**CHAPTER 11**

# FINANCIAL REPORTING CONCEPTS

### CHAPTER STUDY OBJECTIVES

1. ***Explain the importance of having a conceptual framework of accounting, and list the key components.*** The conceptual framework ensures that there is a consistent and coherent set of accounting standards. Key components of the conceptual framework are the: (1) objective of financial reporting; (2) elements of the financial statements; (3) qualitative characteristics; (4) recognition and measurement concepts; and (5) foundational concepts, assumptions, and constraints.

2. ***Explain the objective of financial reporting, and define the elements of the financial statements.*** The objective of financial reporting is to provide useful information for investors and creditors in making decisions in their capacity as capital providers. The elements are assets, liabilities, equity, revenue, and expense. Each element has a specific definition. The definitions provide important guidance on when an element should be recognized.

3. ***Apply the fundamental and enhancing qualitative characteristics of the conceptual framework to financial reporting situations.*** The fundamental qualitative characteristics are relevance and faithful representation. Financial information has relevance if it makes a difference in a decision. Materiality is an important component of relevance. An item is material when it is likely to influence the decision of a reasonably careful investor or creditor. Information is faithfully represented when it shows the economic reality and is complete, neutral, and free from material error.

The enhancing qualitative characteristics are comparability, verifiability, timeliness, and understandability. Comparability enables users to identify the similarities and differences between companies. The consistent use of accounting policies from year to year is part of the comparability characteristic. Information is verifiable if two knowledgeable and independent people would generally agree that it faithfully represents the economic reality. Timeliness means that financial information is provided when it is still highly useful for decision-making. Understandability enables reasonably informed users to interpret and comprehend the meaning of the information provided in the financial statements.

4. ***Apply the recognition and measurement criteria of the conceptual framework to financial reporting situations.*** General recognition criteria require that elements be recognized in the financial statements when it is probable that any economic benefit associated with the item will flow to or from the business and the item has a cost or value that can be measured or estimated with a reasonable amount of reliability. There are two approaches to revenue recognition: (1) contract-based and (2) earnings. The contract-based approach requires that revenue be recognized when promised goods or services are transferred and the amount reflects the consideration the business expects to receive. The earnings approach requires that revenue be recognized when the earnings process is complete, the risks and rewards of ownership have been transferred, and the amount can be reliably measured. Expenses are recognized when there is a decrease in an asset or increase in a liability, excluding transactions with owners, which result in a decrease in owners’ equity. Four measurements used in accounting are (1) historical cost, (2) current cost, (3) realizable value, and (4) present value. Incorrect application of the basic recognition and measurement concepts can lead to material misstatements in the financial statements. Incorrect application can be due to error or intentional misstatement.

5. ***Apply the foundational concepts, assumptions, and constraints of the conceptual framework to financial reporting situations.*** The foundational concepts, assumptions, and constraints form the bedrock of accounting and are used to achieve the objective of financial reporting. The reporting entity concept requires that accounting for a reporting entity’s activities be kept separate and distinct from the accounting for the activities of its owner and all other reporting entities. The going concern assumption assumes that the company will continue operating for the foreseeable future. The monetary unit concept means that money is the common denominator of economic activity. The periodicity concept guides businesses in dividing up their economic activities into distinct time periods. The cost constraint is a pervasive constraint that ensures the value of the information provided is greater than the cost of providing it. The full disclosure concept requires companies to fully disclose circumstances and events that make a difference to financial statement users.

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### Exercises

##### Exercise 1

The conceptual framework for accounting discusses the following:

Code:

A Objective of Financial Reporting

B Qualitative Characteristics of Accounting Information

C Elements of Financial Statements

**Instructions**

For each item below, indicate the area of the conceptual framework that pertains to that item by selecting the appropriate code.

Example:

C Asset (An asset is an element of financial statements.)

\_\_\_\_ 1. Information that is helpful in assessing management’s performance

\_\_\_\_ 2. Owners' equity

\_\_\_\_ 3. Timeliness

\_\_\_\_ 4. Neutral

\_\_\_\_ 5. Expense

\_\_\_\_ 6. Confirmatory value

\_\_\_\_ 7 Faithful representation

\_\_\_\_ 8 Comparability-consistency

\_\_\_\_ 9. Information that is useful in making resource allocation decisions

\_\_\_\_ 10 Full disclosure principle

##### Solution 1 (5 min.)

1. A

2. C

3. B

4. B

5. C

6. B

7. B

8. B

9. A

10. B

Bloomcode: Analysis

Difficulty: Medium

Learning Objective: Explain the importance of having a conceptual framework of accounting, and list the key components.

Section Reference: The Conceptual Framework of Accounting

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CPA: Financial Reporting

AACSB: Analytic

##### Exercise 2

For each item below, indicate whether the item is a(an) (1) Fundamental Qualitative Characteristic, (2) Enhancing Qualitative Characteristic, (3) Element of the Financial Statements, (4) Concept, or (5) Constraint.

Example:

(3)\_ Asset (An asset is an element of financial statements.)

\_\_\_\_ a) Relevance

\_\_\_\_ b) Comparability

\_\_\_\_ c) Cost-Benefit

\_\_\_\_ d) Timeliness

\_\_\_\_ e) Revenue

\_\_\_\_ f) Owner’s equity

\_\_\_\_ g) Faithful representation

\_\_\_\_ h) Going concern

\_\_\_\_ i) Reporting entity

\_\_\_\_ j) Monetary unit

##### Solution 2 (5 min.)

a) (1)

b) (2)

c) (5)

d) (2)

e) (3)

f) (3)

g) (1)

h) (4)

i) (4)

j) (4)

Bloomcode: Analysis

Difficulty: Medium

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##### Exercise 3

Presented below are some business transactions that occurred during 2021 for Kilgana Company:

1. A heavy-duty stapler costing $ 25 is being depreciated over 5 years. The following entry was made:

Depreciation Expense—Stapler 5

Accumulated Depreciation—Stapler 5

2. The owner of Kilgana Company took a vacation to France and charged the travel expenses to the company. The following entry was made:

Travel Expense 4,000

Cash 4,000

3. An account receivable has been deemed a bad debt. The following entry was made:

Allowance for Doubtful Accounts 9,000

Accounts Receivable 9,000

4. Merchandise Inventory with a cost of $ 420,000 is reported at its fair value of $ 510,000. The following entry was made:

Merchandise Inventory 90,000

Gain on Fair Value Adjustment of Inventory 90,000

5. Equipment worth $ 75,000 was acquired at a cost of $ 60,000 from a company that was going out of business. The following entry was made:

Equipment 75,000

Cash 60,000

Gain from on Fair Value Adjustment on Equipment 15,000

**Instructions**

For each situation above, identify the assumption, concept, or constraint that has been violated, if any. If the entry is incorrect, prepare the entry that should have been made, if any.

