

**Module 10 – Financial Statement Analysis & Valuation, 4<sup>th</sup> Edition by Easton, McAnally, Sommers & Zhang**

**Practice Quiz**

1. **Continental** discloses the following in the footnotes to its 10-K report relating to its leasing activities.

Year ending December 31 (\$ millions)	Capital Leases	Aircraft Operating Leases
2006 .....	\$ 39	\$ 1,003
2007 .....	40	966
2008 .....	46	955
2009 .....	16	910
2010 .....	16	924
Later years .....	457	6,310
Total minimum lease payments .....	614	<u>\$11,068</u>
Less: amount representing interest .....	341	
Present value of capital leases .....	273	
Less: current maturities of capital leases .....	22	
Long-term capital leases .....	<u>\$251</u>	

Operating leases are not reflected on-balance-sheet. In our analysis of a company, we often desire to capitalize these operating leases, that is, add the present value of the future operating lease payments to both the reported assets and liabilities. Compute the present value of Continental's operating lease payments assuming a 7% discount rate (the approximate implicit rate on the capitalized leases).

- \$11,068 million
  - \$8,752 million
  - \$7,464 million
  - \$5,170 million
2. **American Express** discloses the following pension footnote in its 10-K report.

(Millions)	2005
Service cost .....	\$104
Interest cost .....	117
Expected return on plan assets .....	(141)
Other .....	32
Net periodic pension benefit cost .....	<u>\$112</u>

How much pension expense does American Express report in its 2005 income statement?

- \$104 million
- \$221 million
- \$80 million
- \$112 million

3. **YUM! Brands, Inc.**, discloses the following pension footnote in its 10-K report.

Pension Benefits (\$ millions)	2005	2004
Benefit obligation at beginning of year. . . . .	\$700	\$629
Service cost . . . . .	33	32
Interest cost . . . . .	43	39
Plan amendments. . . . .	—	1
Curtailment gain . . . . .	(2)	(2)
Settlement loss . . . . .	1	—
Benefits and expenses paid . . . . .	(33)	(26)
Actuarial (gain) loss. . . . .	73	27
Benefit obligation end of year . . . . .	<u>\$815</u>	<u>\$700</u>

The fair market value of YUM!'s plan assets is \$610 million as of 2005. What is the funded status of the plan, and how will this be reflected on YUM!'s balance sheet?

- Underfunded, \$205 million liability
  - Underfunded, \$205 million asset
  - Underfunded, not reflected on the balance sheet
  - Underfunded, \$815 million liability
4. **Fortune Brands, Inc.**, reports the following footnote relating to its leased facilities in its 2005 10-K report.

Future minimum rental payments under noncancelable operating leases as of December 31, 2005 are as follows:

(In millions)	
2006 . . . . .	\$ 45.6
2007 . . . . .	33.5
2008 . . . . .	26.9
2009 . . . . .	20.2
2010 . . . . .	15.7
Remainder . . . . .	<u>37.3</u>
Total minimum rental payments . . . . .	<u>\$179.2</u>

Compute the present value of these operating leases using a discount rate of 7%.

- \$140.7 million
- \$179.2 million
- \$127.3 million
- \$154.9 million

5. **Verizon Communications, Inc.**, provides the following footnote relating to its leasing activities in its 10-K report.

The aggregate minimum rental commitments under noncancelable leases for the periods shown at December 31, 2005, are as follows:

Years (dollars in millions)	Capital Leases	Operating Leases
2006 .....	\$ 37	\$1,184
2007 .....	28	791
2008 .....	21	652
2009 .....	13	504
2010 .....	12	316
Thereafter .....	55	1,050
Total minimum rental commitments .....	166	\$4,497
Less interest and executory costs .....	(54)	
Present value of minimum lease payments .....	112	
Less current installments .....	(17)	
Long-term obligation at December 31, 2005 .....	\$ 95	

Assuming that this is the only available information relating to its leasing activities, what amount does Verizon report on its balance sheet for its total lease obligations?

- a. \$95 million
- b. \$112 million
- c. \$166 million
- d. \$4,452 million

6. **Ford Motor Company** reports the following pension footnote in its 10-K report.

