ANSWERS TO QUESTIONS

1. For plant assets, the cost principle means that cost consists of all expenditures necessary to acquire the asset and make it ready for its intended use.

2. Examples of land improvements include driveways, parking lots, fences, and underground sprinklers.

3. (a) 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.
   (b) 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. 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.

5. (a) Salvage value, also called residual value, is the expected value of the asset at the end of its useful life.
   (b) Salvage value is used in determining depreciation in each of the methods except the declining-balance method.

6. (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 useful life is constant under the straight-line method and variable under the units-of-activity method.

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

8. 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 confidence in the financial statements.

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

10. 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.

11. The plant asset and its accumulated depreciation should continue to be reported on the balance sheet without further depreciation 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 in use. However, once an asset is fully depreciated, even if it is still being used, no additional depreciation should be taken. In no situation can the accumulated depreciation on the plant asset exceed its cost.

12. Natural resources consist of underground deposits of oil, gas, and minerals, and standing timber. These long-lived productive assets have two distinguishing characteristics: they are physically extracted in operations, and they are replaceable only by an act of nature.

13. Depletion is the allocation of the cost of natural resources to expense in a rational and systematic manner over the resource's useful life. It is computed by multiplying the depletion cost per unit by the number of units extracted and sold.

14. The terms depreciation, depletion, and amortization are all concerned with allocating the cost of an asset to expense over the periods benefited. Depreciation refers to allocating the cost of a plant asset to expense, depletion to recognizing the cost of a natural resource as expense, and amortization to allocating the cost of an intangible asset to expense.

15. The intern is not correct. The cost of an intangible asset should be amortized over that asset's useful life (the period of time when operations are benefited by use of the asset). In addition, some intangibles have indefinite lives and therefore are not amortized at all.

16. The favorable attributes which could result in goodwill include exceptional management, desirable location, good customer relations, skilled employees, high-quality products, and harmonious relations with labor unions.

17. 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. And, if goodwill appears on the balance sheet, it means the company has purchased another company for more than the fair market value of its net assets.

18. Goodwill is recorded only when there is a transaction that involves the purchase of an entire business. Goodwill is the excess of cost over the fair market 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.

19. 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, the FASB requires that research and development costs be recorded as an expense when incurred.

20. McDonald's asset turnover ratio is computed as follows:

$$\frac{\text{Net sales}}{\text{Average total assets}} = \frac{\$20.5 \text{ billion}}{\$28.9 \text{ billion}} = .71 \text{ times}$$

21. Since Resco 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. Yapan's depreciation expense in the early years of an asset's useful life will be higher as compared to the straight-line method. Resco's net income will be higher than Yapan's in the first few years of the asset's useful life. And, the reverse will be true late in an asset's useful life.

22. 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. Lopez Corporation uses an accelerated depreciation method for tax purposes to minimize its income taxes and thereby the cash outflow for taxes.

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

24. Expensing these costs will make current period income lower but future period income higher because there will be no additional depreciation expense in future periods. If the costs are ordinary repairs, they should be expensed.

25. PepsiCo's 2009 note 4 shows the following classifications and amounts for its property, plant, and equipment (in millions):

Land and improvements	$ 1,208
Buildings and improvements	5,080
Machinery & equipment, including fleet and software	17,183
Construction in progress	1,441
Accumulated depreciation	(12,241)
	$ 12,671

26. When assets are exchanged, the gain or loss on disposal is computed as the difference between the book value and the fair market value of the asset given up at the time of exchange.

27. Yes, Tatum should recognize a gain equal to the difference between the fair market value of the old machine and its book value. If the fair market value of the old machine is less than its book value, Tatum should recognize a loss equal to the difference between the two amounts.