##### Solution 3 (10 min.)

1. The stapler will last more than one year but its cost is not material. Thus, the materiality constraint should be implemented and capitalizing and depreciating the stapler is not appropriate. At the time of purchase, the correct journal entry is:

Office Supplies 25

Cash 25

2. This treatment violates the economic entity concept. The owner should take this as drawings or a receivable should be established showing the owner owes the money to the company by the following entry:

Drawings / Advance to (or Receivable from) Owner 4,000

Cash 4,000

3. No violation of generally accepted accounting principles.

4. This is a violation of the cost concept. The inventory should not be written up to its fair value. No journal entry should have been made. The inventory should be reported at the lower of cost and net realized value, which is cost in this case.

5. This is a violation of the cost concept. The asset has been recorded at its estimated fair value, not its acquisition cost. The entry should have been:

Equipment 60,000

Cash 60,000

Bloomcode: Analysis

Difficulty: Medium

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##### Exercise 4

An inexperienced accountant for Can’t Add Company recorded the following transactions in the records of the company for the year ended December 31, 2021. The controller has questioned the appropriateness of the entries since she thinks that they have not been recorded in accordance with generally accepted accounting principles. Profit for the year, including the entries described below, is $ 200,000.

1. On January 1, the company president, the owner of the company, took a personal vacation trip to the Gaspé. The trip cost $ 3,000. The accountant recorded the entry as follows:

Travel Expense 3,000

Accounts Payable 3,000

2. The company purchased on account a wastebasket on December 31 at a cost of $ 20. The accountant made the following entry:

Office Equipment 20

Accounts Payable 20

3. Merchandise inventory that cost $ 14,000 had a current net replacement value of $ 22,000. The accountant made the following entry as a result:

Merchandise Inventory 8,000

Gain on fair value adjustment 8,000

4. Equipment with a fair market value of $ 15,000 was acquired in a liquidation sale for cash at a cost of $ 10,000. The accountant recorded the transaction as follows:

Equipment 15,000

Cash 10,000

Gain on fair value adjustments 5,000

5. Can’t Add uses the allowance method. A customer's account receivable for $ 17,000 was uncollectible and the following entry was made:

Bad Debt Expense 17,000

Accounts Receivable 17,000

**Instructions**

a) For each of the above entries, indicate the concept or constraint that was violated.

b) Determine the correct profit for 2021.

##### Solution 4 (15 min.)

a)

1. Economic entity concept

2. Materiality constraint

3. Cost concept

4. Cost concept

5. Matching concept

b)

Concept Profit

Item or Constraint (Overstatement)/Understatement

1. Economic entity $ 3,000

2. Materiality (20)

3. Cost (8,000)

4. Cost (5,000)

5. Matching 17,000

Total understatement 6,980

Uncorrected profit 200,000

Corrected profit $ 206,980

Bloomcode: Evaluation

Difficulty: Hard

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**Exercise 5**

The following are independent situations observed by Aqua Company’s senior accountant at December 31, 2021, the company’s year end. Aqua Company has not adopted the revaluation model for accounting for long-lived assets.

1. Aqua purchased land in February at a cost of $ 60,000 for the purpose of expanding the size of their parking lot, although this project has not yet been started at year end. Due to increases in real estate values, this land has a value of $ 100,000 by year end. An entry to record this increase in value has been recorded, crediting “Gain on Land.”

2. One of the items making up Aqua ’s total current assets of $ 354,000 is an amount of $ 1,400 for Supplies. The company owner asks one of the accounting staff whether she thinks this balance is correct. The staff person takes two days of work time to count the actual supplies on hand and another day to research the exact cost of the items, and subsequently adjusts the balance of Supplies to its exact balance of $ 1,425. As a result of this task, the month-end financial statements are submitted to the company’s lender two days after the reporting deadline.

3. A $ 96,300 payment for a 12-month insurance policy effective March 1 had been debited to Insurance Expense.

4. Included in Accrued Interest Payable is interest on a $ 200,000, 3% note payable. Interest has been paid to December 2, 2021. Accrued interest payable was calculated and recorded as $ 500 by applying the following formula: $ 200,000 x 3% x 1÷12. However, the accountant was concerned because part of December’s interest has already been paid and the formula included a full month’s accrual. He therefore reduces the accrued interest payable by $ 33 ($ 200,000 x 3% x 2÷365).

5. On January 15, 2022, before the financial statement preparation for December 31, 2021 had been completed, a fire destroyed General’s warehouse, which had a carrying value of $ 1,500,000, and inventory with a cost of $ 900,000. The lost assets are insured, but will result in a 6-month interruption in business while being reconstructed. No mention of this event is found in the financial statements.

6. The company completed its year-end inventory count and the controller noticed that obsolete inventory had been included in the physical count and that it was valued at its original cost less an obsolescent factor of 10%. When the controller asked how long the inventory had been on hand, he was told that it was 4 years old; most of their inventory is 6 months old.

**Instructions**

For each of the events, indicate the accounting assumption, concept, or constraint that has been violated and provide your reason. Prepare the correcting entry required, or if no entry is required, explain what other change, if any, should be made to ensure that Aqua’s financial statements comply with GAAP.