(\$ millions)	Pension Benefits	
	U.S. Plans 2005	Non-U.S. Plans 2005
<b>Change in Benefit Obligation</b>		
Benefit obligation at January 1 . . . . .	\$43,077	\$29,452
Service cost . . . . .	734	630
Interest cost . . . . .	2,398	1,408
Amendments . . . . .	—	218
Separation programs . . . . .	179	422
Plan participant contributions . . . . .	41	146
Benefits paid . . . . .	(2,856)	(1,355)
Foreign exchange translation . . . . .	—	(2,936)
Divestiture . . . . .	(400)	(163)
Actuarial (gain) loss . . . . .	722	2,878
Benefit obligation at December 31 . . . . .	<u>\$43,895</u>	<u>\$30,700</u>
<b>Change in Plan Assets</b>		
Fair value of plan assets at January 1 . . . . .	\$39,628	\$20,595
Actual return on plan assets . . . . .	3,922	3,239
Company contributions . . . . .	1,432	1,355
Plan participant contributions . . . . .	41	150
Benefits paid . . . . .	(2,856)	(1,355)
Foreign exchange translation . . . . .	—	(1,924)
Divestiture . . . . .	(309)	(95)
Other . . . . .	(1)	(38)
Fair value of plan assets at December 31 . . . . .	<u>\$41,857</u>	<u>\$21,927</u>

What is the total amount paid to retirees during fiscal 2005 for its U.S. and non-U.S. plans?

- a. \$1,364 million
- b. \$187 million
- c. \$2,787 million
- d. \$4,211 million

7. **Xerox** reports the following pension footnote as part of its 2005 10-K report.

(in millions)	Pension Benefits		Other Benefits	
	2005	2004	2005	2004
<b>Change in Benefit Obligation</b>				
Benefit obligation, January 1 . . . . .	\$10,028	\$8,971	\$1,662	\$1,579
Service cost . . . . .	234	222	19	22
Interest cost . . . . .	581	660	90	89
Plan participants' contributions . . . . .	11	14	15	18
Plan amendments . . . . .	30	232	44	—
Actuarial loss (gain) . . . . .	527	272	(54)	70
Currency exchange rate changes . . . . .	(486)	356	4	6
Curtailments . . . . .	(5)	(2)	—	—
Special termination benefits . . . . .	—	2	—	—
Benefits paid/settlements . . . . .	(618)	(699)	(127)	(122)
Benefit obligation, December 31 . . . . .	<u>\$10,302</u>	<u>\$10,028</u>	<u>\$1,653</u>	<u>\$1,662</u>
<b>Change in Plan Assets</b>				
Fair value of plan assets, January 1 . . . . .	\$ 8,110	\$ 7,301	\$ —	\$ —
Actual return on plan assets . . . . .	933	772	—	—
Employer contribution . . . . .	388	409	112	104
Plan participants' contributions . . . . .	11	14	15	18
Currency exchange rate changes . . . . .	(418)	311	—	—
Transfers/divestitures . . . . .	38	2	—	—
Benefits paid/settlements . . . . .	(618)	(699)	(127)	(122)
Fair value of plan assets, December 31 . . . . .	<u>\$ 8,444</u>	<u>\$ 8,110</u>	<u>\$ —</u>	<u>\$ —</u>

(in millions)	Pension Benefits			Other Benefits		
	2005	2004	2003	2005	2004	2003
<b>Components of Net Periodic Benefit Cost</b>						
<b>Defined benefit plans</b>						
Service cost . . . . .	\$234	\$222	\$197	\$ 20	\$ 22	\$ 26
Interest cost . . . . .	581	660	934	90	89	91
Expected return on plan assets . . . . .	(622)	(678)	(940)	—	—	—
Recognized net actuarial loss . . . . .	98	104	53	31	24	13
Amortization of prior service cost . . . . .	(3)	(1)	—	(24)	(24)	(18)
Recognized net transition (asset) obligation . . . . .	1	(1)	—	—	—	—
Recognized curtailment/settlement loss (gain) . . . . .	54	44	120	—	—	(4)
Net periodic benefit cost . . . . .	<u>343</u>	<u>350</u>	<u>364</u>	<u>117</u>	<u>111</u>	<u>108</u>
Special termination benefits . . . . .	—	2	—	—	—	—
Defined contribution plans . . . . .	71	69	62	—	—	—
Total . . . . .	<u>\$414</u>	<u>\$421</u>	<u>\$426</u>	<u>\$117</u>	<u>\$111</u>	<u>\$108</u>

What is the actual return on pension and health care plan investments in 2005? (*In millions*)

- Pension: \$527      Healthcare: (\$54)
- Pension: \$933      Healthcare: \$ 0
- Pension: (\$622)      Healthcare: \$ 0
- Pension: \$98      Healthcare: \$31

8. **Verizon** reports the following pension and health care benefits footnote as part of its 10-K report.

