
True-False

1. Revenue is recognized at the earliest moment that the critical event and measurability criteria are both satisfied.
2. A sale should **not** be recognized as revenue by the seller at time of sale if payment is made by check.
3. The percentage of completion ratio is determined by dividing costs incurred to date by the contract price.
4. When losses occur on long-term contracts using the completed contract method, they are recognized at the completion of the contract.
5. The installment sales method recognizes revenue and income proportionately as cash is collected.
6. Interest payments are included when computing the recognized gross profit on installment sales.
7. Deferred gross profit on installment sales is generally treated as a deduction from installment sales.
8. The installment sales method of recognizing profit for accounting purposes is acceptable if collection of the sales price is **not** reasonably assured.
9. The account "Billings on Construction in Progress" is shown on the balance sheet as a liability account.
10. Initial franchise fee revenue should be recognized when all material services or conditions relating to the sale have been substantially performed by the franchisor.
11. In franchise arrangements, the franchisee gives the franchisor the exclusive right to sell a product or service in a given locale and use the franchisee's name for a specified period of time.
12. Generally accepted accounting principles leave ample room for managers to manipulate earnings to their satisfaction.
13. "Big bath" restructuring charges are believed to **not** adversely affect stock prices.
14. "Cookie jar reserves" are required under GAAP.
15. The SEC requires that one of four criteria be met to recognize revenue.
16. An arrangement means there is a final understanding between the parties as to the specific nature and terms of the agreed-upon transaction.
17. Nonrefundable upfront fees are recognized as revenue when received.
18. A prior period adjustment results in an adjustment to the company's beginning retained earnings balance.
19. The correction of an error causes previous year financial statements to be retroactively restated for comparative purposes.

20. Errors discovered after the year in which they occur are corrected through footnote disclosure.

Multiple-Choice Questions

Select the best answer from those provided.

21. The earliest moment that the critical event and measurability are both satisfied for revenue recognition is usually
 - a. before the sale.
 - b. after the sale.
 - c. at the time of sale.
 - d. when payment is received.

22. If the critical event and measurability conditions are satisfied, revenue may be recognized before the sale
 - a. as production takes place.
 - b. when the customer pays in advance.
 - c. if the seller legally owns the goods.
 - d. when the customer purchases on credit.

23. If the critical event and measurability conditions are not satisfied, revenue may be recognized after the sale
 - a. when legal ownership passes to the seller.
 - b. when cash is collected.
 - c. as the goods are shipped.
 - d. on the receipt of goods by the customer.

24. All of the following are examples of long-term construction projects except
 - a. military hardware.
 - b. oil tankers.
 - c. bridges.
 - d. residential swimming pool.

25. Under the percentage-of-completion method, the profit to be recognized in any year is based on the ratio of
 - a. incurred contract costs divided by estimated total contract costs.
 - b. incurred contract costs multiplied by estimated total contract costs.
 - c. estimated total contract costs divided by incurred contract costs.
 - d. estimated total contract costs multiplied by incurred contract costs.

Table 3-1

Noah Construction Company is building a large complex for a contract price of \$5,000,000. This is a three-year project estimated to cost \$4,000,000 and the following information is available:

(In \$ thousands)	Year 1	Year 2	Year 3
Costs incurred	\$ 1,000	\$ 1,500	\$ 1,250
Estimated completion costs	\$ 3,000	\$ 1,500	\$ 0
Billings	\$ 750	\$ 1,750	\$ 2,500
Cash collected	\$ 500	\$ 1,500	\$ 3,000

26. Refer to Table 3-1. Using the percentage-of-completion method of revenue recognition, how much income is recognized in Year 2?

- \$ 250,000
- \$ 375,000
- \$ 625,000
- \$ 3,125,000

27. Refer to Table 3-1. Using the percentage-of-completion method of revenue recognition, how much income is recognized in Year 3?

- \$ 375,000
- \$ 625,000
- \$ 1,000,000
- \$ 1,250,000

28. Refer to Table 3-1. Which one of the following entries would be made in Year 1 to record the costs incurred using the percentage-of-completion method of revenue recognition?

a. Inventory: Construction in progress	1,000,000	
Accounts payable, cash, etc.		1,000,000
b. Inventory: Construction in progress	1,000,000	
Income on long-term construction contract		1,000,000
c. Inventory: Construction in progress	1,000,000	
Billings on construction in progress		1,000,000
d. Income on long-term construction contract	1,000,000	
Accounts payable, cash, etc.		1,000,000