**Solution 5** (10 min.)

1. The cost concept has been violated. Assets used in the business should be reported at cost unless an impairment has occurred. To correct this, the entry is:

Gain on Land 40,000

Land 40,000

2. The cost constrainthas been violated. The benefit of the more precise information (that the Supplies are worth $ 1,425 not $ 1,400) has come at a cost of delayed financial reporting. The benefit is not worth the cost of missing the reporting deadline.

3. The matching concept has been violated. The expense should be matched with the months during which the policy is in place. To correct this, the prepaid portion should be recorded:

Prepaid Insurance ($ 96,300 x 2÷12) 16,050

Insurance Expense 16,500

4. The materiality concept has been violated. The $ 33 difference is unlikely to affect the decisions being made by users of the financial statements. It is not necessary to make an entry as the difference is immaterial.

5. The full disclosure principle has been violated. Because this information is critical to users of the financial statements to assess the financial viability of the company, it should be included as a note to the financial statements. No entry is required, just the additional note disclosure.

6. The expense recognition criterion states that expenses are recognized when there is a decrease in an asset. The obsolete inventory has clearly declined in value and thus an expense should be recognized.

Bloomcode: Evaluation

Difficulty: Hard

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**Exercise 6**

Generally accepted accounting principles include the following assumptions, concepts, and constraints:

A Going concern assumption

B Economic entity concept

C Revenue recognition criteria

D Matching

E Full disclosure

F Cost concept

G Cost constraint

H Materiality constraint

The following independent situations occurred in different companies:

1. One third of the company's sales were made to a related party and this fact is disclosed in the financial statements.

2. The company's inventory's cost is $ 50,000, its retail value is $ 120,000, and if liquidated could be sold at auction for $ 30,000. The inventory is reported at $ 50,000 on the company's balance sheet.

3. A company's accountant notices that the petty cash account was not adjusted prior to preparing the year-end financial statements and the account balance is incorrect by $ 13.52. However, the accountant decides to release the financial statements without making the correction.

4. The proprietor of an unincorporated business maintains two bank accounts and two sets of accounting records—one for household expenses, and the other for business purposes.

5. The company records revenue when services are provided, not when the customers pay for the service.

6. The company has a large number of accounts receivable that individually have small balances. In order to determine the allowance for doubtful accounts, the company uses an estimate based on past experience rather than taking the time to evaluate the collectibility of individual accounts.

7. Insurance expense is recorded each month, although the insurance policy covers a full year and is paid annually.

8. A patent with an indefinite life has an original cost of $ 12,500 although the company was recently offered $ 1,000,000 by another company who wants to buy it.

9. Interest is payable semi-annually and is recorded only when paid, with no adjustment at year end even though payment dates do not coincide with the year-end date.

10. A former employee has sued the company for a large amount, but no mention is made of this case in the financial statements.

11. After obtaining an independent appraisal that indicated a significant increase in value over original cost, the company restated its land at the higher amount. The company has not adopted the revaluation model for accounting for long-lived assets.

12. The company accountant recently spent two days calculating the accrued utilities expense on 130 individual apartments for the last few days of the year. In the past, the amounts were estimated.

13. The company's sales are made on credit, but to keep accounting costs down, sales are recorded when the customer accounts are paid.

14. When preparing financial statements, the company's policy is to record all correcting entries, whether the correction is for $ 200,000 or $ 2.

15. The proprietor's babysitting costs are recorded in the company expense accounts.

16. All assets are restated at their liquidation values.

**Instructions**

For each of the situations, identify the assumption, concept, constraint, or recognition criteria that provides the best explanation by selecting the appropriate code. Each code will be used more than once; however, each situation only has one correct answer.

**Solution 6** (10 min.)

1. E

2. A

3. H

4. B

5. C

6. G

7. D

8. F

9. D

10. E

11. F

12. G

13. C

14. H

15. B

16. A

Bloomcode: Analysis

Difficulty: Medium

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**Exercise 7**

A number of unrelated transactions recorded by Abba Company are as follows:

1. At year end the Depreciation expense is calculated as $ 10,000, which results in a net book value that is $ 14,000 greater than the equipment’s liquidation value:

Loss on fair value adjustment 14,000

Depreciation Expense 10,000

Accumulated Depreciation 24,000

2. The proprietor of Abba paid for her household cleaning costs out of the business bank account:

Cleaning Expense 140

Cash 140

3. A customer pays for November services in October. The October entry is:

Cash 525

Service Revenue 525

4. Abba guaranteed the loan of a related party, Provincial Corp., and Provincial defaulted on its loan. In December, the bank demanded payment of $ 100,000 from Abba, who negotiated to make the payments in 4 equal monthly instalments, the first of which was made in December. The following entry was recorded by Abba when the December payment was made. No further information was provided in its financial statements because it is probable that Provincial will be able to make the remainder of the payments.

Loss on Loan Guarantee 25,000

Cash 25,000

**Instructions**

For each of the above situations, identify the accounting assumption, concept, constraint, or recognition criteria that have been violated. Prepare the correct journal entry as it should have been made. If no entry should have been made, or if additional financial statement disclosure is required, explain.

**Solution 7** (8 min.)

1. The going concern assumption has been violated. The liquation values of assets are relevant to the financial statement user only if the company actually has a plan to liquidate the assets. The original entry should have been:

Depreciation Expense 10,000

Accumulated Depreciation 10,000

2. The economic entity concept has been violated. The owners’ personal expenses should not be recorded as business expenses. If company funds are used to pay personal expenses, the payment should be recorded as a receivable from the owner, as follows:

Drawings 140

Cash 140

3. The revenue recognition criteria have been violated. The revenue should be recognized in November, not October. The payment should have been recorded as follows:

Cash 525

Unearned Revenue 525

4. The full disclosurehas been violated. No entry is required because the additional loss is unlikely to occur. However, the fact that there is a possibility of additional losses should be disclosed.

Bloomcode: Evaluation

Difficulty: Hard

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##### Exercise 8

For each of the independent situations described below, list the assumption, characteristic, concept, or constraint that has been violated, if any. List only one term for each case.

