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Financial Reporting and Analysis (6th Ed.)
Chapter 2 Solutions
Accrual Accounting and Income Determination
Exercises

Exercises

E2-1. Determining accrual and cash basis revenue
(AICPA adapted)

Since the subscription begins with the first issue of 2015, no revenue can be recognized in 2014 on an accrual basis. No product or service has been exchanged between Gee Company and its customers. Therefore, no subscription revenue has been earned.

On a cash basis, Gee would recognize the full amount of cash received of $36,000 as revenue in 2014.

E2-2. Determining unearned subscription revenue
(AICPA adapted)

Since subscription revenue is not earned until the customer has received the jellies, unearned subscription revenue should be equal to the amount of subscriptions sold but not yet expired.

Sold in 2014/Expiring in 2015	$250,000
Sold in 2014/Expiring in 2016	180,000
Sold in 2013*/Expiring in 2015	85,000
Unearned subscription revenue	**$515,000**

*(The subscriptions sold in 2013 that did not expire in 2013 or in 2014 must be carried over to 2015 where they will be earned and recognized.)

E2-3. Determining unearned revenue
(AICPA adapted)

Year 2013 Sales:		
Unredeemed at 12/31/13	$	75,000
Sold in 2013/redeemed in 2014		(25,000)
Sold in 2013/Expired in 2014		(50,000)
Unearned revenue at 12/31/14	$	- 0 -

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Year 2014 Sales:

Sales of gift certificates	$	250,000
Less: 10% not to be redeemed		(25,000)
Sold in 2014/redeemed in 2014		(175,000)
Unearned revenue at 12/31/14	$	50,000

Total unearned revenue at 12/31/14 is $50,000.

E2-4. Determining when to recognize revenue
(AICPA adapted)

Generally, sales revenue is recognized at the date of delivery, because that generally is the time at which a sale (title has passed) has occurred. At that point the two criteria for revenue recognition were met; the revenue is (1) realized or realizable and (2) it is earned. Therefore, the amount of sales revenue recognized in 2014 is $600,000 (200,000 gallons x $3 = $600,000).

E2-5. Converting from accrual to cash basis revenue
(AICPA adapted)

Under the cash basis of income determination, the company would not regard its ending accounts receivable as revenue but it would include beginning accounts receivable that are assured to be collected in cash during the current year(except for accounts written off). To find cash basis revenue, we have to subtract the increase in accounts receivable from the revenue figure:

Accrual basis revenue	$1,750,000
+ Beginning accounts receivable balance	375,000
- Ending accounts receivable balance	(505,000)
- Write-offs of accounts receivable	(20,000)
Cash basis revenue (cash collections on accounts receivable)	**$1,600,000**

Alternate Solution:

Accounts Receivable

Beginning balance	$375,000		
Sales on account (Accrual basis revenue)	1,750,000		
		$20,000	Accounts receivable write-off
		$1,600,000	Solve for: **Cash collections**
Ending balance	$505,000		

$375,000 + $1,750,000 - $20,000 - X = $505,000
X = $1,600,000

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E2-6. Converting from cash to accrual basis revenue
(AICPA adapted)

To change Dr. Hamilton's revenue from cash basis to an accrual basis, we have to add the earned but uncollected accounts receivable and subtract the beginning accounts receivable collected in 2014 but earned in 2013. We also need to subtract fees collected in 2014 but not earned until 2015 (unearned fees on 12/31/14):

Cash basis revenue	$200,000
- Beginning accounts receivable (12/31/13)	(18,000)
+ Ending accounts receivable (12/31/14)	25,000
- Unearned fees on 12/31/14	(8,000)
Accrual basis revenue	**$199,000**

E2-7. Converting from accrual to cash basis expense
(AICPA adapted)

The total amount of insurance premiums paid in 2014 is equal to the insurance expense for 2014 plus the ending balance in prepaid insurance and less the beginning balance in prepaid insurance.

2014 Insurance expense	$875,000
+ Ending balance in prepaid insurance 12/31/14	245,000
- Beginning balance in prepaid insurance 12/31/13	(210,000)
Insurance premiums paid in 2014	**$910,000**

Alternate Solution:

The amount of premiums paid can be determined from a T-account analysis of prepaid insurance.

