

# Non-current (Long-term) Liabilities

Test ID: 7694161

## Question #1 of 71

Question ID: 414649

The difference between the fair value of a defined benefit pension plan's assets and its estimated benefit obligation is recognized:

- ✓ **A) on the balance sheet as a net pension asset or liability.**
- X B) as an actuarial adjustment in other comprehensive income.
- X C) on the income statement as pension expense.

### Explanation

A net pension asset or net pension liability defined benefit plan is the difference between the fair value of the plan's assets and the estimated benefit obligation. A plan with a net pension asset is said to be overfunded, and a plan with a net pension liability is said to be underfunded.

## Question #2 of 71

Question ID: 414648

An employer offers a defined benefit pension plan and a defined contribution pension plan. The employer's balance sheet is *most likely* to present an asset or liability related to:

- X **A) the defined contribution plan.**
- ✓ **B) the defined benefit plan.**
- X C) both of these pension plans.

### Explanation

Only a defined benefit plan has a funded status that would appear on the balance sheet as an asset or liability. Employer payments into a defined contribution plan are recognized as expenses in the period incurred.

## Question #3 of 71

Question ID: 485783

A company issues 5% semiannual coupon, 3-year, \$1,000 par value bonds on January 1, 20X0, when the market interest rate is 13.3%. The sale proceeds are \$800. Under the effective interest rate method, what amount of interest expense per \$1,000 par value will the company record for the year ending December 31, 20X1?

- ✓ **A) \$116.29.**
- X B) \$106.40.
- X C) \$66.29.

### Explanation

Based on a semiannual interest rate of 6.65% (13.30% / 2):

<u>Period</u>	<u>Interest Expense</u>	<u>Coupon Payment</u>	<u>Discount Amortization</u>	<u>Bond Carrying Value</u>
0	0.00			\$800.00
1	53.20	25.00	28.20	828.20

2	55.08	25.00	30.08	858.28
3	<b>57.08</b>	25.00	32.08	890.36
4	<b>59.21</b>	25.00	34.21	\$924.57

Interest expense for Year 2 is  $\$57.08 + \$59.21 = \$116.29$ .

#### Question #4 of 71

Question ID: 414626

Under an operating lease (versus a finance lease) which of the following is higher for the lessee?

- ☒ **A) Cash flow from financing.**
- ☐ **B) Cash flow from operations.**
- ☐ **C) Assets.**

##### Explanation

The lessee's cash flows from financing will be higher for an operating lease because the payments made for an operating lease are operating cash outflows, not financing cash outflows. The payments made under a finance lease are split between interest paid and principal. The latter is charged to cash flow from financing.

#### Question #5 of 71

Question ID: 414634

Under a finance lease (versus an operating lease) which of the lessee's financial ratios will be higher?

- ☐ **A) Return on equity.**
- ☒ **B) Debt/equity.**
- ☐ **C) Asset turnover.**

##### Explanation

The debt/equity ratio will be higher because the finance lease requires the creation of a long-term liability on the balance sheet.

#### Question #6 of 71

Question ID: 414616

Which of the following provisions would *least likely* be included in the bond covenants? The borrower must:

- ☐ **A) not increase dividends to common shareholders while the bonds are outstanding.**
- ☒ **B) maintain a debt-to-equity ratio of no less than 2:1.**
- ☐ **C) maintain insurance on the collateral that secures the bond.**

##### Explanation

A lender wants to prohibit the borrower from becoming more leveraged. This can be done by requiring a leverage ratio that is no more than a specified amount. Reducing leverage would be beneficial to the lender by lowering risk.

#### Question #7 of 71

Question ID: 414609

For a firm financed with common stock and long-term fixed-rate debt, an analyst should *most appropriately* adjust which of the following items for a change in market interest rates?

- ☐ A) Interest expense.
- ☒ B) Debt-to-equity ratio.
- ☐ C) Cash flow from financing.

#### Explanation

For the purpose of analysis, the value of debt should be adjusted for a change in interest rates. This will change the debt-to-equity ratio. Because changes in interest rates will change the market value of the debt, but not the coupon, interest expense will be unchanged. (However, if a firm has variable-rate debt, interest expense will change when interest rates change, but the market value of the variable-rate debt will not change significantly.)

---

### Question #8 of 71

Question ID: 414604

A zero coupon bond, compared to a bond issued at par, will result in higher:

- ☐ A) interest expense.
- ☐ B) cash flows from financing (CFF).
- ☒ C) cash flows from operations (CFO).

#### Explanation

The zero-coupon bond will have higher cash flows from operations, as the cash interest expense in this case is zero and no cash is paid until maturity. Candidates should remember that any bond issued at a discount will have more cash flow from operations and less cash flow from financing.

---

### Question #9 of 71

Question ID: 414606

A firm issues a \$5 million zero coupon bond with a maturity of four years when market rates are 8%. Assuming semiannual compounding periods, the total interest on this bond is:

- ☐ A) \$1,200,000.
- ☐ B) \$1,600,000.
- ☒ C) \$1,346,549.

#### Explanation

The interest paid on the bond will be the difference between the future value of the bond of \$5,000,000 and the proceeds of the bond when it was originally issued.

First find the present value of the bond found by  $N = 8$ ;  $FV = 5,000,000$ ;  $I = 4$ ;  $PMT = 0$ ;  $CPT \rightarrow PV = -3,653,451$ . This is the amount of money the bond generated when it was originally issued.