1. The Who Company reports only current assets and current liabilities on its balance sheet. Intangible assets and a 20-year mortgage payable are reported as a current asset and a current liability, respectively. Liquidation of the company is unlikely.

2. Gabi Company is in its third year of operation and has yet to issue financial statements. (Do not use full disclosure principle.)

3. Griffin Company is carrying inventory at its net realizable value of $ 110,000. The inventory had an original cost of $ 135,000.

4. Paul Company expenses some office equipment that is inexpensive even though it has a useful life that exceeds 1 year.

5. Singh Corporation has selected FIFO as its inventory cost flow formula during the current year. Next year it plans to change to the weighted average cost formula.

##### Solution 8 (5 min.)

1. Going concern assumption

2. Timeliness

3. No violation (qualitative characteristic - relevance and faithful representation)

4. No violation (materiality constraint)

5. Consistency (qualitative characteristic)

Bloomcode: Analysis

Difficulty: Medium

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**Exercise 9**

The following are independent situations observed by Mersey’s senior accountant at December 31, 2021, the company’s year end. Mersey has not adopted the revaluation model for accounting for long-lived assets.

1. The draft financial statements include an item listed under non-current assets “Human resources” but there is no financial amount included.

2. Mersey’s employees are paid a bonus based on profit. Mersey’s management would like to minimize the amount of bonus paid, and so they instructed a junior accountant to write down inventory by $ 1,000,000 and record a Loss on Inventory. Their argument is that the “fire sale” value of the inventory would be lower than recorded cost by this amount. Mersey has no intention of liquidating the inventory under such circumstances, but expects to sell the inventory in the normal course of business at amounts significantly above cost.

3. A building being constructed for a customer was 90% complete, and accordingly 90% of the related revenue had been correctly included in sales for the year. The total projected cost of construction is $ 600,000. Of the $ 540,000 cost of the project incurred to date, $ 200,000 has been expensed to COGS

4. Mersey owns 5% of the shares of Liverpool Investments. A note to Liverpool’s financial statements describes a valuable new patent registered by Liverpool and the anticipated profits that are expected to result. A junior accountant at Mersey recorded an entry “Debit Intangible Assets; Credit Gain on Patent Registration” in the amount of $ 220,000, which is 5% of the amount at which Liverpool has recorded the cost of the patent.

5. In November, Mersey entered into a service contract to provide maintenance services to a client for a fee of $ 20,000 per month. On signing the contract, the client paid Mersey a $ 40,000 deposit on services to be provided. The term of the contract is from December 15, 2021 through December 15, 2022. The $ 40,000 deposit was recorded as Service Revenue.

**Instructions**

For each of the events, indicate an accounting assumption, concept, constraint, or recognition criteria that have been violated and provide your reason. Prepare the correcting entry required, or if no entry is required, explain what other change, if any, should be made to ensure that Mersey’s financial statements comply with GAAP.

**Solution 9** (10 min.)

1. Under the general recognition criterion, an item will be included in the financial statements if it can be measured and if a reasonable basis of measurement can be met. This item is not an asset and should not be included on the balance sheet. No entry is required, but the reference should be removed from the balance sheet.

2. The going concern assumption has been violated. The financial statements should be prepared on the assumption that the business will continue unless there are concrete liquidation plans. This means the inventory should be reported at the lower of cost and net realizable value. The entry to correct this is:

Inventory 1,000,000

Loss on Inventory 1,000,000

3. The matching concepthas been violated. Since 90% of the revenue has been recognized, so should 90% of the costs. To correct this, the following entry is required:

Cost of Goods Sold [($ 600,000 x 90%) – $ 200,000] 340,000

Inventory 340,000

4. The economic entity concept has been violated. Because Liverpool and Mersey are two separate legal entities, no part of Liverpool’s assets should be included in the financial statements of Mersey. To correct this, the following entry is required:

Gain on Patent Registration 220,000

Intangible Assets 220,000

5. The revenue recognition criterion has been violated. Revenue should be recognized when the service is provided to the client. To correct this, the following entry is required:

Service Revenue 30,000

Unearned Revenue 30,000

Total deposit $ 40,000 less amount earned in December ($ 40,000 x 0.5÷2 months)

Bloomcode: Evaluation

Difficulty: Hard

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AACSB: Analytic

**Exercise 10**

The following are independent situations observed by Dino Industrial’s senior accountant at December 31, 2021, the company’s year end:

1. Dino has parts inventory for use in its construction department (not for resale). The inventory includes over 1,500 different items, with between 10 and 100 of each item in stock. The cost of the individual items ranges from $ 0.30 to $ 1.50. In the past, the inventory quantities have been estimated by weighing the parts bins. This year, the accountant had the individual items counted and priced to provide more precise information. The total estimated value of the items is $ 45,000, which is material in total. It took four staff a full day to count the inventory at a cost of $ 1,000 in labour costs, and it would have taken two staff a half day to complete the estimate by weighing at a cost of $ 250. After the count, an entry of $ 27 was needed to reduce the inventory balance to actual. The entry was debited to Construction Supplies Expense.

2. Goods with a sales price of $ 55,000 were shipped to a customer FOB shipping point. The goods were picked up by the shipping company on December 31, 2021, and delivered to the customer on January 2, 2022. The customer’s invoice was prepared and recorded in January 2022.

3. Prepaid expenses include $ 12,000 in prepaid rent related to the long-term lease of a branch office. When the lease was signed 4 years ago, Dino had to pay a $ 6,000 deposit, which comprises the final month’s rent. Rental rates have since doubled in that location, so an entry has been recorded to reflect this value as follows: “Debit Prepaid Rent $ 6,000; Credit Rent Expense $ 6,000.” The junior accountant’s argument for making this entry is that the company has benefited from the long-term lease and the financial statements should reflect this benefit.

4. One of the owners of Dino purchased a vacation property for $ 190,000 with company funds. The transaction was recorded as a debit to Property, Plant, and Equipment, and a credit to Cash.

**Instructions**

For each of the events, indicate the accounting assumption, concept, constraint, or recognition criteria that have been violated and provide your reason. Prepare the correcting entry required, or if no entry is required, explain what other change, if any, should be made to ensure that Dino’s financial statements comply with GAAP.