Prepaid Insurance

Beginning balance	$210,000		
Premiums paid	**X**	$875,000	Amounts charged to insurance expense
Ending balance	$245,000		

$210,000 + X - $875,000 = $245,000
X = $875,000 + $245,000 - $210,000
X = $910,000

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E2-8. Determining Gain (loss) from discontinued operations

Munnster Corporation
Partial Income Statement
For the Years Ended December 31

	2014	2013
**Income from continuing operations, before taxes	$ 1,405,000	$ 920,000
Income tax expenses	421,500	276,000
Income from continuing operations after taxes	983,500	644,000
Discontinued operations:		
Loss from discontinued division, net of tax benefits of $151,500 in 2014 and $51,000 in 2013	(353,500)	(119,000)
Gain from sale of discontinued division, net of taxes expense of $105,000	245,000	- 0 -
Net income	$ 875,000	$ 525,000

**Income from continuing operations, before taxes excludes the losses from discontinued division and is calculated as follows:

	2014	2013
Income from continuing operations, before taxes	$ 900,000	$ 750,000
Loss from discontinued division, before taxes	505,000	170,000
Income from continuing operations, before taxes (excluding losses from discontinued division):	$ 1,405,000	$ 920,000

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E2-9. Determining loss on discontinued operations

Under, results of operations on an operating segment or component of an entity classified as held for sale are to be reported in discontinued operations in the periods in which they occur (net of tax effects). For Revsine, the loss from operations for the discontinued segment would be $350,000 determined as follows:

Loss from 1/1/14 to 8/31/14	($300,000)
Loss from 9/1/14 to 12/31/14	($200,000)
Total pre-tax loss	($500,000)
Tax benefit at 30%	150,000
Operating loss, net of tax effects	($350,000)

None of the expected profit from operating the segment or component for Revsine in 2015 or the estimated gain on sale is recognized in 2014. These amounts will be recognized in 2015 as they occur.

E2-10. Determining period vs. product costs

	Period Cost	Product Cost
		Matched with sales as inventory cost
Depreciation on office building	X	
Insurance expense for factory building		X
Product liability insurance premium	X	
Transportation charges for raw materials		X
Factory repairs and maintenance		X
Rent for inventory warehouse*	X	
Cost of raw materials		X
Factory wages		X
Salary to chief executive officer	X	
Depreciation on factory		X
Bonus to factory workers		X
Salary to marketing staff	X	

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Administrative expenses	X	
Bad debt expense**	X	
Advertising expense	X	
Research and development	X	
Warranty expense***	X	
Electricity for plant		X

*Rent for inventory warehousing can be argued to be product costs and included as part of inventory costs. However, many companies expense this cost as a period expense because of materiality considerations.

** Bad debt expense is typically deducted from sales to arrive at Net Sales. We show it as a period cost because it is not shown as an inventory cost that is shown as part of Cost of goods sold.

***Warranty expense is matched against sales in the period in which the products subject to warranties are sold, not when the warranty costs are incurred. However, it is not an inventory cost that becomes part of cost of goods sold. Therefore, we show it as a period expense.

E2-11. Cash versus accrual analysis

To report Kelly Plumbing Supply's revenues on an accrual basis, we need to subtract the accounts receivable collected in December but earned in November and add the sales on account made during December to the cash received from customers during December 2014.

To report Kelly Plumbing's expenses on an accrual basis, we have to subtract the cash paid to suppliers in December for inventory purchased and used in November and add inventory that was purchased in November and used in December to the cash paid to suppliers for inventory during December 2014.