29. Refer to Table 3-1. Which one of the following entries would be made in Year 1 to record the income recognized using the percentage-of-completion method of revenue recognition?

a. Inventory: Construction in progress	250,000	
Income on long-term construction contract		250,000
b. Inventory: Construction in progress	375,000	
Billings on construction in progress		375,000
c. Inventory: Construction in progress	625,000	
Billings on construction in progress		625,000
d. Income on long-term construction contract	3,125,000	
Accounts payable, cash, etc.		3,125,000

30. Refer to Table 3-1. Which one of the following entries would be made in Year 2 to record the customer billing using the percentage-of-completion method of revenue recognition?

a. Accounts receivable	1,500,000	
Cash		1,500,000
b. Accounts receivable	1,500,000	
Billings on construction in progress		1,500,000
c. Accounts receivable	1,750,000	
Income on long-term construction contract		1,750,000
d. Accounts receivable	1,750,000	
Billings on construction in progress		1,750,000

31. Refer to Table 3-1. Which one of the following entries would be made in Year 3 to record the completion and acceptance of the project using the completed-contract method of revenue recognition?

a. Construction in progress	5,000,000	
Billings on construction in progress		5,000,000
b. Billings on construction in progress	5,000,000	
Construction in progress		3,750,000
Income on long-term construction contract		1,250,000
c. Construction in progress	3,750,000	
Income on long-term construction contract	1,250,000	
Billings on construction in progress		5,000,000
d. Billings on construction in progress	1,250,000	
Construction in progress		1,250,000

32. When losses occur on long-term contracts using the percentage-of-completion method, they are recognized
- in their entirety as soon as it becomes known that a loss will be suffered.
 - at the completion of the project.
 - proportionately over the contract period using costs incurred as a base.
 - evenly over the contract period.

33. When losses occur on long-term contracts using the completed-contract method, they are recognized
- proportionately over the contract period using costs incurred as a base.
 - evenly over the contract period.
 - in their entirety as soon as it becomes known that a loss will be suffered.
 - at the completion of the project.

Table 3-2

The Sarver Farm has completed the fall harvest with 50,000 bushels of premium wheat. The wheat cost \$75,000 from planting to harvest and the market price of the wheat on the day it is placed in the silo is \$2.50 per bushel. Hauppauge sells 42,000 bushels in Year 1 and holds the remaining 8,000 until Year 2 when it sells for \$3.00 per bushel.

34. Refer to Table 3-2. Using the completed transaction (sales) method, how much net revenue should Sarver recognize in Year 1?
- \$ 42,000
 - \$ 50,000
 - \$ 105,000
 - \$ 125,000
35. Refer to Table 3-2. Using the market price (production) method, how much net revenue should Sarver recognize in Year 1?
- \$ 42,000
 - \$ 50,000
 - \$ 105,000
 - \$ 125,000
36. Refer to Table 3-2. Using the completed transaction (sales) method, how much net revenue should Sarver recognize in Year 2?
- \$ 4,000
 - \$ 12,000
 - \$ 24,000
 - \$ 42,000

37. Refer to Table 3-2. Using the market price (production) method, how much net revenue should Sarver recognize in Year 2?
- \$ 4,000
 - \$ 12,000
 - \$ 24,000
 - \$ 42,000

Table 3-3

Ford Appliance Center records revenue on the installment sales method. The following information is available for the first two years of business.

	Year 1	Year 2
Sales	\$200,000	\$250,000
Cost of goods sold	140,000	162,500
Cash collections:		
Year 1 sales	100,000	80,000
Year 2 sales		130,000

38. Refer to Table 3-3. How much realized gross profit on installment sales will Ford recognize in Year 1?
- \$ 20,000
 - \$ 30,000
 - \$ 60,000
 - \$ 100,000
39. Refer to Table 3-3. How much realized gross profit on installment sales will Ford recognize in Year 2?
- \$ 24,000
 - \$ 45,500
 - \$ 69,500
 - \$ 130,000
40. Refer to Table 3-3. Which one of the following entries properly records the installment sales for Year 2?
- | | | |
|---|---------|---------|
| a. Accounts receivable—Year 1 | 200,000 | |
| Accounts receivable—Year 2 | 250,000 | |
| Realized gross profit on installment sales | | 450,000 |
| b. Realized gross profit on installment sales | 250,000 | |
| Installment sales revenue | | 250,000 |
| c. Installment sales revenue | 250,000 | |
| Realized gross profit on installment sales | | 250,000 |

d. Accounts receivable—Year 2	250,000	
Installment sales revenue		250,000

41. Refer to Table 3-3. Which one of the following entries properly records the cost of installment goods sold for Year 2?