Then take the difference between the \$5,000,000 future price and the \$3,653,451 from the proceeds = \$1,346,549 which is the interest paid on the bond.

---

### Question #10 of 71

Question ID: 414607

When bonds are issued at a premium:

- ✓ **A) earnings of the firm increase over the life of the bond as the bond premium is amortized.**
- X **B) earnings of the firm decrease over the life of the bond as the bond premium is amortized.**
- X **C) coupon interest paid decreases each period as bond premium is amortized.**

#### Explanation

As bond premium is amortized, interest expense will be successively lower each period, thus increasing earnings over the life of the bond.

---

### Question #11 of 71

Question ID: 414643

Penguin Company is planning to lease a \$5 million machine to produce goods for eventual sale. Penguin is able to structure the lease so as to classify it as either an operating or a finance lease. Advantages to Penguin of classifying this lease as an operating lease are *least likely* to include that:

- X **A) the lease is not reported as debt on Penguin's balance sheet, so leverage ratios are not increased.**
- X **B) depreciation is not recorded.**
- ✓ **C) no disclosures of payments due under the lease are required.**

#### Explanation

Cash payments due under an operating lease must be disclosed in the notes to the financial statements for each of the following five years and in aggregate. Operating leases are simpler to account for and the often adverse ratio implications of offsetting increases in assets and liabilities are avoided.

---

### Question #12 of 71

Question ID: 414610

On December 31, 20X3 Okay Company issued 10,000 \$1000 face value 10-year, 9% bonds to yield 7%. The bonds pay interest semi-annually. On its financial statements (prepared under U.S. GAAP) for the year ended December 31, 20X4, the effect of this bond on Okay's cash flow from operations is:

- ✓ **A) -\$900,000.**
- X **B) -\$755,735.**
- X **C) -\$700,000.**

#### Explanation

The coupon payment is a cash outflow from operations.  $(\$10,000,000 \times 0.09) = \$900,000$ .

---

### Question #13 of 71

Question ID: 414629

Which of the following is *least likely* one of the criteria under U.S. GAAP for classifying a lease as a finance lease? The:

- ✓ **A) lessor retains ownership of the property at the end of the lease term.**
- X **B) lease contains a bargain purchase option.**
- X **C) term of the lease is 75% or more of the estimated economic life of the leased property.**

Explanation

If the lease transfers ownership of the property to the lessee at the end of the lease term, the lessee will classify the lease as a finance lease.

---

**Question #14 of 71**

Question ID: 414631

In a direct-financing lease, the implicit rate is such that the present value of the minimum lease payments:

- ✓ **A) equals the cost of the leased asset.**
- X **B) is lower than the cost of the leased asset.**
- X **C) equals the sale price of the leased asset.**

Explanation

In a direct-financing lease, the implicit rate is such that the present value of the MLPs equals the cost of the leased asset. Thus, at lease inception the total assets do not change and no gain is recognized.

---

**Question #15 of 71**

Question ID: 414639

If a lessee enters into a finance lease rather than an operating lease, it can expect to have a:

- ✓ **A) higher debt-to-equity ratio.**
- X **B) lower debt-to-equity ratio.**
- X **C) higher return on assets.**

Explanation

Leasing the asset with an operating lease avoids recognition of the debt on the lessee's balance sheet. Having fewer assets and liabilities on the balance sheet than would exist if the assets were purchased increases profitability ratios (e.g., return on assets) and decreases leverage ratios (e.g., debt-to-equity ratio). In the case of a finance lease, the assets are reported on the balance sheet and are depreciated.

---

**Question #16 of 71**

Question ID: 414590

Over time, the reported amount of the annual interest expense on a long-term bond issued at a discount will:

- X **A) remain constant.**
- X **B) decrease.**
- ✓ **C) increase.**

Explanation

A portion of the discount must be amortized to the interest expense each year. The amortized amount is debited to interest expense and credited to debt. So debt goes up. The interest expense is debt times the effective interest rate. Thus, interest expense will increase over time.

---

### Question #17 of 71

Question ID: 434313

Compared to issuing a bond at par value, and holding all else equal, when a company issues a bond at a premium, its effect on the debt/equity ratio will be:

- ☐ A) no effect on the ratio over the life of the bond.
- ☐ B) an increasing trend in the ratio over the life of the bond.
- ☒ C) a decreasing trend in the ratio over the life of the bond.

#### Explanation

Net book value of debt decreases over the life of the bond because the premium amortizes. Stockholders' equity increases over the life of the bond because interest expense decreases each period. This results in a decreasing trend in the debt/equity ratio over the life of the bond, compared to the trend if a bond had been issued at par value.

---

### Question #18 of 71

Question ID: 414599

Assume a city issues a \$5 million bond to build a new arena. The bond pays 8 percent semiannual interest and will mature in 10 years. Current interest rates are 9%. Interest expense in the second semiannual period is *closest to*:

- ☐ A) \$106,550.
- ☒ B) \$210,830.
- ☐ C) \$80,000.

#### Explanation

*Step 1: Compute the present value of the bond: Since the current interest rate is above the coupon rate the bond will be issued at a discount.*

$$FV = \$5,000,000; N = 20; PMT = (0.04)(\$5 \text{ million}) = \$200,000; I/Y = 4.5; CPT \rightarrow PV = -\$4,674,802$$

*Step 2: Compute the interest expense at the end of the first period.*

$$= (0.045)(\$4,674,802) = \$210,366$$

*Step 3: Compute the interest expense at the end of the second period.*

$$= (\text{new balance sheet liability})(\text{current interest rate})$$

$$= \$4,674,802 + \$210,366 = \$4,885,168 \text{ new balance sheet liability}$$

$$(0.045)(\$4,885,168) = \$219,833$$

---

### Question #19 of 71

Question ID: 414600

A bond is issued with the following data:

- \$10 million face value.
- 9% coupon rate.
- 8% market rate.
- 3-year bond with semiannual payments.

