was destroyed in a winter storm. Such storms occur approximately every four years. Ocean incurred \$20,000 of costs in dismantling the warehouse and plans to replace it. The tax rate is 30%. The following data relate to the warehouse:

Current carrying amount \$ 300,000 Replacement cost 1,100,000

What amount of gain should Ocean report as a separate component of income before extraordinary items?

- A. \$1,030,000
- B. \$780,000
- C. \$730,000
- D. \$0

Correct Answer: C

Choice "c" is correct. \$730,000 gain reported as a separate component of income before extraordinary items.



Replacement cost	\$1,100,000
Less: Deductible clause	<u>(50,000)</u>
Subtotal - insurance proceeds	1,050,000
Less: Costs to dismantle old warehouse	<u>(20,000)</u>
Subtotal	1,030,000
Less: Current carrying amount	<u>(300,000)</u>
Gain on insurance settlement of casualty	<u>\$ 730,000</u>

QUESTION 3

A statement of cash flows for a development stage enterprise:

- A. Is the same as that of an established operating enterprise and, in addition, shows cumulative amounts from the enterprise's inception.
- B. Shows only cumulative amounts from the enterprise's inception.
- C. Is the same as that of an established operating enterprise, but does not show cumulative amounts from the enterprise's inception.
- D. Is not presented.

Correct Answer: A

Rule: Development stage enterprises should present financial statements in accordance with GAAP and make additional disclosures such as cumulative amounts from inception for: net losses, deficits, sales, expenses, and cash flows and supplementary data.

Choice "a" is correct, per the rule shown above.

Choice "b" is incorrect. Current amounts are shown as well as cumulative amounts.

Choice "c" is incorrect. Cumulative amounts from inception are shown.

Choice "d" is incorrect. A statement of cash flows is required.

QUESTION 4

Which of the following is a generally accepted accounting principle that illustrates the practice of conservatism during a particular reporting period?

- A. Capitalization of research and development costs.
- B. Accrual of a contingency deemed to be reasonably possible.



- C. Reporting investments with appreciated market values at market value.
- D. Reporting inventory at the lower of cost or market value.

Correct Answer: D

Choice "d" is correct. The rule of conservatism states that revenues and gains should be recognized when the earnings process is complete, but that expenses and losses should be expensed immediately. Reporting inventory at the lower of cost or market requires the recording of a loss on inventory when market is lower than cost in the period the loss is sustained, rather than when the inventory is sold, consistent with the rule of conservatism. Choice "a" is incorrect. Because the future benefits of RandD costs are questionable, these cost should be expensed immediately, consistent with the rule of conservatism and the matching principle. Choice "b" is incorrect. The rule of conservatism only requires the accrual of "probable" losses. The accrual of a reasonably possible loss is not required and the accrual of any contingent gain, whether probable, reasonably possible, or remote, is prohibited. Choice "c" is incorrect. The reporting of marketable securities with appreciated values at market value requires the recording of a gain on the asset before the gain is realized. This contradicts the rule of conservatism, but is allowed because fair value is a more relevant measure of the value of marketable securities.

QUESTION 5

A segment of Ace Inc. was discontinued during 1992. Ace's loss from discontinued operations should not:

- A. Include employee relocation costs associated with the decision to dispose.
- B. Exclude operating losses from the date the decision to dispose of the segment was made until the end of 1992.
- C. Include additional pension costs associated with the decision to dispose.
- D. Include operating losses of the current period up to the date the decision to dispose of the segment was made.

Correct Answer: B

Choice "b" is correct. Ace's loss on discontinued operations should not exclude operating losses from the date the decision to dispose of the segment was made until the end of 1992. All 1992 operating losses should be included. Choice "a" is incorrect. Employee relocation costs associated with the decision to dispose should be included in the loss from discontinued operations. Choice "c" is incorrect. Additional pension costs associated with the decision to dispose should be included in the loss from discontinued operations. Choice "d" is incorrect. Ace's loss on discontinued operations should include operating losses of the current period up to the date the decision to dispose of the segment was made and also after that date. All 1992 operating losses should be included.

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