a. Cost of installment goods sold	162,500	
Inventory		162,500
b. Cost of installment goods sold	302,500	
Inventory		302,500
c. Cost of installment goods sold	162,500	
Installment sales revenue		162,500
d. Cost of installment goods sold	302,500	
Installment sales revenue		302,500

42. Refer to Table 3-3. Which one of the following entries properly records the deferral of gross profit on Year 2 installment sales **not** yet collected?

a. Cost of installment goods sold	62,500	
Deferred gross profit—Year 2	87,500	
Installment sales revenue		250,000
b. Cost of installment goods sold	302,500	
Deferred gross profit—Year 1	60,000	
Deferred gross profit—Year 2	87,500	
Installment sales revenue		450,000
c. Deferred gross profit—Year 2	42,000	
Deferred gross profit—		
Adjustment to accounts receivable—Year 2		42,000
d. Deferred gross profit—		
Adjustment to accounts receivable	42,000	
Deferred gross profit—Year 2		42,000

43. Refer to Table 3-3. Which one of the following entries properly records realized gross profit on installment sales of Year 1 in Year 2?

a. Deferred gross profit—Year 1	60,000	
Deferred gross profit—Year 2	87,500	
Realized gross profit on installment sales		147,500
b. Deferred gross profit—Year 1	24,000	
Recognized gross profit		

		on installment sales—Year 1	24,000
c. Installment sales revenue	69,500		
Realized gross profit on installment sales			69,500
d. Installment sales revenue	87,500		
Realized gross profit on installment sales			87,500

44. When applying the installment sales method the accounting system must match collections with the specific sales year to which the cash collections relate in order to apply the correct

- net profit percentage to accounts receivable.
- gross profit percentage to accounts receivable.
- net profit percentage to cash receipts.
- gross profit percentage to cash receipts.

45. Under the installment sales method, interest charged by the sellers is

- immaterial and GAAP allows it to be combined with recognized gross profit.
- recognized out of the last cash collection of the sale.
- recorded separately out of the periodic cash proceeds.
- recognized out of the first cash collection of the sale.

46. Under the cost recovery method of revenue recognition

- income is recognized on a proportionate basis as the cash is received from the sale.
- Income is recognized immediately.
- Income is recognized when the cash received from the sale exceeds the cost of the product sold.
- None of the above.

47. Continuing franchise fees should be recorded by the franchisor

- as revenue when received.
- as revenue in the period they are received and earned.
- in accordance with the franchise agreement.
- as revenue only after the balance of the initial franchise fee has been received.

48. Initial franchise fees should be recorded as revenue by the franchisor

- in accordance with the franchise agreement.
- when cash is received from the franchisee.
- when all material services relating to the sale have been substantially performed.

- d. None of the above.
49. Companies that fail to meet analysts' earnings expectations are
- often rewarded by investors.
 - often penalized by investors.
 - have had no consequences to the companies.
 - are forced into reorganization.
50. Earnings management
- can be used to manipulate earnings.
 - is mandated under the SEC rules for publicly held companies.
 - is a new theory of management.
 - is rarely used.
51. In an effort to "clean up" company balance sheets, managers have often
- taken minimal restructuring write-offs.
 - understated estimated charges for future expenditures.
 - overstated estimated charges for future expenditures.
 - been required to invest their own assets in the company.
52. All of the following are questionable restructuring charges **except** for
- services to be provided in some future period by lawyers and accountants.
 - special bonuses for officers.
 - expenses for retraining and relocating people.
 - costs related to consolidating operations.
53. Conventional wisdom is that
- investors value a company's stock based on sustainable operating earnings.
 - investors focus on one-time special charges and write-offs.
 - "big bath" items adversely affect stock price.
 - restructuring an organization causes bankruptcy.
54. The fair value of in-process R & D is
- difficult to measure but easy to verify.
 - easy to measure but difficult to verify.
 - difficult to measure and verify.
 - easy to measure and verify.
55. Under the purchase method of accounting for combinations
- the seller must allocate a portion of the selling price to the firm's incom-
- plete R & D activities.
56. A series of immaterial errors spread across several accounts
- values assigned by the buyer to R & D projects that have no alternative future use are expensed immediately.
 - must always be corrected.
 - all R & D costs must be capitalized and amortized over future periods.
 - can, in the aggregate, have a material affect on bottom line earnings.
57. Intentional misstatements of estimates
- are highly unusual in financial reporting.
 - do not have any impact on earnings.
 - are unlikely to draw attention from the external auditor if they fall within acceptable ranges.
 - are acceptable under GAAP.
58. The SEC allows recognition of revenue when
- all the criteria are met.
 - 3 out of 4 criteria are met.
 - 2 out of 4 criteria are met.
 - only one criterion has been met.
59. All of the following are criteria for revenue recognition under the SEC **except**
- persuasive evidence of an exchange arrangement exists.
 - delivery has occurred or services have been rendered.
 - collectibility is reasonably assured.
 - the buyer's price to the seller is unfixed.
60. Goods shipped on consignment
- are always recognized as revenue by the seller when received by the customer.
 - may have delayed revenue recognition until unsold products are returned.
 - belong to the customer.
 - are always counted in the customer's inventory.
61. Sales with delayed delivery
- should never be recognized as revenue until the products are delivered to the customer.
 - belong to the customer.