**Solution 10** (10 min.)

1. The cost constrainthas been violated. Dino has just spent $ 750 ($ 1,000 – $ 250) more than necessary to make an adjustment of $ 27 without providing significantly better information than the estimate process provided. There is no need to make another entry, but Dino should not repeat this process in the future.

2. The terms of the sale “FOB shipping point” means the customer has accepted ownership at the time the shipping begins. The revenue recognition criterion is met when the goods are shipped. To record this entry in December 2021 as required, Dino should record the following entry:

Accounts Receivable 55,000

Sales Revenue 55,000

3. The cost concept has been violated. The prepaid rent should be reported at its original cost. In order to correct this, the entry made by the accountant should be reversed as follows:

Rent Expense 6,000

Prepaid Rent 6,000

4. The economic entity concept has been violated. Only assets that are for the benefit of the business should be recorded in the company’s financial statements. To correct this, the following entry is required:

Loan Receivable 190,000

Property, Plant, and Equipment 190,000

Bloomcode: Evaluation

Difficulty: Hard

Learning Objective: Explain the objective of financial reporting, and define the elements of the financial statements.

Section Reference: The Objective of Financial Reporting

Learning Objective: Apply the recognition and measurement criteria of the conceptual framework to financial reporting situations.

Section Reference: Recognition and Measurement Criteria

Learning Objective: Apply the foundational concepts, assumptions, and constraints of the conceptual framework to financial reporting situations.

Section Reference: Foundational Concepts, Assumptions, and Constraints

CPA: Financial Reporting

AACSB: Analytic

**Exercise 11**

A number of unrelated transactions recorded by Farm Company are as follows:

1. At the end of the month, the obsolete inventory was valued at $ 17,000. No entry was made.

2. Provincial, which owns an art gallery, purchases a valuable painting for $ 40,000 in November, and sells it in January, which is after the company’s year end. The entry made when the painting is purchased is:

Cost of Goods Sold 40,000

Cash 40,000

3. Equipment was purchased for $ 8,000 from a store that is going out of business. The equipment was appraised at $ 10,000.

Equipment 10,000

Cash 8,000

Retained Earnings 2,000

**Instructions**

For each of the above situations, identify the accounting assumption, concept, constraint, or recognition criteria that have been violated. Prepare the correct journal entry as it should have been made. If no entry should have been made, or if additional financial statement disclosure is required, explain.

**Solution 11** (8 min.)

1. The expense recognition criterionhas been violated. Where an asset has declined in value, an expense should be recognized. The entry should be:

Inventory Obsolescence Expense 17,000

Inventory 17,000

2. Matching has been violated. The cost of goods sold should be recorded in the same period that the revenue occurs. The correct entry to record the purchase of the painting is:

Merchandise Inventory 40,000

Cash 40,000

3. The cost concept is violated. The equipment should have been recorded at the amount the company paid for it as follows:

Equipment 8,000

Cash 8,000

Bloomcode: Evaluation

Difficulty: Hard

Learning Objective: Explain the objective of financial reporting, and define the elements of the financial statements.

Section Reference: The Objective of Financial Reporting

Learning Objective: Apply the recognition and measurement criteria of the conceptual framework to financial reporting situations.

Section Reference: Recognition and Measurement Criteria

Learning Objective: Apply the foundational concepts, assumptions, and constraints of the conceptual framework to financial reporting situations.

Section Reference: Foundational Concepts, Assumptions, and Constraints

CPA: Financial Reporting

AACSB: Analytic

##### Exercise 12

For each of the independent situations described below, list the assumption, concept, constraint, or recognition criteria that have been violated, if any. List only one term for each case.

1. Chris Burgess, MD, had the clinic accountant prepare his personal tax return. He paid the accountant using clinic funds and debited the clinic's "Professional Fees" account.

2. Chu Company does not use an account for allowance for doubtful accounts. Instead, accounts receivable are written off directly to Bad Debt Expense if they remain unpaid after 24 months.

3. Equipment is carried at its fair value on the Chipawa Company balance sheet, which is $ 25,000 higher than cost. Fontaine Chipawa has not adopted the revaluation model for accounting for long-lived assets.

4. Depreciation Expense for Rowland Company is $ 15,000. The company will have a net loss of $ 12,000 if the depreciation is recorded, but a profit of $ 3,000 if depreciation is deferred a year. The decision is made to defer the depreciation to next year which is expected to be more profitable.

5. The land of Fountain Company is appraised at $ 200,000 more than its cost. The new accountant for the company recommends booking the appraised value and showing a "Gain from Revaluation" on the income statement. Fountain Company has not adopted the revaluation model for accounting for long-lived assets.

##### Solution 12 (5 min.)

1. Economic entity concept

2. Matching concept

3. Cost

4. Matching concept

5. Cost

Bloomcode: Evaluation

Difficulty: Hard

Learning Objective: Explain the objective of financial reporting, and define the elements of the financial statements.

Section Reference: The Objective of Financial Reporting

Learning Objective: Apply the foundational concepts, assumptions, and constraints of the conceptual framework to financial reporting situations.

Section Reference: Foundational Concepts, Assumptions, and Constraints

CPA: Financial Reporting

AACSB: Analytic

##### Exercise 13

Match the following qualitative characteristics of financial statements to the appropriate code:

Code:

A Faithful representation

B Timeliness

C Neutral

D Verifiable

E Relevance

F Complete

1. Information is available to decision makers before the information loses its ability to influence decisions.
2. Accounting information reports the economic reality of a transaction, not its legal form.
3. All of the information necessary to show the economic reality of transactions is provided.
4. Information makes a difference in a decision.
5. Users are assured that the financial information shows the economic reality of the transaction.
6. Information is free from bias that is intended to attain a predetermined result.

##### Solution 13 (5 min.)

1. B

2. A

3. F

4. E

5. D

6. C

Bloomcode: Analysis

Difficulty: Medium

Learning Objective: Apply the fundamental and enhancing qualitative characteristics of the conceptual framework to financial reporting situations.