Cash received from customers during December 2014	$387,000
Cash received in December for November accounts receivable	(139,000)
December sales made on account-collected in January	141,000
Accrual basis revenues	$389,000

Cash paid to suppliers for inventory during December 2014	$131,000
Payments for inventory purchased and used in November	(19,000)
Inventory purchased in November but used in December	39,000
Accrual basis expenses	$151,000

Accrual basis revenues	$389,000
Less: Accrual basis expenses	(151,000)

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Gross profit for the month of December $238,000

E2-12. Determining effect of omitting year-end adjusting entries

OS = overstated
US = understated
NE = no effect

Item	Assets	Liabilities	Net Income
1. Supplies Inventory			
Direction of effect	OS	NE	OS
Dollar amount of effect	$9,000[1]		$9,000

[1]Expense not recorded = $12,000 - $3,000

Item	Assets	Liabilities	Net Income
2. Unearned Revenue			
Direction of effect	NE	OS	US
Dollar amount of effect		$6,000[2]	$6,000

[2]Revenue not recorded = $6,000 from July 1, 2014 to December 31, 2014

Item	Assets	Liabilities	Net Income
3. Gasoline Expense			
Direction of effect	NE	US	OS
Dollar amount of effect		$2,500[3]	$2,500

[3]Gasoline expense not recorded = $2,500

Item	Assets	Liabilities	Net Income
4. **Interest Expense**			
Direction of effect	NE	US	OS
Dollar amount of effect		$4,500[4]	$4,500

[4]Interest expense for 9 months not accrued = $50,000 x 0.12 x 9/12 = $4,500

Item	Assets	Liabilities	Net Income
5. Depreciation Expense			
Direction of effect	OS	NE	OS
Dollar amount of effect	$10,000[5]		$10,000

[5]Depreciation expense not recorded = $30,000/3 = $10,000

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E2-13. Preparing a multiple-step income statement

Hardrock Mining Co. **Income Statement** **Year Ended December 31, 2014** **($ in 000)**	
Net sales	$5,281,954
Cost of products sold	(4,765,505)
Gross Profit	$516,449
Marketing, administrative and other expenses	(193,147)
Interest expense	(17,143)
Investment losses*	(57,752)
Restructuring charges	(8,777)
Earnings before income taxes	$239,630
Provision for income taxes	(71,889)
Income before extraordinary item	$167,741
Extraordinary gain, net of income tax effect of $3,600**	8,400
Net income	$176,141
Earnings per common share:	
Income before extraordinary item	$16.77
Extraordinary gain, net of income tax effect	0.84
Net income	$17.61

The "Other, net" caption as originally reported is broken down as follows:

* "Other, net" as originally reported ($ in 000)	$54,529
Less: Restructuring charge	(8,777)
Plus: Extraordinary gain	12,000
Investment losses	$57,752

The gain related to the property taken by the government under its "eminent domain" rights qualifies for extraordinary gain treatment because such takings meet the unusual and infrequent test. Extraordinary items are presented "net of tax" as calculated below. The "restructuring loss" may be infrequent, but would not be considered unusual, thus it is not extraordinary and should be separately disclosed as a component of operating income. Removing these two items from "Other, net" leaves only the investment losses in the original caption, which should be relabeled "investment losses."

** Extraordinary item	$12,000
Income taxes on extraordinary item (30% tax rate)	3,600

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Extraordinary item, net of taxes	$8,400

The foreign currency loss ($55,000) does not surpass any reasonable materiality threshold (e.g., greater than 1% of net income) so it may remain in "marketing, administrative and other expenses." Had this loss been material, separate disclosure as a component of operating income would be warranted.

Per share disclosures are required on the face of the income statement for income from operations and items that follow on the income statement.

E2-14. Preparing income statement with irregular items

KEW Corporation **Partial Income Statement** **For the Year Ended December 31, 2014**	
Income from continuing operations before income taxes	$ 4,344,000**
Income tax expense	(1,520,400)
Income from continuing operations	$ 2,823,600
Discontinued operations:	
Loss from operation of discontinued division, net of tax benefit of $227,500	(422,500)
Loss from disposal of discontinued division, net of tax benefit of $84,000	(156,000)
Income before extraordinary item	$ 2,245,100
Extraordinary loss, net of income tax benefit of $138,250	(256,750)
Net income	$ 1,988,350
Earnings per common share:	
Income from continuing operations	$ 5.65
Discontinued operations:	
Loss from operation of discontinued division	$ (0.85)
Loss from disposal of discontinued division	$ (0.31)
Income before extraordinary item	$ 4.49
Extraordinary loss	$ (0.51)
Net income	$ 3.98
*Cost of machinery sold during 2014	$ 300,000
Less: Accumulated depreciation	(225,000)
Book value of machinery	$ 75,000