- c. can recognize revenue if the buyer requests in the sales agreement that the transaction be on a "bill and hold" basis.
- d. are a usual way to do business.
62. Goods sold on layaway
- should not be recognized as revenue until the products are delivered to the customer.
 - belong to the customer.
 - must recognize revenue under the installment sales method.
 - are not allowed under GAAP.
63. Revenue from nonrefundable up-front fees
- can never be recognized.
 - must be recognized immediately.
 - are not allowed under GAAP.
 - are usually deemed to be earned as the services are delivered over the full term of the service contract.
64. Internet companies that simply act as agent or broker in a transaction must record sales using the
- gross method.
 - net method.
 - commission method.
 - discount method.

Essay and Computational Questions

65. Gifford Construction Corporation has entered into a long-term fixed contract to build a performing arts center for Philbin University. The fixed price is \$71,500,000. The costs, estimated costs, and billing activity for the three years of the contract are shown below:

	2002	2003	2004
Construction costs incurred to date	20,000,000	45,000,000	70,000,000
Estimated future costs	35,000,000	30,000,000	—
Billings to date	24,700,000	43,758,000	71,500,000
Cash collections to date	20,995,000	41,570,100	71,500,000

Required:

1. Compute the gross profit to be recognized under the percentage-of-completion method on Gifford's income statements for each year under the contract.

2. Compute construction in progress net of billings under the percentage-of-completion method at the end of 2002 and 2003. Be sure to indicate whether the balance is classified as an asset or liability.
3. Compute the gross profit to be recognized under the completed contract method on Gifford's income statements for each year under the contract.
4. Which method is more conservative: the percentage-of-completion method or the completed contract method? Explain.

66. Read the following excerpts from *The Wall Street Journal* and answer the subsequent questions.

Cendant Corp. said that meeting strict new Securities and Exchange Commission requirements for how it records certain sales will cut its 1998 earnings by seven to nine cents a diluted share, more than previously expected.

The marketing and franchising company, moving to clean up three years of accounting fraud, also said it had a net loss of \$217.2 million, or 27 cents a diluted share, last year after reassessing its special charges...

Cendant, based in Parsippany, N.J., had expected some impact from the SEC's insistence that it delay recording some revenue. But, after reviewing Cendant's membership-club businesses, the SEC concluded that because buyers of discount-club memberships can seek refunds any time during the first year, Cendant shouldn't book revenue until after that refund period ends, the company said...

Included in the restated 1997 net loss are a \$26.8 million loss from discontinued businesses that Cendant is trying to sell; a one-time charge of \$229.9 million for CUC accounting problems; a one-time charge of \$283.1 million for the cumulative effect of the SEC accounting change, and a one-time charge of \$504.7 million, or 58 cents a diluted share, for costs related to mergers, including the CUC and HFS Inc. merger that created Cendant.

Required:

- The Cendant article mentions accounting fraud and accounting problems. Explain management incentives for distorting accounting.
- Would the new revenue recognition policy resulting from the SEC investigation be considered conservative or liberal accounting?
- The excerpt mentions "a one-time charge of \$283.1 million for the cumulative effect of the SEC accounting change." Explain how this charge will be shown on the income statement.
- The charge for the SEC accounting change reduces net income and, as a consequence, retained earnings and stockholders' equity. What other balance sheet account(s) is (are) probably affected by the accounting change? In other words, given that an account on the income statement is being debited, what balance sheet account is probably being credited? Ignore income tax effects in

responding to this question.

67. Read the following excerpt from *The Wall Street Journal* and answer the subsequent questions.

Tyco International went from Wall Street darling to whipping boy in dramatic fashion Wednesday in the wake of an analyst's report accusing the fast-growing Bermuda-based conglomerate of creative accounting.