Assuming market rates do not change, what will the bond's market value be one year from now and what is the total interest expense over the life of the bond?

	<u>Value in 1-Year</u>	<u>Total Interest Expense</u>
X A)	11,099,495	2,437,893
X B)	10,181,495	2,962,107
✓ C)	10,181,495	2,437,893

#### Explanation

To determine the bond's market value one year from now:  $FV = 10,000,000$ ;  $N = 4$ ;  $I = 4$ ;  $PMT = 450,000$ ;  $CPT \rightarrow PV = \$10,181,495$ .

To determine the total interest expense:

1.  $FV = 10,000,000$ ;  $N = 6$ ;  $I = 4$ ;  $PMT = 450,000$ ;  $CPT \rightarrow PV = \$10,262,107$ . This is the price the purchaser of the bond will pay to the issuer of the bond. From the issuer's point of view this is the amount the issuer will receive from the bondholder.
2. Total interest expense over the life of the bond is equal to the difference between the amount paid by the issuer and the amount received from the bondholder.

$$[(6)(450,000) + 10,000,000] - 10,262,107 = 2,437,893$$

### Question #20 of 71

Question ID: 414619

As compared to purchasing an asset, which of the following is least likely an incentive to structure a transaction as a finance lease?

- X A) Risk of obsolescence is reduced because the asset is returned to the lessor.
- ✓ B) The lease enhances the balance sheet by the lease liability.
- X C) The terms of the lease can be negotiated to better meet each party's needs.

#### Explanation

Operating leases enhance the balance sheet by excluding the lease liability. With a finance lease, an asset and a liability are reported on the balance sheet just like a purchase made with debt.

### Question #21 of 71

Question ID: 414621

A firm is *most likely* to lease an asset rather than purchasing it if the asset:

- X A) has a high salvage value relative to its cost.
- X B) is costly to move from place to place.
- ✓ C) may be made obsolete by rapid technological advances.

### Explanation

One of the motivations for leasing assets instead of purchasing them is that a leased asset that has been made obsolete by new technology can be returned to the lessor at the end of the lease. Neither of the other choices is a motivation for leasing assets instead of purchasing them.

---

## Question #22 of 71

Question ID: 414594

Which of the following statements regarding zero-coupon bonds is *most* accurate?

- ☐ A) Interest expense is a combination of operating and financing cash flows.
- ☐ B) The interest expense in each period is found by applying the discount rate to the book value of debt at the end of the period.
- ☒ C) A company should initially record zero-coupon bonds at their discounted present value.

### Explanation

The liability initially recorded for a zero-coupon bond is equal to the proceeds received, which is the present value of the principal repayment discounted at the company's normal borrowing rate. Interest expense is found by applying the discount rate to the book value of debt at the *beginning* of the period, and there is no cash outflow from operations for a zero coupon bond.

---

## Question #23 of 71

Question ID: 414613

A company redeems \$10,000,000 of bonds that it issued at par value for 101% of par or \$10,100,000. In its statement of cash flows, the company will report this transaction as a:

- ☒ A) 10,100,000 CFF outflow.
- ☐ B) \$10,100,000 CFO outflow.
- ☐ C) \$10,000,000 CFF outflow and \$100,000 CFO outflow.

### Explanation

Cash paid to redeem a bond is classified as a cash flow from financing activities.

---

## Question #24 of 71

Question ID: 414612

A firm can recognize a gain or loss on derecognition of a bond the firm has issued:

- ☐ A) either before maturity or at maturity.
- ☐ B) at maturity, but not before maturity.
- ☒ C) before maturity, but not at maturity.

### Explanation

If a firm redeems a bond before maturity for a price that is different from the carrying value of the bond liability, the firm will recognize the difference as a gain or a loss. At maturity, the carrying value of the bond liability is equal to the face value of the bond, therefore the firm does not experience a gain or loss by repaying the face value.

---



### Question #25 of 71

Question ID: 414645

Classifying a lease as an operating lease for a lessee, as opposed to a finance lease, will result in:

<u>Current Ratio</u>	<u>Debt/Equity Ratio</u>	<u>Asset Turnover Ratio</u>
X <b>A) Higher</b>	<b>Lower</b>	<b>Lower</b>
X <b>B) Lower</b>	Lower	Higher
✓ <b>C) Higher</b>	Lower	Higher

#### Explanation

For a lessee using operating leases, the current ratio will be higher, the debt/equity ratio will be lower, and the asset turnover will be higher than they would be with finance leases. With operating leases, assets and liabilities are lower.

### Question #26 of 71

Question ID: 434310

A company issues an annual-pay bond with a face value of \$135,662, maturity of 4 years, and 7% coupon, while market interest rates for its bonds are 8%. What is the unamortized discount at the end of the first year?

- ✓ **A) \$3,495.**
- X **B) \$1,209.**
- X **C) \$538.**

#### Explanation

Face value of bonds = \$135,662.

Proceeds from bond sale:  $I/Y = 8.00\%$ ;  $N = 4$ ;  $PMT = \$135,662 \times 0.07 = \$9,496.34$ ;  $FV = \$135,662$ ;  $CPT PV = \$131,169$

Unamortized discount at issuance =  $\$135,662 - \$131,169 = \$4,493$ .