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continued

Selling price of machinery	$ 85,000
Less: Book value of machinery	(75,000)
Gain on sale of machinery	$ 10,000
**Income from continuing operations as reported	4,350,000
Write off uncollectible note	(16,000)
Gain on sale of machinery	10,000*
Income from continuing operations before taxes	$ 4,344,000

Note to the instructor: Because KEW occasionally sells used machinery, the machinery sale described in the problem should be separately disclosed as a component of operating income, not as an irregular item. The expropriation loss is among the items cited in the text as typically being extraordinary items. The stated fact that KEW had no other foreign operations reinforces—from KEW's perspective—the unusual and infrequent nature of this loss.

E2-15. Change in inventory methods

Requirement 1:

Retained earnings balance at January 1, 2014, using LIFO		$1,750,000
Increased pretax income prior to 2014 using FIFO	$80,000	
Less: income tax at 30%	(24,000)	
Cumulative net income and thus retained earnings would have been higher by		56,000
Retained earnings balance at January 1, 2014, using FIFO		$1,806,000

Requirement 2:

1/1/2014 To record a change in inventory method

DR Inventory (increase inventory to FIFO)	$80,000	
CR Retained earnings (additional income If FIFO had been used)		$56,000
CR Deferred tax liability (30% x $80,000)		24,000

E2-16. Income statement presentation

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Event 1 is a discontinued operation and would appear on the income statement below income from continuing operations. To qualify for discontinued operation treatment, the sold component must be separable, both operationally and financially, from the rest of the operation. Further, Krewatch cannot have any significant continuing involvement in the operations of the sold component. These conditions appear to be met..

Event 2 would be reported as a special, nonrecurring or unusual item and thus would be included in income from continuing operations. Restructurings may be infrequent, but they are not that unusual in today's business environment so this event is not an extraordinary item.

Event 3 is an extraordinary item and would appear on the income statement below income from continuing operations. To qualify for extraordinary treatment, an extinguishment now must meet the unusual and infrequent test. Given that the retired bonds were the only ones issued in the company's history, this test appears to be met.

Event 4 is a change in accounting principle and would require retrospective application (i.e., prior year income statement numbers presented for comparative purposes would be restated to reflect the average cost method of inventory costing. The current year income statement numbers would be based on applying the average cost method. The effect of the accounting principle change on the current period income numbers would be disclosed in a note to the financial statements explaining the accounting change.

Event 5 is a change in accounting estimate and thus would be included in income from continuing operations. No special income statement disclosure of this event is required. Depreciation expense in 2014 (and beyond) will be calculated using the (new) shorter lives. The range of equipment lives used for depreciation purposes may need to be adjusted in the notes to Krewatch's financial statements.

Event 6 is a special, nonrecurring or unusual item and thus would be included in income from continuing operations. Inventory write-offs may be infrequent, but they are not unusual so this event is not an extraordinary item.

Event 7 is a special, nonrecurring or unusual item and thus would be included in income from continuing operations. Equipment sales are considered a normal part of ongoing business activity.

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E2-17. Comprehensive income

JDW Corporation
Income Statement and Statement of Comprehensive Income
For the Year Ended December 31, 2014

Sales	$ 2,929,500
Cost of goods sold	(1,786,995)
Gross profit	1,142,505
Selling and administrative expenses	(585,900)
Income from operations, before income taxes	556,605
Income taxes	(166,982)
Net income	$ 389,623
Net income	$ 389,623
Unrealized holding loss, net of tax of $6,600	(15,400)
Foreign currency translation adjustment	26,250
Unrealized loss from pension adjustment, net of tax of $2,100	(4,900)
Comprehensive income	$ 395,573

E 2-18. Reporting of Revaluations in OCI.

