

CHAPTER 9

Reporting and Analyzing Long-Lived Assets

ANSWERS TO QUESTIONS

1. For plant assets, the historical cost principle states that plant assets are recorded at cost, which consists of all expenditures necessary to acquire the asset and make it ready for its intended use.

2. In a cash transaction, cost is equal to the cash paid.

In a noncash transaction, cost is equal to the cash equivalent price paid, which is the fair value of the asset given up or the fair value of the asset received, whichever is more clearly determinable.

3. When only the land is to be used, all demolition and removal costs of the building less any proceeds from salvaged materials are necessary expenditures to make the land ready for its intended use. Any costs for clearing, draining, filling, and grading are also part of the cost of the land. And any back taxes are also included in the cost of the land.

When both the land and building are to be used, necessary costs of the building include remodeling expenditures and the cost of replacing or repairing the roofs, floors, wiring, and plumbing.

4. The potential benefits of leasing are (1) reduced risk of obsolescence (an obvious concern to Ronald), (2) little or no required down payment, (3) shared tax advantages, (4) assets and liabilities may not reported on the balance sheet.

5. You should explain to the president that depreciation is a process of allocating the cost of a plant asset to expense over its service (useful) life in a rational and systematic manner. Recognition of depreciation is not intended to result in the accumulation of cash for replacement of the asset.

6. (a) Salvage value is the expected cash value of the asset at the end of its useful life.

(b) Salvage value is used in determining depreciable cost in the straight-line method by subtracting it from the plant asset's cost.

7. (a) Useful life is expressed in years under the straight-line method and in units of activity under the units-of-activity method.

(b) The pattern of periodic depreciation expense over an asset's useful life is constant under the straight-line method and variable under the units-of-activity method.

8. The effects of the three depreciation methods on annual depreciation expense are: Straight-line—constant amount; units-of-activity—varying amounts; declining-balance—decreasing amounts.

9. A revision of depreciation is made in current and future years but not retroactively. The rationale is that continual restatement of prior periods would adversely affect the reader's confidence in the financial statements.

10. Ordinary repairs are made to maintain the operating efficiency and expected productive life of the asset. Capital expenditures are additions and improvements made to increase efficiency, productive capacity, or expected useful life of the asset. Ordinary repairs are recognized as expenses when incurred; capital expenditures are generally debited to the plant asset affected.

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11. In a sale of plant assets, the book value of the asset is compared to the proceeds received from the sale. If the proceeds of the sale exceed the book value of the plant asset, a gain on disposal occurs. If the proceeds of the sale are less than the book value of the plant asset sold, a loss on disposal occurs.
12. The plant asset and related accumulated depreciation should continue to be reported on the balance sheet without further depreciation or adjustment until the asset is retired. Reporting the asset and related accumulated depreciation on the balance sheet informs the reader of the financial statements that the asset is still being used by the company. However, once an asset is fully depreciated, even if it is still being used, no additional depreciation should be taken on this asset. In no situation can the depreciation on the plant asset exceed the cost of the plant asset.
13. Tootsie Roll depreciates its buildings over 20 to 35 years and its machinery and equipment over 5 to 20 years.
14. Depreciation and amortization are both concerned with writing off the cost of an asset to expense over the periods benefited. Depreciation refers to allocating the cost of a plant asset to expense and amortization to allocating the cost of an intangible asset to expense.
15. It is true that successful marketing campaigns often benefit multiple accounting periods in the future, enhancing the company's value, and potentially creating goodwill. However, from an accounting perspective David's proposal is unacceptable. First of all, accounting standards only allow the recording of "purchased goodwill" that results from the purchase of another business. Internally created goodwill is not allowed to be recorded. Second, marketing expenditures are to be treated as expenses of the period in which they are incurred. They can not be capitalized. It is unethical to capitalize costs simply to boost reported income by spreading the cost over multiple periods.
16. The intern is not correct. If an intangible asset has a limited life, the cost of the asset should be amortized over that asset's useful life (the period of time when operations are benefited by use of the asset) or its legal life, whichever is shorter. The cost of intangible assets with indefinite lives should not be amortized.
17. The favorable attributes which could result in goodwill include exceptional management, desirable location, good customer relations, skilled employees, high quality products, fair pricing policies, and harmonious relations with labor unions.
18. Goodwill is the value of many favorable attributes that are intertwined in the business enterprise. Goodwill can be identified only with the business as a whole and, unlike other assets, cannot be sold separately. Goodwill can only be sold if the entire business is sold.
19. Goodwill is recorded only when there is an exchange transaction that involves the purchase of an entire business. Goodwill is the excess of cost over the fair value of the net assets (assets less liabilities) acquired. The recognition of goodwill without an exchange transaction would lead to subjective valuations which would reduce the reliability of financial statements.

Goodwill is not amortized because it has an indefinite life. It remains at its original value as an intangible asset unless it is considered to be impaired. If it is impaired, it is written down.

Questions Chapter 9 (Continued)

20. Research and development costs present several accounting problems. It is sometimes difficult to assign the costs to specific projects, and there are uncertainties in identifying the extent and timing of future benefits. As a result, research and development costs are usually recorded as an expense when incurred.

21. Campbell Soup Company's return on assets is computed as follows:

$$\frac{\text{Net Income}}{\text{Average Total Assets}} = \frac{\$736}{\$6,265} = 11.7\%$$

22. The return on assets is closely monitored by management. It is the product of the profit margin and the asset turnover. At first glance, if this new product line has a lower profit margin, then it will reduce the company's asset turnover. However, it is likely that it will have a higher turnover than the company's more expensive offerings. As a consequence, it is not possible to know what effect the new product line will have on the company's return on assets without knowing the expected effect on the company's asset turnover.

23. (a) Grocery stores usually have a high asset turnover and a low profit margin.

(b) Car dealerships normally have a low asset turnover and a high profit margin.

24. Since Gooden uses the straight-line depreciation method, its depreciation expense will be lower in the early years of an asset's useful life as compared to using an accelerated method. Perron's depreciation expense in the early years of an asset's useful life will be higher as compared to the straight-line method. Gooden's net income will be higher than Perron's in the first few years of the asset's useful life.

25. Yes, the tax regulations of the IRS allow a company to use a different depreciation method on the tax return than is used in preparing financial statements. Garcia Corporation uses an accelerated depreciation method for tax purposes to minimize its income taxes in the early years of the assets' lives.

26. By selecting a higher estimated useful life, Leslie Corp. is spreading the plant assets' cost over a longer period of time. The depreciation expense reported in each period is lower and net income is higher. Camby's choice of a shorter estimated useful life will result in higher depreciation expense reported in each period and lower net income.

27. In the operating activities section of the statement of cash flows, depreciation expense (from plant assets) and amortization expense (from intangible assets) are added back to net income in the determination of net cash provided by operating activities. In the investing section, cash paid to purchase plant assets or intangible assets is shown as a use of cash. If the company sells any of its used plant assets, or if it sells intangibles, it would report the amount of cash received as a source of cash from investing activities.