First year interest expense =  $\$131,169 \times 0.08 = \$10,494$ .

Coupon payment =  $\$135,662 \times 0.07 = \$9,496$ .

Change in discount =  $\$10,494 - \$9,496 = \$998$ .

Discount at the end of first year =  $\$4,493 - \$998 = \$3,495$ .

### Question #27 of 71

Question ID: 414638

Which of the following statements about leases is *least* accurate?

- X **A) All else equal, when a lease is capitalized the lessee's income will rise over the term of the lease.**
- X **B) In the first years of a finance lease, the lessee's debt to equity ratio is greater than it would have been if the firm had used an operating lease.**

- ✓ **C)** In the first years of a finance lease, the lessee's current ratio is greater than it would have been had the firm used an operating lease.

Explanation

From the lessee's perspective, if a lease is considered to be a *finance lease* instead of an operating lease, then the lessee's *current liabilities will be greater* until the lease has expired. This will result in a *lower current ratio* (larger denominator).

In the early years, the *capitalized lease expense* (interest plus depreciation) is greater than in the later years because interest expense decreases over time. Less expenses = more income.

In the first years of a finance lease the lessee's debt to equity ratio will be greater than if the firm had used an operating lease because in the case of the finance lease, the numerator is comprised of (debt + lease), while the numerator in the case of the operating lease is (debt) only. In addition, the greater capitalized lease expense flows through to decrease shareholder's equity (the denominator).

---

**Question #28 of 71**

Question ID: 414603

For a given par value, which of the following debt issues will have the highest cash flows from financing?

- X **A) Zero-coupon bond.**  
✓ **B) Bonds issued at premium.**  
X **C) Bonds issued at discount.**

Explanation

The bonds issued at premium will have the highest cash flows from financing.

---

**Question #29 of 71**

Question ID: 414611

At the beginning of 20X3, Creston Company issues \$10 million face amount of 6% coupon bonds when the market rate of interest is 7%. The bonds mature in four years and pay interest annually. Assuming the effective interest rate method, what is the bond liability Creston will report at the end of 20X3?

- X **A) \$9,661,279**  
✓ **B) \$9,737,568**  
X **C) \$10,346,511**

Explanation

Under the effective interest rate method, the bond liability is equal to the present value of the remaining cash flows discounted at the market rate of interest at the issue date. At the end of this year, there are 3 annual payments of \$600,000 and one payment of \$10,000,000 remaining. Using your financial calculator, the present value is \$9,737,568 (N = 3, I = 7, PMT = 600,000, FV = 10,000,000, Solve for PV).

---

**Question #30 of 71**

Question ID: 485784

Crawford Corp. and Vernon Corp. are lessors who have leased assets on identical terms to firms with similar credit ratings.

Crawford reports its lease as a sales-type lease and Vernon reports its lease as a direct financing lease. It is *most likely* that:

- ☐ A) Crawford retains the leased asset on its balance sheet.
- ☒ B) both firms report under U.S. GAAP.
- ☐ C) Vernon reports under IFRS.

#### Explanation

For a lessor, under U.S. GAAP, a capital lease may be reported as either a sales-type or direct financing lease. This distinction is not made for a financing (capital) lease under IFRS.

---

### Question #31 of 71

Question ID: 467388

A bond is issued at the end of the year 20X0 with an 8% semiannual coupon rate, 5 years to maturity, and a par value of \$1,000. The bond's yield at issuance is 10%. Using the effective interest method, if the yield has decreased to 9% at the end of the year 20X1, the balance sheet liability for the bond is *closest to*:

- ☐ A) 967.
- ☒ B) 935.
- ☐ C) 923.

#### Explanation

Using the effective interest method, the value of the liability is calculated using the bond's yield at issuance. At the end of 20x1 the bond will have 8 semiannual periods remaining until maturity.

$N = 8$ ;  $I/Y = 10 / 2 = 5$ ;  $PMT = 8 / 2 \times 1,000 = 40$ ;  $FV = 1,000$ ;  $CPT PV = -935.37$ .

---

### Question #32 of 71

Question ID: 414596

A company issued a bond with a face value of \$67,831, maturity of 4 years, and 7% annual-pay coupon, while the market interest rates are 8%.

What is the unamortized discount when the bonds are issued?

- ☒ A) \$2,246.65.
- ☐ B) \$1,748.07.
- ☐ C) \$498.58.

#### Explanation

Coupon payment =  $(\$67,831)(0.07) = \$4,748.17$ .

Present value of bond:  $FV = \$67,831$ ,  $N = 4$ ,  $I = 8$ ,  $PMT = \$4,748.17$ ,  $CPT PV = \$65,584.35$ .

Discount =  $\$67,831 - \$65,584.35 = \$2,246.65$ .

---

### Question #33 of 71

Question ID: 414589

Proceeds from issuing a bond are recorded on the statement of cash flows as an inflow from:

- ☐ A) investing (CFI).
- ☒ B) financing (CFF).
- ☐ C) operations (CFO).

Explanation

Cash from financing (CFF) is increased by the amount of the proceeds.

---

**Question #34 of 71**

Question ID: 414624

A lessee *most likely* has an incentive to structure a lease as an operating lease rather than a finance lease when it:

- ☐ A) is very profitable.
- ☐ B) does not have debt covenants.
- ☒ C) has a high debt-to-equity ratio.