Section Reference: Qualitative Characteristics of Useful Financial Information

CPA: Financial Reporting

AACSB: Analytic

##### Exercise 14

For each of the independent situations described below, list the assumption, concept, constraint, or recognition criteria that have been violated and describe the appropriate treatment.

1. MacDonald Industrial purchased a piece of land that was listed for $ 150,000. The company worked very hard in negotiations and both parties agreed on a purchase price of $ 139,000. Lawson’s accountant has recorded the land on the books at $ 150,000 because she felt this was the most representative fair value at the time of purchase.

2. Chantal’s Hair Salon purchases many different hair and cosmetic supplies to be used within the salon and sold to customers. Darlene only has one credit card that she uses to make personal and business purchases. She often gets confused which purchases are for business purposes so she records all credit card transactions through the salon.

3. Buddie’s Furniture operates in a small town and often sells on credit without any detailed credit checks. The company sold merchandise to Darcy last year and he failed to pay the amount owing so Buddie wrote off his account. Buddie has recently made another sale to Darcy on credit for $ 12,000 without any security on the transaction. Buddie records all sale transactions once the goods are delivered and title passes.

4. Fancy Diamonds is a Canadian company that reports its financial statements in Canadian dollars. The company often sells its diamonds to customers in the United States and receives U.S. dollars. Fancy records the U.S. dollar amounts within the accounting records without any currency exchange.

##### Solution 14 (10 min.)

1. Cost principle – GAAP requires that initial measurement be made at cost. Although the asking price for the land was $ 150,000, MacDonald only paid $ 139,000 which represents the company’s cost. MacDonald should adjust the accounting records and reduce the land value to its cost of $ 139,000.

2. Reporting entity – GAAP requires business transactions to be recorded separately from personal transactions. Chantal should reconcile her credit card statements to isolate the personal transactions and exclude these from the business. It should also be recommended that Chantal acquire a business credit card to facilitate this task.

3. Revenue recognition – Although the goods are delivered and legal title has passed to Darcy, collectibility is not reasonably assured due to past history with this customer and the lack of credit verification. As a result, under the earnings approach revenue should not be recorded until Darcy pays Buddie. Buddie should reverse the entry.

4. Monetary unit – Since Fancy’s functional currency is Canadian dollars, all U.S. dollar transactions should be translated to Canadian when recorded in the accounting records. Fancy should make a correcting entry to record the proper amount in Canadian dollars based on the current rate in effect on the date of the transaction.

Bloomcode: Evaluation

Difficulty: Hard

Learning Objective: Apply the recognition and measurement criteria of the conceptual framework to financial reporting situations.

Section Reference: Recognition and Measurement Criteria

Learning Objective: Apply the foundational concepts, assumptions, and constraints of the conceptual framework to financial reporting situations.

Section Reference: Foundational Concepts, Assumptions, and Constraints

CPA: Financial Reporting

AACSB: Analytic

**Exercise 15**

Comfort King Ltd. sells central air units and furnaces to local residents as well as ongoing maintenance plans. Jack Frost agreed to an arrangement with Comfort King to purchase a central air package for $ 4,000 on May 1, 2021. In addition to the sale, the arrangement includes installation, maintenance on the central air unit for two years, and a one-time furnace cleaning, which will occur when the central air unit is installed. Jack Frost is receiving a great deal as the full contract price represents the stand-alone value of the central air unit. Comfort King also provides installation, central air maintenance, and furnace cleaning services separately to its customers as follows: installation fee $ 400, annual central air maintenance fee $ 250, and furnace cleaning fee $ 100. Comfort King installed the unit and cleaned the furnace on May 20, 2021, and was immediately paid the agreed-upon price by Jack Frost.

**Instructions**

Complete the following steps to determine if the appropriate criteria have been met for Comfort King to recognize revenue under the contract-based approach to revenue recognition. Be sure to conclude whether Comfort King can recognize the revenue and when it would be appropriate to do so.

1. Is there a contract?
2. What is the performance obligation?
3. What is the transaction price?
4. Is there a need to allocate the selling price?
5. Has the performance obligation been satisfied?

**Solution 15** (15 min.)

1. Yes. Comfort King and Jack Frost entered into an agreement to purchase a central air package on May 1, 2021 for $ 4,000.

2. There are multiple performance obligations in this arrangement – sale of the central air unit, furnace cleaning, and a two-year maintenance plan for the central air unit.

3. The transaction price is $ 4,000.

4. Since there are multiple performance obligations, we must allocate the transaction price based on their stand-alone market values as follows:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Performance Obligation | Stand-alone value | % of total stand-alone value | Contract Price | Allocation of contract price |
| Sale of central air unit | $ 4,000 | 80% | $ 4,000 | $ 3,200 |
| Installation of unit | 400 | 8% | 4,000 | 320 |
| Furnace cleaning | 100 | 2% | 4,000 | 80 |
| A/C maintenance | ($ 250 x 2) 500 | 10% | 4,000 | 400 |
|  | $ 5,000 | 100% |  | $ 4,000 |

5. The sale of the air central air unit, installation, and furnace cleaning have all been completed on May 20, 2021 when the unit was delivered and installed, and the furnace was cleaned. The obligation to perform annual maintenance on the central air unit has not been completed. This aspect will be completed on an annual basis as the maintenance term lapses.

Conclusion:

Point of revenue recognition:

Sale of central air unit - $ 3,200 on May 20, 2021

Installation of unit - $ 320 on May 20, 2021

Furnace cleaning - $ 80 on May 20, 2021

Annual maintenance on central air - $ 200 at the end of each year (i.e., May 20, 2022 and 2023)

Bloomcode: Analysis

Difficulty: Medium

Learning Objective: Apply the recognition and measurement criteria of the conceptual framework to financial reporting situations.