1. Revaluations occur when the company hires and then receives a valuation report from a professional appraiser. The company has no current interest in selling the land or property, plant, and equipment, so any changes in value are ***unrealized***. Because these changes in value are unrealized and the company has no current interest in realizing them through a sales transaction, the changes in value are reported in Other Comprehensive Income. If the company were to actually sell the property to realize the changes in value, then the changes would appear in Net Income.

2. The values of land and property, plant, and equipment went up because the company reports the Revaluation changes as a positive increase in Other Comprehensive Income.

3. U.S. GAAP does not allow for upward Revaluation of land or property, plant, and equipment. Therefore there would be no entry observed for Revaluation in Other Comprehensive Income.

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E2-19: Calculating EPS

1. Net income – Preferred stock dividend = $10.5 - $2 = $8.5 million
2. Weighted Average number of common shares
   = 0.25 x 20 + 0.75 x 26 = 24.5 million shares
3. EPS = $8.5/24.5 = $0.347 per share

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Financial Reporting and Analysis (6th Ed.)
Chapter 2 Solutions
Accrual Accounting and Income Determination
Problems

Problems

P2-1. Determining royalty revenue
(AICPA adapted)

Royalty revenue should be recognized when earned, regardless of when the cash is collected. Royalty revenue earned from 12/1/13 to 5/31/14 is $240,000 (30% x $800,000). Since 12/31/13 Royalties receivable was $40,000, that portion of the $240,000 was earned in 2013. Therefore, royalty revenue earned from 1/1/14 to 5/31/14 is $200,000 ($240,000 - $40,000). Royalty revenues earned from 6/1/14 to 11/30/14 were $180,000 (30% x 600,000), and the amount earned from 12/1/14 to 12/31/14 was $30,000 (30% x 100,000). The total 2014 revenue is $410,000 as shown below.

Earned 12/1/13 to 5/31/14 (30% x $800,000)	$240,000
Less amount earned 12/1/13 to 12/31/13	(40,000)
Earned 1/1/14 to 5/31/14	200,000
Earned 6/1/14 to 11/30/14 (30% x $600,000)	180,000
Earned 12/1/14 to 12/31/14 (30% x $100,000)	30,000
Amount earned in 2014	**$410,000**

P2-2. Preparing Journal entries and statement

Requirement 1: Journal Entries

1/1/14: To record entry for cash contributed by owners

DR Cash	$200,000	
CR Contributed capital		$200,000

1/1/14: To record entry for rent paid in advance

DR Prepaid rent	$24,000	
CR Cash		$24,000

3/1/14: No entry upon signing of contract

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7/1/14: To record entry for purchase of office equipment

DR Equipment	$100,000	
CR Cash		$100,000

11/30/14: To record entry for salary paid to employees

DR Salaries expense	$66,000	
CR Cash		$66,000

12/31/14: To record entry for advance-consulting fees received from Norbert Corp. which are unearned at year-end.

DR Cash	$20,000	
CR Advances from customer		$20,000

Requirement 2: Adjusting Entries

DR Rent expense	$12,000	
CR Prepaid rent		$12,000

Only one year's rent is expensed in the income statement for 2014. The balance will be expensed in next year's income statement.

DR Accounts receivable	$150,000	
CR Revenue from services rendered		$150,000

The income was earned this year because Frances Corp. has completed its obligation.

DR Depreciation expense	$10,000	
CR Accumulated depreciation		$10,000

Annual depreciation is $100,000/5 = $20,000. Since the equipment was used for only 6 months, the depreciation charge for this year is only $20,000/2 = $10,000.

DR Salaries expense	$6,000	
CR Salaries payable		$6,000

To accrue salaries expense for December 2014.