Explanation

A firm with a high debt-to-equity ratio is more likely to use an operating lease instead of a capital lease. Use of an operating lease avoids the recognition of debt on the lessee's balance sheet and will not increase the debt-to-equity ratio.

---

**Question #35 of 71**

Question ID: 414637

For a given lease payment and term, which of the following is *least accurate* regarding the effects of the classification of the lease as a finance lease as compared to an operating lease?

- ☐ A) The lessee's asset turnover will be lower for a finance lease.
- ☐ B) The lessee's debt-to-equity ratio will be higher for a finance lease.
- ☒ C) The lessee's current ratio will be higher for a finance lease.

Explanation

The lessee's current ratio will be lower because the current portion of the finance lease increases current liabilities, hence reducing the current ratio.

---

**Question #36 of 71**

Question ID: 414602

Nomad Company issued \$1,000,000 face value 2-year zero coupon bonds on December 31, 20X2 to yield 8% interest. Bond proceeds were \$857,339. In 20X3 Nomad recorded interest expense of \$68,587. In 20X4 Nomad recorded interest expense of \$74,074 and paid out \$1,000,000 to redeem the bonds. Based on these transactions only, Nomad's Statement of Cash Flows would show cash flow from operations (CFO) of:

- ☒ A) zero in all years.
- ☐ B) -\$68,587 in 20X3 and -\$74,074 in 20X4.
- ☐ C) -\$142,661 in 20X4.

Explanation

All of the cash flows for zero coupon bonds are included in cash flow from financing activities and none in cash flow from operations.

---

### Question #37 of 71

Question ID: 414627

Which of the following statements that classify a lease as a finance lease under U.S. GAAP is *least* accurate?

- ☐ A) A bargain purchase option exists.
- ☐ B) Title is transferred at the end of the lease period.
- ☒ C) The present value of the lease payments is at least 80% of the fair market value of the asset.

#### Explanation

For a lease to be classified as a finance (capital) lease the present value of the lease payments must be at least 90% of the fair market value of the asset.

---

### Question #38 of 71

Question ID: 414640

Which of the following statements regarding the effect of a finance lease on the lessee's statement of cash flows is *least* accurate?

- ☐ A) The interest expense portion of the lease payments reduces cash flow from operations.
- ☒ B) The rental expense serves to reduce the cash flow for financing because it is an investment expense.
- ☐ C) The change in the finance lease liability on the balance sheet is a cash flow from financing.

#### Explanation

In finance leases, there is only interest expense and principal repayment. Rental expense is only charged when the lease is an operating lease.

---

### Question #39 of 71

Question ID: 434311

An firm is issuing a bond with the following characteristics:

- Face value = \$10.0 million
- Annual coupon = 5.6%
- Market yield at issuance = 6.5%
- 5 year maturity

Ignoring flotation costs, at issuance the bond will increase:

- ☒ A) assets by \$9.626 million.
- ☐ B) cash flow from investing by \$9.626 million.
- ☐ C) liabilities by \$10.0 million.

#### Explanation

Proceeds raised are the present value of the bond:  $FV = 10,000,000$ ;  $PMT = 560,000$ ;  $I/Y = 6.5$ ;  $N = 5$ ;  $CPT PV = 9,625,989$ . At issuance, the firm will receive cash flow from *financing* of \$9.626 million. Assets (cash) and liabilities (long-term debt) will increase by this amount.

---

### Question #40 of 71

Question ID: 414597

Interest expense is reported on the income statement as a function of:

- ☐ A) the unamortized bond discount.
- ☒ B) the market rate.
- ☐ C) the coupon payment.

#### Explanation

Interest expense is always equal to the book value of the bond at the beginning of the period multiplied by the market rate at issuance.

---

### Question #41 of 71

Question ID: 414588

Assuming all else equal, if the coupon rate offered on a bond is less than the corresponding market rate of interest, the bond will be issued at:

- ☒ A) a discount.
- ☐ B) par.
- ☐ C) a premium.

#### Explanation

If the coupon rate is less than the market rate, the bond must be sold at a discount so the effective rate on the bond equals the market rate.

---

### Question #42 of 71

Question ID: 414642

Which of the following statements regarding a direct financing lease is *least* accurate?

- ☒ A) Interest revenue on the lessor's income statement equals the implicit interest rate times the lease payment.
- ☐ B) The principal portion of the lease payment is a cash inflow from investing on the lessor's cash flow statement.
- ☐ C) The lessor recognizes no gross profit at the inception of the lease.

#### Explanation

Interest revenues are calculated by multiplying the implicit interest rate by net receivables at the beginning of the period.

---

### Question #43 of 71

Question ID: 414623

Compared to a finance lease, an operating lease is *most likely* to be favored when:

- ☐ **A) at the end of the lease, the lessee may be better able to sell the asset than the lessor.**
- ☒ **B) the lessee has bond covenants relating to financial policies.**
- ☐ **C) management compensation is not based on returns on invested capital.**

Explanation

If the lessee has bond covenants (e.g., debt-to-equity ratio) relating to its financial policies that it must follow, it is best to have an operating lease due to the fact that the operating lease will keep the asset off of the balance sheet resulting in less liabilities.

---

**Question #44 of 71**

Question ID: 414628

Which of the following statements about the impact of leases on the financial statements of the lessee is *least* accurate?