Obligations At December 31 (dollars in millions)	Pension		Health Care and Life	
	2005	2004	2005	2004
<b>Change in Benefit Obligation</b>				
Beginning of year . . . . .	\$37,395	\$40,968	\$27,077	\$24,581
Service cost . . . . .	721	712	373	282
Interest cost . . . . .	2,070	2,289	1,519	1,479
Plan amendments . . . . .	181	(65)	59	248
Actuarial loss, net . . . . .	390	2,467	520	2,017
Benefits paid . . . . .	(2,977)	(2,884)	(1,706)	(1,532)
Termination benefits . . . . .	11	4	1	2
Settlements . . . . .	(35)	(6,105)	—	—
Acquisitions and divestitures, net . . . . .	(194)	—	(34)	—
Other . . . . .	(1)	9	—	—
End of year . . . . .	<u>\$37,561</u>	<u>\$37,395</u>	<u>\$27,809</u>	<u>\$27,077</u>
<b>Change in Plan Assets</b>				
Beginning of year . . . . .	\$39,106	\$42,776	\$ 4,549	\$ 4,467
Actual return on plan assets . . . . .	4,246	4,874	348	471
Company contributions . . . . .	852	443	1,085	1,143
Benefits paid . . . . .	(2,977)	(2,884)	(1,706)	(1,532)
Settlements . . . . .	(35)	(6,105)	—	—
Acquisitions and divestitures, net . . . . .	(202)	2	—	—
End of year . . . . .	<u>\$40,990</u>	<u>\$39,106</u>	<u>\$ 4,276</u>	<u>\$ 4,549</u>

Net Periodic Cost Years Ended December 31 (dollars in millions)	Pension			Health Care and Life		
	2005	2004	2003	2005	2004	2003
Service cost . . . . .	\$ 721	\$ 712	\$ 785	\$ 373	\$ 282	\$ 176
Interest cost . . . . .	2,070	2,289	2,436	1,519	1,479	1,203
Expected return on plan assets . . . . .	(3,348)	(3,709)	(4,150)	(353)	(414)	(430)
Amortization of transition asset . . . . .	—	(4)	(41)	2	2	2
Amortization of prior service cost . . . . .	45	60	23	285	234	(9)
Actuarial loss (gain), net . . . . .	146	57	(337)	278	187	130
Net periodic benefit (income) cost . . . . .	<u>\$ (366)</u>	<u>\$ (595)</u>	<u>\$ (1,284)</u>	<u>\$2,104</u>	<u>\$1,770</u>	<u>\$1,072</u>

What does Verizon's income statement report for both its pension and health care plans in 2005? (*In millions*)

- |                            |                             |
|----------------------------|-----------------------------|
| a. Pension: \$852 expense  | Healthcare: \$1,085 expense |
| b. Pension: \$721 expense  | Healthcare: \$373 expense   |
| c. Pension: \$366 income   | Healthcare: \$2,104 expense |
| d. Pension: \$3,348 income | Healthcare: \$353 income    |

9. The **Abercrombie & Fitch** 10-K report contains the following footnote relating to its leasing activities. This is the only information it discloses relating to its leasing activity.

At January 28, 2006, the Company was committed to non-cancelable leases with remaining terms of one to 15 years. A summary of operating lease commitments under non-cancelable leases follows (thousands):

2006 .....	\$187,674
2007 .....	\$187,397
2008 .....	\$178,595
2009 .....	\$169,856
2010 .....	\$155,670
Thereafter .....	\$538,635

Assuming that its operating leases relate to real estate, and that A&F depreciated such assets on a straight-line basis with no salvage value and useful life of 8 years, estimate the effect on the company's 2006 income before tax of capitalizing these operating leases. Use a 7% discount rate.

- a. Reduce income before taxes by \$10,585,000
  - b. Increase income before taxes by \$187,674,000
  - c. Reduce income before taxes by \$187,674,000
  - d. Reduce income before taxes by \$198,259,000
10. Which of the following is *not* a component of net pension expense?
- a. Interest cost
  - b. Expected return on plan assets
  - c. Benefits paid to retirees
  - d. Amortization of prior service cost