Section Reference: Recognition and Measurement Criteria

CPA: Financial Reporting

AACSB: Analytic

**Exercise 16**

Comfort King Ltd. sells central air units to local residents as well as ongoing maintenance plans. Jack Frost agreed to an arrangement with Comfort King to purchase a central air package for $ 4,000 on May 1, 2021. In addition to the sale, the arrangement includes unit installation and maintenance on the central air unit for two years. Jack Frost is receiving a great deal as the full contract price represents the stand-alone value of the central air unit. Comfort King also provides installation and central air maintenance separately to its customers as follows: installation fee $ 400 and annual central air maintenance fee $ 250. Comfort King installed the unit on May 20, 2021, and was immediately paid the agreed-upon price by Jack Frost.

**Instructions**

Complete the following steps to determine if the appropriate criteria have been met for Comfort King to recognize revenue under the contract-based approach to revenue recognition. Be sure to conclude whether Comfort King can recognize the revenue and when it would be appropriate to do so.1. Is there a contract?

1. 2. What is the performance obligation?
2. 3. What is the transaction price?
3. 4. Is there a need to allocate the selling price?
4. 5. Has the performance obligation been satisfied?

**Solution 16** (15 min.)

1. Yes. Comfort King and Jack Frost entered into an agreement to purchase a central air package on May 1, 2021 for $ 4,000.

2. There are multiple performance obligations in this arrangement – sale of the central air unit and a two-year maintenance plan for the central air unit.

3. The transaction price is $ 4,000.

4. Since there are multiple performance obligations, we must allocate the transaction price based on their stand-alone market values as follows:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Performance Obligation | Stand-alone value | % of total stand-alone value | Contract Price | Allocation of contract price |
| Sale of central air unit | $ 4,000 | 81.6% | $ 4,000 | $ 3,264 |
| Installation of unit | 400 | 8.2% | 4,000 | 328 |
| A/C maintenance | ($ 250 x 2) 500 | 10.2% | 4,000 | 408 |
|  | $ 4,900 | 100% |  | $ 4,000 |

5. The sale of the air central air unit and installation have been completed on May 20, 2021 when the unit was delivered and installed. The obligation to perform annual maintenance on the central air unit has not been completed. This aspect will be completed on an annual basis as the maintenance term lapses.

Conclusion:

Point of revenue recognition:

Sale of central air unit - $ 3,264 on May 20, 2021

Installation of unit - $ 328 on May 20, 2021

Annual maintenance on central air - $ 204 at the end of each year (i.e., May 20, 2022 and 2023)

Bloomcode: Analysis

Difficulty: Medium

Learning Objective: Apply the recognition and measurement criteria of the conceptual framework to financial reporting situations.

Section Reference: Recognition and Measurement Criteria

CPA: Financial Reporting

AACSB: Analytic

**Exercise 17**

Comfort King Ltd. sells central air units to local residents. Jack Frost agreed to an arrangement with Comfort King to purchase a central air unit for $ 4,000 on May 1, 2021. In addition to the sale, the arrangement includes unit installation which was completed on May 20, 2021. Comfort King only provides installation services for its customers who purchase new units. Comfort King was immediately paid the agreed-upon price by Jack Frost.

**Instructions**

Complete the following steps to determine if the appropriate criteria have been met for Comfort King to recognize revenue under the contract-based approach to revenue recognition. Be sure to conclude whether Comfort King can recognize the revenue and when it would be appropriate to do so.

1. Is there a contract?

2. What is the performance obligation?

3. What is the transaction price?

4. Is there a need to allocate the selling price?

5. Has the performance obligation been satisfied?

**Solution 17** (10 min.)

1. Yes. Comfort King and Jack Frost entered into an agreement to purchase a central air unit on May 1, 2021 for $ 4,000.

2. There are two performance obligations in this arrangement, to supply and install the central air unit.

3. The transaction price is $ 4,000.

4. Although there are two performance obligations, the installation costs are imbedded into the total contract price and cannot be separated since Comfort King does not provide these services on a stand-alone basis. Furthermore, the delivery and installation of the central air unit occurs simultaneously so there is no need to separate the two components.

5. The sale of the air central air unit and installation have been completed on May 20, 2021 when the unit was delivered and installed, and therefore revenue can be realized at that time.

Conclusion:

Point of revenue recognition: Sale of central air unit and installation - $ 4,000 on May 20, 2021

Bloomcode: Analysis

Difficulty: Medium

Learning Objective: Apply the recognition and measurement criteria of the conceptual framework to financial reporting situations.

Section Reference: Recognition and Measurement Criteria

CPA: Financial Reporting

AACSB: Analytic

**Exercise 18**

The following transactions occurred during 2021:

1. A television set is delivered to the customer in August. Six instalment payments of $ 200 per month begin the following January. Ignore interest considerations.

2. Goods are sold FOB shipping point. An item with a retail value of $ 10,000 is loaded onto the truck on May 31, but not unloaded until June 3 because the recipient delayed paying the freight bill until then. The vendor prepares and mails the invoice to the customer on June 10.

3. A computer network system and related cables are delivered to the customer's premises on March 31. Installation is completed by April 30, after which the system is ready for use. The vendor provides monthly support and upgrades for 4 months following the month of installation (through end of August). The value of the system and cables is $ 50,000, the value of the installation services is $ 22,000, and the value of the monthly support totals $ 6,000.

4. Goods are sold FOB destination. An order with an invoice total of $ 3,500 is loaded onto the truck January 31 and delivered on February 1.

5. A customer prepays for 10 oil changes for a total of $ 300. During December, two oil changes are completed for this customer.

**Instructions**

Identify in which month revenue should be recognized in each situation. If revenue should be recognized in more than one month, calculate the amounts that apply to each relevant month.

**Solution 18** (10 min.)

1. Because the goods have been delivered to the customer, the full sales price of $ 200 x 6 = $ 1,200 should be recognized in August.

2. The $ 10,000 revenue should be recognized in May because that is the period in which the customer accepted ownership in accordance with the terms of the sale “FOB shipping point.”

3. The revenue for sale of the system ($ 50,000) and installation ($ 22,000) should be recognized in April because that is when the service is complete and the goods become available for use by the customer. The monthly support should be recognized at the rate of $ 6,000 ÷ 4 = $ 1,500 per month from May through August.