- ☒ **A) Cash flow from investing is higher for a finance lease than an operating lease.**
- ☐ **B) A finance lease results in higher liabilities compared to an operating lease.**
- ☐ **C) Net income is lower in the early years of a finance lease than an operating lease.**

Explanation

Cash flow from investing is *not* affected by a lease being either a finance or an operating lease. Finance leases reduce cash flow from operations by only the portion of the lease payment attributed to interest expense. Cash flow from financing is reduced by the rest of the finance lease payment which is the principal part of the payment.

---

**Question #45 of 71**

Question ID: 414593

When the market rate is greater than the coupon rate, the bond is called a:

- ☐ **A) par bond.**
- ☒ **B) discount bond.**
- ☐ **C) premium bond.**

Explanation

When the market rate is greater than the coupon rate, the bond will sell at a discount as investors will only buy the bond at a price which is less than fair value due to the coupon being lower than the market rate.

---

**Question #46 of 71**

Question ID: 414591

At the date of issuance the market interest rate was above the coupon rate. Bonds of this nature would sell for:

- ☐ **A) par.**
- ☐ **B) premium.**
- ☒ **C) discount.**

Explanation

When the contract rate on a bond is lower than the market rate, a bond will sell for a discount.

---

### Question #47 of 71

Question ID: 414614

Ivo Company has a \$10 million face value bond issue outstanding. These bonds include a call option that permits Ivo to redeem the bonds at any time for 101% of par. These bonds were issued at a premium and have a carrying value of \$10,200,000. If Ivo calls the bonds, its income statement will reflect:

- ☐ A) a loss on redemption.
- ☒ B) a gain on redemption.
- ☐ C) neither a gain nor a loss on redemption.

#### Explanation

The firm can call the bonds for 101% of \$10 million, or \$10,100,000. Redeeming bonds for less than the carrying value of the bond liability results in a gain.

---

### Question #48 of 71

Question ID: 414633

Compared to an operating lease, a lessee using a finance lease is *least likely* to have:

- ☒ A) higher cash flow from financing during the lease period.
- ☐ B) lower net income in the earlier years of the lease.
- ☐ C) a lower current ratio.

#### Explanation

Since a portion of the lease payment is treated as repayment of principal under a finance lease, cash flow from financing will be lower.

---

### Question #49 of 71

Question ID: 414615

Larry Purcell, an entry-level fixed income analyst at Knowlton & Smeades LLC, was discussing debt covenants with his supervisor, Andy Holzman. During the meeting Purcell made the following statements regarding bond covenants:

Statement 1: If a firm violates any of its debt covenants, the company will immediately go into bankruptcy and the creditors of the firm will take over the liquidation of its assets.

Statement 2: Debt covenants are important in evaluating a firm's credit risk and to better understand how the restrictions of the covenants can affect the firm's growth prospects and choice of accounting policies.

With respect to these statements:

- ☐ A) both are incorrect.
- ☒ B) only one is correct.
- ☐ C) both are correct.

#### Explanation

Lenders and other creditors use debt covenants in their lending agreements to restrict the activities of the debtor that could adversely impact the creditors' position. If any bond covenant is violated, the firm is in technical default on its debt. The creditors



can demand payment of the debt, however, the terms are generally renegotiated. As such, the company does not automatically enter into bankruptcy and have its assets liquidated by the creditors.

---

### Question #50 of 71

Question ID: 414647

The present value of benefits earned during the current period by participants in a defined benefit pension plan is *best* described as the plan's:

- ✓ **A) service cost.**
- X **B) net pension liability.**
- X **C) past service cost.**

#### Explanation

Service cost refers to the benefits earned in the current period by a defined benefit plan's participants. Past service costs are benefits awarded retroactively when a plan is initiated or changed. Net pension liability or net pension asset is the difference between the fair value of a defined benefit plan's assets and the firm's estimated obligation to pay benefits.

---

### Question #51 of 71

Question ID: 414650

A firm is more solvent if it has:

- X **A) low leverage and coverage ratios.**
- X **B) high leverage and coverage ratios.**
- ✓ **C) low leverage ratios and high coverage ratios.**

#### Explanation

Low leverage ratios suggest the firm has relatively little debt compared to its equity and assets. High coverage ratios suggest the firm generates enough earnings to meet its interest payments.

---

### Question #52 of 71

Question ID: 414592

A firm issues a \$5 million zero coupon bond with a maturity of four years when market rates are 8%. Assume semi-annual compounding.

What is the firm's initial liability and the value of the liability in six months?

- |             | <u>Initial Liability</u> | <u>Liability in 6 months</u> |
|-------------|--------------------------|------------------------------|
| X <b>A)</b> | <b>\$5,000,000</b>       | <b>\$5,000,000</b>           |
| ✓ <b>B)</b> | <b>\$3,653,451</b>       | <b>\$3,799,589</b>           |
| X <b>C)</b> | <b>\$3,675,149</b>       | <b>\$3,675,149</b>           |

#### Explanation

The initial liability is:  $N = 8$ ,  $I/Y = 4\%$ ,  $PMT = 0$ ,  $FV = \$5,000,000$ , Compute  $PV = -\$3,653,451$ .

The value of the liability 6 months is:  $[\$3,653,451 + \{0.04(\$3,653,451)\}] = \$3,799,589$

---

### Question #53 of 71

Question ID: 434312

A company issues an annual-pay bond with the following characteristics:

Face value	\$67,831
Maturity	4 years
Coupon	7%
Market interest rates	8%

What is the unamortized discount at the end of the first year?

- ☐ A) \$1,209.
- ☐ B) \$538.
- ☒ C) \$1,750.

