

## AICPA

*FAR*

*CPA Financial Accounting and Reporting*

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## Question: 1

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 B represents the general accounting treatment required for these transactions. These treatments are:

- . Cumulative effect approach - Include the cumulative effect of the adjustment resulting from the accounting change or error correction in the 1993 financial statements, and do not restate the 1992 financial statements.
- . Retroactive or retrospective restatement approach - Restate the 1992 financial statements and adjust 1992 beginning retained earnings if the error or change affects a period prior to 1992.
- . Prospective approach - Report 1993 and future financial statements on the new basis but do not restate 1992 financial statements.

Item to Be Answered

Quo changed from LIFO to FIFO to account for its finished goods inventory. List B (Select one)

- A. Cumulative effect approach.
- B. Retroactive or retrospective restatement approach.
- C. Prospective approach.

**Answer: B**

Explanation:

Choice "B" is correct. A change in accounting principle should be shown in the retained earnings statement of the earliest year presented as an adjustment of the beginning balance. All prior year financial statements are recast.

## Question: 2

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

Quo changed from FIFO to average cost to account for its raw materials and work in process inventories. 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.

**Answer: A**

Explanation:

Choice "a" is correct. Change in inventory pricing method from FIFO to average cost is a change in accounting principle.

### Question: 3

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 B represents the general accounting treatment required for these transactions. These treatments are: . Cumulative effect approach - Include the cumulative effect of the adjustment resulting from the accounting change or error correction in the 1993 financial statements, and do not restate the 1992 financial statements.

. Retroactive or retrospective restatement approach - Restate the 1992 financial statements and adjust 1992 beginning retained earnings if the error or change affects a period prior to 1992.

. Prospective approach - Report 1993 and future financial statements on the new basis but do not restate 1992 financial statements.

Item to Be Answered

Quo changed from FIFO to average cost to account for its raw materials and work in process inventories. List B (Select one)

- A. Cumulative effect approach.
- B. Retroactive or retrospective restatement approach.
- C. Prospective approach.

**Answer: B**

Explanation:

Choice "B" is correct. A change in accounting principle should be shown in the retained earnings statement of the earliest year presented as an adjustment of the beginning

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balance. All prior year financial statements are recast.

### 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

Quo sells extended service contracts on its products. Because related services are performed over several years, in 1993 Quo changed from the cash method to the accrual method of recognizing income from these service contracts.

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.

<b>Answer: C</b>
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Explanation:

Choice "c" is correct. Change from the cash method to the accrual method is a correction of an error in previously presented financial statements.

### Question: 5

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 B represents the general accounting treatment required for these transactions. These treatments are:

- . Cumulative effect approach - Include the cumulative effect of the adjustment resulting from the accounting change or error correction in the 1993 financial statements, and do not restate the 1992 financial statements.
- . Retroactive or retrospective restatement approach - Restate the 1992 financial

statements and adjust 1992 beginning retained earnings if the error or change affects a period prior to 1992.

. Prospective approach - Report 1993 and future financial statements on the new basis but do not restate 1992 financial statements. Item to Be Answered

Quo sells extended service contracts on its products. Because related services are performed over several years, in 1993 Quo changed from the cash method to the accrual method of recognizing income from these service contracts.

List B (Select one)

A. Cumulative effect approach.

B. Retroactive or retrospective restatement approach.

C. Prospective approach.

**Answer: B**

Explanation:

Choice "B" is correct. If comparative FS are issued, restate prior year's FS. If comparative FS are not issued, restate prior year-end's retained earnings account by "adjusting" (net of tax) the opening balance of the current retained earnings statement.

Note that when an error is corrected, retroactive restatement is used, and when there is a change in accounting principle, retrospective restatement is done. However, this is only a difference in terminology.

## Question: 6

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.

**Answer: C**

Explanation:

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: 7

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 B represents the general accounting treatment required for these transactions. These treatments are:

- . Cumulative effect approach - Include the cumulative effect of the adjustment resulting from the accounting change or error correction in the 1993 financial statements, and do not restate the 1992 financial statements.
- . Retroactive or retrospective restatement approach - Restate the 1992 financial statements and adjust 1992 beginning retained earnings if the error or change affects a period prior to 1992.
- . Prospective approach - Report 1993 and future financial statements on the new basis but do not restate 1992 financial statements.

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 B (Select one)

- A. Cumulative effect approach.
- B. Retroactive or retrospective restatement approach.
- C. Prospective approach.

**Answer: B**

Explanation:

Choice "B" is correct. If comparative FS are issued, restate prior year's FS. If comparative FS are not issued, restate prior year-end's retained earnings account by "adjusting" (net of tax) the opening balance of the current retained earnings statement.