4. The $ 3,500 revenue should be recognized in February because that is the period in which the customer accepted ownership in accordance with the terms of the sale “FOB destination.” Therefore, the vendor has legal title to the goods until delivered to the destination.

5. During December, service revenue of $ 60 ($ 300÷10 x 2 = $ 60) should be recognized because that is when that proportion of the services were provided.

Bloomcode: Analysis

Difficulty: Medium

Learning Objective: Apply the recognition and measurement criteria of the conceptual framework to financial reporting situations.

Section Reference: Recognition and Measurement Criteria

CPA: Financial Reporting

AACSB: Analytic

**Exercise 19**

Spanish Marine Supplies is a marine supplier of tugboat engines. As part of the selling process, the company will install the tugboat engine, conduct sea trials on the engine, provide any servicing required on the engine for the first year of operation, and not require a payment from the client until 60 days after the client’s acceptance of the engine. The engine will remain the property of Spanish until the first payment is made, even though the boat is not the property of Spanish. The company’s customers frequently ask Spanish to customize the engines to suit their needs. These customization changes can be extensive and may take several months.

**Instructions**

Comment on when you think Shediac should recognize revenue.

**Solution 19** (5 min.)

Revenue is recognized when all of the following conditions are met:

1. The seller has transferred to the buyer the significant risks and rewards of ownership.

2. The seller does not have control over the goods or continuing managerial involvement.

3. The amount of revenue can be reliably measured.

4. It is probable there will be an increase in economic resources.

5. Costs relating to the sale of the goods can be reliably measured.

If there is no customization, then the company could recognize revenue when the customer makes the payment at the end of 60 days and assumes legal title to the engine. If there is customization, then the revenue would be not be able to be recognized until all of the work has been completed, the revenue is known, and the customer has accepted and paid for the engine.

Bloomcode: Analysis

Difficulty: Medium

Learning Objective: Apply the recognition and measurement criteria of the conceptual framework to financial reporting situations.

Section Reference: Recognition and Measurement Criteria

CPA: Financial Reporting

AACSB: Analytic

**Exercise 20**

Target Security Company provides surveillance services to numerous corporate customers. The company has recently signed a new surveillance contract with Martin Manufacturing on January 1 for a period of one month at a cost of $ 500. On January 31, Target completed the contract and invoiced Martin for the full contract price due in 30 days.

**Instructions**

Complete the following steps to determine if the appropriate criteria have been met for Target to recognize revenue under the contract-based approach to revenue recognition. Be sure to conclude whether Target can recognize the revenue and when it would be appropriate to do so.

1. Is there a contract?
2. What is the performance obligation?
3. What is the transaction price?
4. Is there a need to allocate the selling price?
5. Has the performance obligation been satisfied?

**Solution 20** (10 min.)

1. Yes. Target and Martin signed a contract for one month of surveillance services for consideration of $ 500.

2. There is only one performance obligation – to provide one month of services.

3. The transaction price is $ 500.

4. Since there is only one performance obligation, the entire transaction price will be allocated to the one-month surveillance service.

5. Yes. Target completed the contract on January 31 as this was the stated period of service agreed under the contract. Target now has a right to receive payment of $ 500 from Martin.

Conclusion: All five steps of the contract-based approach to revenue recognition are complete on January 31, and therefore full revenue of $ 500 should be recorded on this date.

Bloomcode: Analysis

Difficulty: Medium

Learning Objective: Apply the recognition and measurement criteria of the conceptual framework to financial reporting situations.

Section Reference: Recognition and Measurement Criteria

CPA: Financial Reporting

AACSB: Analytic

**Exercise 21**

Ed Sullivan Sailing Ltd. sold $ 175,500 of boat parts on credit in September. A total of 30% of the goods were shipped FOB destination and 70% were shipping FOB shipping point. At September 30, $ 25,000 of the goods that were FOB destination, were in transit. During September the company collected $ 100,000 cash from its customers. The company estimates that about 2% of the sales will become uncollectible and that about 8% of the sales will be returned by the customer. How much revenue should the company recognize for the month?

**Solution 21** (10 min.)

Sales 175,500

Deduct goods in transit 25,000

Gross sales 150,500

Less sales returns and allowances ($ 150,500 \* 8%) 12,040

Net sales 138,460

Bloomcode: Application

Difficulty: Medium

Learning Objective: Apply the recognition and measurement criteria of the conceptual framework to financial reporting situations.

Section Reference: Recognition and Measurement Criteria

CPA: Financial Reporting

AACSB: Analytic

**Exercise 22**

In the following transactions, indicate when revenue should be recognized:

1. In September, La Cloche University collects tuition revenue for the term from students. The term runs from September through December.

2. Burns Island Company sells merchandise with terms of 2/10, n/30, FOB destination.

3. The Ottawa Senators sell season tickets to games in Canadian Tire Centre. Fans can purchase the tickets at any time, although the season doesn’t officially begin until September. It runs from September through May.

4. Canada Airline sells you a refundable airline ticket in September for your flight home at Christmas.

5. The University Bookstore has the following return policy for textbook sales: “Textbooks (new and used) may be returned for seven calendar days from the start of classes. After that time, textbooks (new and used) may be returned within 48 hours of purchase.”

**Solution 22** (10 min.)

1. The revenue should be recognized on a time period basis, which means a certain amount of revenue will be earned each month. Revenue is recognized as the service is performed.

2. The revenue for this sale will be recognized when the goods are delivered to the customer.

3. The ticket revenue will be recognized on a game-by-game basis. As the game occurs, the revenue for the ticket sales for that game will be recognized.

4. The revenue will not be recognized until the service is provided which is when the flight occurs in December.

5. If the bookstore has been in business for a long time, then it would be able to accurately predict the textbook return and thus will be able to use a % of sales for a sales return and allowance, and recognize revenue when the books are sold.

Bloomcode: Analysis

Difficulty: Medium

Learning Objective: Apply the recognition and measurement criteria of the conceptual framework to financial reporting situations.

Section Reference: Recognition and Measurement Criteria

CPA: Financial Reporting

AACSB: Analytic

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