#### Explanation

Face value of bonds = \$67,831

Proceeds from bond sale:  $I/Y = 8$ ;  $N = 4$ ;  $PMT = \$67,831 \times 0.07 = \$4,748.17$ ;  $FV = \$67,831$ ;  $CPT PV = \$65,582$

Unamortized discount at issuance =  $\$67,831 - \$65,582 = \$2,249$ .

First year interest expense =  $\$65,582 \times 0.08 = \$5,247$

Coupon payment =  $\$67,831 \times 0.07 = \$4,748$

Change in discount =  $\$5,247 - \$4,748 = \$499$

Unamortized discount at end of first year =  $\$2,249 - \$499 = \$1,750$ .

---

### Question #54 of 71

Question ID: 414598

On December 31, 2004, Newberg, Inc. issued 5,000 \$1,000 face value seven percent bonds to yield six percent. The bonds pay interest semi-annually and are due December 31, 2011. On its December 31, 2005, income statement, Newberg should report interest expense of:

- ☐ A) \$300,000.
- ☒ B) \$316,448.
- ☐ C) \$350,000.

#### Explanation

Newberg, upon issuance of the bonds, recorded bonds payable of  $N = 2 \times 7 = 14$ ,  $PMT = \$175,000$ ,  $I/Y = 6/2 = 3$ ,  $FV = \$5,000,000$ ,  $CPT PV = \$5,282,402$ . Interest expense June 30, 2005, was  $\$5,282,402 \times (0.06 / 2) = \$158,472$ . The coupon payment was \$175,000, reducing bonds payable to  $\$5,282,402 - (\$175,000 - \$158,472) = \$5,265,874$ . Interest expense December 31, 2005, was  $\$5,265,874 \times (0.06 / 2) = \$157,976$ . Total interest expense in 2005 was  $\$158,472 + \$157,976 = \$316,448$ .

---

### Question #55 of 71

Question ID: 414608

Which of the following statements for a bond issued with a coupon rate above the market rate of interest is *least* accurate?

- ✓ **A) The value of the bond will be amortized toward zero over the life of the bond.**
- X **B) The associated interest expense will be lower than that implied by the coupon rate.**
- X **C) The bond will be shown on the balance sheet at the premium value.**

Explanation

The value of the bond's premium will be amortized toward zero over the life of the bond, not the value of the bond.

---

**Question #56 of 71**

Question ID: 414644

Which of the following statements regarding finance and operating leases is *least* accurate?

- X **A) During the life of an operating lease, the rent expense equals the lease payment.**
- ✓ **B) For financial reporting of finance and operating leases, no entry is required on the lessee's balance sheet at the inception of the lease.**
- X **C) Asset turnover is higher for the lessee with an operating lease than a finance lease.**

Explanation

If the lease is an operating lease there is no entry made on the balance sheet for the lessee. For finance leases, the leased asset and liability are recognized on the balance sheet by the amount equal to the present value of the minimum lease payments using as the discount rate the lower of the lessor's implicit rate or the lessee's incremental borrowing rate.

---

**Question #57 of 71**

Question ID: 414622

The lessee has an incentive to classify a lease as an operating lease, rather than as a finance lease, because an operating lease:

- X **A) has no risk involved because the lessor assumes all risk.**
- X **B) has payments that are less than a capital lease's payments.**
- ✓ **C) does not appear on the balance sheet.**

Explanation

Having less assets and liabilities on the balance sheet than would exist if the asset were purchased increases profitability ratios (e.g., return on assets) and decreases leverage ratios (e.g., the debt to equity ratio).

---

**Question #58 of 71**

Question ID: 414625

An analyst compares two companies that are identical except that Company X uses finance leases and Company Y uses operating leases. The analyst would expect Company X's debt-to-equity ratio, relative to Company Y's, to be:

- ✓ **A) higher.**
- X **B) lower.**
- X **C) the same.**

#### Explanation

Lease capitalization adds both current and noncurrent liabilities to debt, resulting in a corresponding increase in the debt-to-equity and other leverage ratios. Thus, Company X's (Debt + Lease)/Equity is greater than Company Y's Debt/Equity.

---

### Question #59 of 71

Question ID: 414605

Which of the following statements is *least* accurate? When a bond is issued at a discount:

- ☐ **A) the interest expense will be equal to the coupon payment plus the amortization of the discount.**
- ☐ **B) the interest expense will increase over time.**
- ☒ **C) cash flows from financing will be increased by the par value of the bond issue.**

#### Explanation

Upon issuance, cash flow from financing will be increased by the amount of the proceeds.

---

### Question #60 of 71

Question ID: 414651

Other things equal, and ignoring issuance costs, a firm that raises cash by issuing a new bond is *most likely* to:

- ☒ **A) increase its leverage ratios and decrease its coverage ratios.**
- ☐ **B) increase its leverage ratios and increase its coverage ratios.**
- ☐ **C) decrease its leverage ratios and increase its coverage ratios.**

#### Explanation

Leverage ratios will increase because debt increases while equity remains unchanged, and (assuming equity is positive) debt increases proportionally by more than assets. Coverage ratios decrease because interest payments increase while EBIT is unchanged.

---

### Question #61 of 71

Question ID: 414646

Which of the following is *least likely* disclosed in the financial statement footnotes of a lessee?

- ☐ **A) The lease payments to be paid in each of the next five years.**
- ☐ **B) A general description of the leasing arrangement.**
- ☒ **C) The lease interest rate.**

#### Explanation

The interest rate used by the lessee is not a required disclosure.