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Requirement 3: Income statement

Frances Corporation Income Statement For Year Ended December 31, 2014		
Revenue from services rendered		$150,000
Less: Expenses		
Salaries	($72,000)	
Rent	(12,000)	
Depreciation	(10,000)	(94,000)
Net income		$56,000

Requirement 4: Balance sheet

Frances Corporation Balance Sheet December 31, 2014		
Assets		
Cash		$30,000
Accounts receivable		150,000
Prepaid rent		12,000
Equipment	$100,000	
Less: Accumulated depr.	(10,000)	
Net equipment		90,000
Total assets		$282,000
Liabilities		
Salaries payable		$6,000
Advances from customers		20,000
Stockholders' Equity		
Capital stock		200,000
Retained earnings		56,000
Total liabilities and stockholders' equity		$282,000

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P2-3. Converting accounting records from cash basis to accrual basis (AICPA adapted)

Requirement 1:

Stein Flowers
Conversion from Cash basis to Accrual basis
December 31, 2014

	Cash basis		Adjustments				Accrual basis	
	Dr.	Cr.	Dr.		Cr.		Dr.	Cr.
Cash	$23,200						$23,200	
Accounts receivable	16,200		$11,300	**(1)**				27,500
Inventory	58,000		13,900	**(4)**				71,900
Furniture and fixtures	128,500						128,500	
Land improvements	50,000						50,000	
Accumulated depreciation and amortization		$32,400			$14,875	**(6)**		
$47,275								
Accounts payable		21,000			12,500	**(3)**		
33,500								
Stein, drawings			73,000	**(9)**				73,000
Stein, capital		124,900	2,000	**(7)**	2,900	**(5)**		
125,800								
Allowance for uncollectibles					2,800	**(2)**		
2,800								
Prepaid insurance			3,000	**(5)**				3,000
Contingent liability					40,000	**(8)**		
40,000								
Utilities payable					1,500	**(7)**		
1,500								
Payroll taxes payable					1,600	**(7)**		
1,600								
Sales		660,000			11,300	**(1)**		
671,300								
Purchases	307,300		12,500	**(3)**				319,800
Salaries	174,000				60,000	**(9)**		114,000
Payroll taxes	12,400		500 **(7)**				12,900	
Insurance expense	9,000		2,900	**(5)**	3,000	**(5)**		8,900
Rent expense	34,200						34,200	
Utilities expense	12,500		600 **(7)**				13,100	
Living expense	13,000				13,000	**(9)**		
Bad debt expense			2,800	**(2)**				2,800
Amortization for land improvement			1,875	**(6)**				1,875
Depreciation expense			13,000	**(6)**				13,000
Loss pending litigation			40,000	**(8)**				40,000
Cost of goods sold					13,900	**(4)**		
13,900								

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$838,300	$838,300	$177,375	$177,375	$937,675	$937,675

Journal entries:

		Debit	Credit
1)	**DR** Accounts receivable	$11,300	
	CR Sales		$11,300
	To adjust accounts receivable to $27,500		
2)	**DR** Bad debt expense	$2,800	
	CR Allowance for uncollectibles		$2,800
	To record adjustment for uncollectable accounts		
3)	**DR** Purchases	$12,500	
	CR Accounts payable		$12,500
	To adjust accounts payable to $33,500		
4)	**DR** Inventory	$13,900	
	CR Cost of goods sold		$13,900
	To adjust inventory to $71,900		
5)	**DR** Prepaid insurance[1] ($9,000 x 4/12)	$3,000	
	DR Insurance expense[2]	2,900	
	CR Insurance expense		$3,000
	CR Stein, capital		2,900

[1]To allocate $9,000 insurance between this year and next.
[2]To record the first 4 months of expense for 2014 ($8,700/12 mos. = $725/mo. x 4 = $2,900).

		Debit	Credit
6)	**DR** Amortization of land improvements	$1,875	
	DR Depreciation expense	13,000	
	CR Accumulated depreciation and amortization		$14,875
	To record depreciation and amortization expense		
7)	**DR** Stein, capital	$2,000	
	DR Payroll taxes	500	
	DR Utilities	600	
	CR Utilities payable		$1,500
	CR Payroll taxes payable		1,600
	To record year-end accrual expenses and adjust expenses and capital at the beginning of the year		
8)	**DR** Loss from pending litigation	$40,000	
	CR Contingent liability		$40,000
	To accrue a contingent liability		
9)	**DR** Stein, drawings	$73,000	

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CR	Salaries	$60,000
CR	Living expenses	13,000
	To adjust drawings account for personal expenses	

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