More than \$6 billion was wiped off the market value of Tyco, which has spent \$30 billion in acquisitions during the past three years to become a powerhouse in disposable medical products, electrical components, fire protection and underwater telecommunications. The heavy selling in Tyco stock triggered a trading halt 50 minutes before the New York Stock Exchange close.

The sudden hammering was triggered by a report from Texas money manager David Tice... "Tyco has potentially utilized big bath restructuring charges to help reported results," Tice said in an interview Wednesday. Tyco is planning a conference call with Wall Street analysts this morning.

Required:

1. Explain how "big bath restructuring charges" improve the appearance of a firm.
2. Explain why stock prices fell after the market learned of Tice's report.
3. The Tyco article mentions "creative accounting." Explain management incentives for distorting accounting.

Question 4 is a general question and does not relate to the prior article.

4. Assume that a *Wall Street Journal* article states that a firm overstated its revenue. Explain which balance sheet account(s) was (were) probably manipulated to accomplish the revenue overstatement. Do not discuss retained earnings.

Answers

1. M; True
2. E; False
3. M; False
4. M; False
5. E; True
6. M; False
7. M; False

8. M; True
9. M; False
10. M; True
11. M; False
12. M; True
13. M; True
14. M; False
15. M; False
16. M; True
17. M; False
18. M; True
19. M; True
20. M; False
21. M; (c)
22. M; (a)
23. M; (b)
24. E; (d)
25. M; (a)
26. D; (b)
27. D; (b)
28. M; (a)
29. M; (a)
30. M; (d)
31. M; (b)
32. M; (a)
33. M; (c)
34. M; (a)
35. M; (b)
36. M; (b)
37. M; (a)
38. M; (b)
39. M; (c)
40. M; (d)
41. M; (a)

Contract price less (costs incurred to date plus expected costs)	16,500,000	(3,500,000)	1,500,000
Gross profit earned in year			
Percent completed times expected gross profit less gross profit recognized in prior years	6,000,000	(9,500,000)	5,000,000

2. Net construction in process

	2002	2003
Construction in progress		
Costs to date	20,000,000	45,000,000
Gross profit to date	6,000,000	(3,500,000)
	26,000,000	41,500,000
Billings to date	(24,700,000)	(43,758,000)
<u>Net construction in progress (billings)</u>	<u>1,300,000</u>	<u>(2,258,000)</u>

In 2002, Gifford has a net asset of 1,300,000, whereas in 2003, it has a liability of 2,258,000.

3. Gross profit under completed contract method

	2002	2003	2004
Gross profit	—	(3,500,000)	5,000,000

4. The completed contract method is more conservative because no profits are recognized until the end of the contract, and losses are recognized as soon as they are predicted. Under the percentage-of-completion method, profits are recognized in accounting periods prior to the end of the contract. DM

66. Solution:

1. Management may receive bonuses tied to earnings. In addition, management may be trying to maintain debt covenants or obtain more favorable terms on a new debt issuance. Management may also be trying to improve stock prices by giving the market erroneous information.

2. It would be considered conservative. First, the article says that the new accounting will "delay recording some revenue," which by definition is more conservative than what Cendant had been doing. Second, many businesses allow refunds but still book revenue and then estimate an allowance for returns. The SEC's policy seems more conservative than most cases involving refunds.

3. It will be shown net-of-tax below income from continuing operations and before net income.

4. Accounts receivable and/or unearned revenue. DM

67. Solution:

1. In a "big bath," a firm tries to identify all possible costs that can be viewed as part of a restructuring and expense them at the same time. Analysts often view restructuring charges as transitory events. Consequently, management sometimes tries to shift future operating expenses into current restructuring charges. Also, by taking large restructuring charges, firms are more likely to meet or exceed future net income targets. Finally, restructuring charges provide accruals that can be adjusted in the future to produce income.

2. Investors may be re-evaluating earnings growth. They may also fear the cost of lawsuits or possible tightening of credit if management is found to be dishonest.

3. Management may have bonuses tied to earnings. They may also have stock-based compensation, which is influenced by financial disclosures. It may also be trying to issue debt or stock. In both cases, management tries to make the balance sheet and income statement as favorable as possible.

4. Accounts receivable are most likely overstated because it is often the other side of the entry for revenue recognition. Understatement of Unearned revenue would also overstate revenue. If revenue and accounts receivable have been overstated, then Cost of goods sold has probably been overstated and Inventory has probably been understated. **DL**