---

### Question #62 of 71

Question ID: 414641

The Mader Corporation leases an asset for five years with lease payments of \$10,000 per year. If Mader classifies the lease as a

finance lease, which financial statements are affected at the end of the first year?

- ☐ A) **Income statement only.**
- ☐ B) Income statement and balance sheet only.
- ☒ C) Statement of cash flows, income statement, and balance sheet.

Explanation

The classification of a lease as a finance lease creates an asset, a debt obligation, financing cash flows (amortization of the loan), and operating cash flows (interest expense).

---

**Question #63 of 71**

Question ID: 456302

Samson Therapeutics records all leases as operating leases. Compared to recording capital leases, this results in lower:

- ☐ A) **inventory.**
- ☐ B) expenses.
- ☒ C) leverage.

Explanation

Finance (capital) leases are recorded on the balance sheet, and by recording all leases as operating leases, the company can reduce its leverage. Lease accounting has no effect on inventory. "Expenses" is not the best answer as operating leases will result in higher expenses in the later years relative to the finance (capital) lease.

---

**Question #64 of 71**

Question ID: 414632

For a finance lease, the amount recorded initially by the lessee as a liability will *most likely*:

- ☐ A) **be less than the fair value of the leased asset.**
- ☒ B) equal the present value of the minimum lease payments at the beginning of the lease.
- ☐ C) equal the total of the minimum lease payments.

Explanation

With a finance lease, both an asset and liability are reported on the lessee's balance sheet, with lease payments divided between interest and principal components. The future payments on principal and interest must be discounted to present value at the beginning of the lease.

---

**Question #65 of 71**

Question ID: 414635

On the lessee's cash flow statement, the principal portion of a finance lease payment is a:

- ☒ A) **financing cash flow.**
- ☐ B) investing cash flow.
- ☐ C) operating cash flow.

Explanation

The principal portion of a finance lease payment is a financing cash outflow for the lessee. The interest portion is an operating cash outflow.

---

### Question #66 of 71

Question ID: 414630

According to U.S. GAAP, which of the following would *least likely* require a lessee to capitalize a lease?

- ☒ **A) The lessee has an option to purchase the asset for its fair market value at the end of the lease.**
- ☐ **B) The present value of the minimum lease payments is 90% or more of the fair value of the leased asset.**
- ☐ **C) The lease term is 75% or more of the estimated life of the leased asset.**

#### Explanation

Under U.S. GAAP, a lease must be capitalized if it contains a bargain purchase option, not just a purchase option.

---

### Question #67 of 71

Question ID: 414636

If a lease is treated as a finance lease, as compared to being treated as an operating lease, the effect on the lessee's current ratio and the debt/equity ratio will be an:

- |  | <u>Current Ratio</u> | <u>Debt/Equity Ratio</u> |
|--|----------------------|--------------------------|
| <input checked="" type="checkbox"/> <b>A) Decrease</b> |                      | <b>Increase</b>          |
| <input type="checkbox"/> <b>B) Increase</b>            |                      | Decrease                 |
| <input type="checkbox"/> <b>C) Increase</b>            |                      | Increase                 |

#### Explanation

With finance leases the lessee's assets, current liabilities, and long-term liabilities will be greater than if the lease was an operating lease. With the debt to equity ratio, the liability is in the numerator, which results in an increase in the ratio. With the current ratio, current liabilities are increased and are in the denominator which results in a decrease in the ratio.

---

### Question #68 of 71

Question ID: 414620

Compared to a finance lease, an operating lease results in which of the following on the lessee's balance sheet?

- ☒ **A) Lower liabilities.**
- ☐ **B) Higher assets.**
- ☐ **C) Higher liabilities.**

#### Explanation

An operating lease results in an lower liabilities and lower assets compared to a finance lease. The lessee does not record an asset or liability on the balance sheet, but must disclose information about operating lease obligations in the financial statement

notes. Lease payments are recognized as rental expense on the income statement.

---

### Question #69 of 71

Question ID: 414595

A \$1,000 bond is issued with an 8% semiannual coupon rate and 5 years to maturity when market interest rates are 10%. What is the initial liability?

- ✓ **A) 923.**
- X **B) 1023.**
- X **C) 855.**

#### Explanation

FV = 1000; PMT = 80/2; N = 5 × 2; I/Y = 10/2; solve for PV = 923.

---

### Question #70 of 71

Question ID: 414617

In analyzing disclosures related to the financing liabilities of a company, which of the following disclosures would be *least* helpful to the analyst?

- X **A) Filings with the Securities and Exchange Commission (SEC) that disclose all outstanding securities and their features.**
- ✓ **B) The present value of the future bond payments discounted at the coupon rate of the bonds.**
- X **C) The interest expense for the period as provided on the income statement or in a footnote.**

#### Explanation

When analyzing disclosures related to financing liabilities, analysts would review the balance sheet and find the present value of the promised future liability payments. These payments would then be discounted at the rate in effect at issuance (i.e., the yield to maturity), not the coupon rate of the bonds.

---

### Question #71 of 71

Question ID: 414618

Which of the following is *least likely* to be disclosed in the financial statements of a bond issuer?

- X **A) Collateral pledged as security in the event of default.**
- ✓ **B) The market rate of interest on the balance sheet date.**
- X **C) The amount of debt that matures in each of the next five years.**

#### Explanation

The market rate on the balance sheet date is not typically disclosed. The amount of principal scheduled to be repaid over the next five years and collateral pledged (if any) are generally included in the footnotes to the financial statements.