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QUESTION 1

The following items were among those that were reported on Lee Co.'s income statement for the year ended December 31, 1989:

| | |
|--|-----------|
| Legal and audit fees | \$170,000 |
| Rent for office space | 240,000 |
| Interest on inventory floorplan | 210,000 |
| Loss on abandoned data processing equipment used in operations | 35,000 |

The office space is used equally by Lee's sales and accounting departments. What amount of the abovelisted items should be classified as general and administrative expenses in Lee's multiple-step income statement?

- A. \$290,000
- B. \$325,000
- C. \$410,000
- D. \$500,000

Correct Answer: A

| | |
|--|----------------|
| Legal and audit fees | \$170,000 |
| Rent for admin office ($1/2 \times \$240,000$) | <u>120,000</u> |
| Total general and administrative expenses | \$290,000 |

Note: 1/2 of the office space of \$240,000 was used by the sales department, which should be allocated to "selling expenses" (not general and administrative).

Choice "a" is correct. \$290,000.

QUESTION 2

Due to a decline in market price in the second quarter, Petal Co. incurred an inventory loss. The market price is expected to return to previous levels by the end of the year. At the end of the year the decline had not reversed. When should the loss be reported in Petal's interim income statements?

- A. Ratably over the second, third, and forth [sic] quarters.
- B. Ratably over the third and fourth quarters.
- C. In the second quarter only.
- D. In the fourth quarter only.

Correct Answer: D



Choice "d" is correct. When the loss is probable and estimable, the expected loss must be recorded in full.

This loss becomes such at the end of the fourth quarter. Therefore, the inventory must be valued on the year-end at the lower of cost or market, recognizing the loss at that time.

Choice "a" is incorrect. Expected losses must be recorded in full when the loss is probable and estimable and not ratably over several quarters. Choice "b" is incorrect. Expected losses must be recorded in full when the loss is probable and estimable and not ratably over several quarters. Choice "c" is incorrect.

Since the loss is not probable at the end of the second quarter, no amount should be recognized at that time.

QUESTION 3

What is the underlying concept that supports the immediate recognition of a contingent loss?

- A. Substance over form.
- B. Consistency.
- C. Matching.
- D. Conservatism.

Correct Answer: D

Choice "d" is correct. Conservatism is a prudent reaction to uncertainty to try to ensure that uncertainty and risks inherent in business situations are adequately considered. Recognition of a contingent loss is the recording of an amount representing uncertainty and risk in a business situation. SFAC 2, SFAS 5 para. 82 Choice "a" is incorrect. The substance over form concept presumes that the transaction form may not dictate the accounting treatment. Choice "b" is incorrect. Consistency is conformity from period to period with unchanging policies and procedures. SFAC 2 Choice "c" is incorrect. The matching principle dictates that expenses be matched with the related revenues generated or the time period in which the expense is incurred and known. SFAS #5 cites matching as the one concept supporting the immediate recognition of a contingent loss, but it is not the primary underlying concept. SFAS 5 para. 76

QUESTION 4

On January 2, 1993, Quo, Inc. hired Reed to be its controller. During the year, Reed, working closely with Quo's president and outside accountants, made changes in accounting policies, corrected several errors dating from 1992 and before, and instituted new accounting policies. Quo's 1993 financial statements will be presented in comparative form with its 1992 financial statements. This question represents one of Quo's transactions. List A represents possible clarifications of these transactions as: a change in accounting principle, a change in accounting estimate, a correction of an error in previously presented financial statements, or neither an accounting change nor an accounting error.

Item to Be Answered During 1993, Quo determined that an insurance premium paid and entirely expensed in 1992 was for the period January 1, 1992, through January 1, 1994.

List A (Select one)



- A. Change in accounting principal.
- B. Change in accounting estimate.
- C. Correction of an error in previously presented financial statements.
- D. Neither an accounting change nor an accounting error.

Correct Answer: C

Choice "c" is correct. Expensing insurance premiums when paid (rather than allocating them to the periods benefited) is a correction of an error in previously presented financial statements.

QUESTION 5

According to the FASB's conceptual framework, the process of reporting an item in the financial statements of an entity is:

- A. Recognition.
- B. Realization.
- C. Allocation.
- D. Matching.

Correct Answer: A

Choice "a" is correct. Recognition.

According to the FASB's conceptual framework, the process of reporting an item in the financial statements of an entity is recognition.

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