## Question: 8

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

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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. During 1993, Quo increased its investment in Worth, Inc. from a 10% interest, purchased in 1992, to 30%, and acquired a seat on Worth's board of directors. As a result of its increased investment, Quo changed its method of accounting for investment in Worth, Inc. from the cost method to the equity method.

List A

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

<b>Answer: D</b>
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Explanation:

Choice "d" is correct. A change from the cost method (less than 20% ownership) to the equity method (20% or more ownership or a Board seat or other significant influence) of accounting for investment in an investee is neither an accounting change nor an accounting error. If it is not an accounting change, it cannot be a change in accounting principle or a change in accounting estimate since those two types of changes are both accounting changes.

There is a considerable amount of controversy on this particular answer. Some people think that this change is a change in accounting principle (something certainly changed, but was it the accounting principle?), and others think it is a change in accounting entity (which is not one of the available answers; anyway, did the accounting entity actually change or is it the same entity accounted for differently?). Under SFAS No. 154, a change in accounting principle is treated retrospectively and a change in accounting entity is treated retrospectively.

This kind of change (cost to equity) has never been specifically identified in any accounting literature as either a change in accounting principle or a change in accounting entity. The words "cost method" were never mentioned in APB 20 (other than the full cost method for oil & gas companies, which is an entirely different subject), nor was it mentioned in SFAS No. 154. It was, however, discussed in APB 18 (the pronouncement for the equity method) in Paragraph 19m (bold added): "An investment in common stock of an investee that was previously accounted for on other than the equity method may become qualified for use of the equity method by an increase in the level of ownership described in paragraph 17 (i.e., acquisition of additional voting stock by the investor, acquisition or retirement of voting stock by the investee, or other transactions). When an investment qualifies for use of the equity method, the investor should adopt the equity method of accounting. The investment, results of operations (current and prior periods presented), and retained earnings of the investor should be adjusted retroactively in a

manner consistent with the accounting for a step-by-step acquisition of a subsidiary." What does all this mean? It means that, when there is a change in the percentage of ownership that changes accounting from the cost method to the equity method, the change is treated retroactively (just like changes in accounting entity used to be treated, although they are now treated retrospectively). It does not say that the change is a change in accounting principle or anything else. Nothing in SFAS No.154 changed this treatment. So all this still makes Choice "d" correct. This whole issue might easily be considered to be splitting hairs, at the very least. Some questions on the CPA exam are just that way. Most are not.

## Question: 9

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 B represents the general accounting treatment required for these transactions. These treatments are:

- . Cumulative effect approach - Include the cumulative effect of the adjustment resulting from the accounting change or error correction in the 1993 financial statements, and do not restate the 1992 financial statements.
- . Retroactive or retrospective restatement approach - Restate the 1992 financial statements and adjust 1992 beginning retained earnings if the error or change affects a period prior to 1992.
- . Prospective approach - Report 1993 and future financial statements on the new basis but do not restate 1992 financial statements.

During 1993, Quo increased its investment in Worth, Inc. from a 10% interest, purchased in 1992, to 30%, and acquired a seat on Worth's board of directors. As a result of its increased investment, Quo changed its method of accounting for investment in Worth, Inc. from the cost method to the equity method.

List B

- A. Cumulative effect approach.
- B. Retroactive or retrospective restatement approach.
- C. Prospective approach.

**Answer: B**

Explanation:

Choice "B" is correct. The equity method of accounting is applied retroactively when the investor has acquired 20% ownership. Prior to acquiring the ability to influence the investee, the cost method is proper. The retroactive restatement approach does not mean that this change is the correction of an error (which is now treated retroactively), a change in accounting principle (which is now treated retrospectively), or a change in accounting entity (which is now treated retrospectively). It just means that retroactive restatement is



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the proper treatment.

### Question: 10

According to the FASB conceptual framework, what does the concept of reliability in financial reporting include?

- A. Effectiveness.
- B. Certainty.
- C. Precision.
- D. Neutrality.

<b>Answer: D</b>
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Explanation:









Choice "d" is correct. The concept of reliability in financial reporting includes; neutrality, representational faithfulness and verifiability.

Choices "a", "b", and "c" are incorrect, per the above.

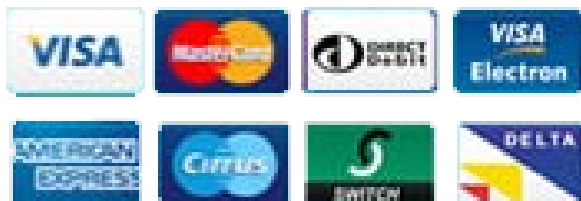
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