Financial & Managerial Accounting for Decision Makers, 3rd Edition by Dyckman, Hanlon, Magee, Pfeiffer, Hartgraves, and Morse

Chapter 10—Reporting and Analyzing Leases, Pensions, and Income Taxes

Solutions to Practice Quiz

1. International Corporation reported the following items in the 2016 pension footnote (in millions).

Service cost......................................	$506
Amortization of prior service cost........	145
Interest cost.......................................	490
Expected return on plan assets..........	770
Actuarial gain.....................................	19

Based on this information what is the total net periodic pension benefit cost?

a. $ 352
b. $1,930
c. $ 390
d. $ 62

Answer: a
Rationale: The total net periodic pension benefit cost during the period as follows: Service cost + Interest cost - Expected return on plan assets + Amortization of PSC – Actuarial gain: $506 + $490 – $770 + 145 – 19 = $352

2. Which of the following is *not* considered when estimating the annual pension expense?

a. Compensation levels and estimated rates of pay increases
b. Employee turnover rates
c. Expected rate of returns to be earned on pension plan assets.
d. The current financial condition of the company

Answer: d
Rationale: Compensation levels, turnover and expected rates of return are all factors that are considered when establishing the annual pension expense.

Use the following information to answer Questions 3-5.

Morgan Company began operations in 2015. The company reported $58,000 of depreciation expense on its income statement in 2015 and $32,000 in 2016. On its tax returns, Morgan deducted $84,000 for depreciation in 2015 and $94,000 in 2016. The 2016 tax return shows a tax obligation (liability) of $38,400 based on a 40% tax rate.

3. What is the temporary difference between the book value of depreciable assets and the tax basis of these assets at the end of 2015?

a. $ 4,000
b. $48,000
c. $26,000
d. $38,000

Answer: c
Rationale: $84,000 – 58,000 = $26,000

4. What is the temporary difference between the book value of depreciable assets and the tax basis of these assets at the end of 2016?

a. $22,000
b. $52,000
c. $38,400
d. $88,000

Answer: d
Rationale: ($84,000 + $94,000) – ($58,000 + $32,000) = $88,000.

5. What is the deferred tax liability for 2016?

a. $ 6,000
b. $10,000
c. $22,000
d. $35,200

Answer: d
Rationale: $88,000 x 40% = $35,200

6. During 2016, Thomas Company reported the following unconditional purchase obligations in its footnotes:

Year ending December 31, 2016	(in thousands $)
Less than one year	87.6
1-3 years	79.2
3-5 years	4.5
5-7 years	0.5

If Thomas' total assets equal $540,000 and its total stockholders' equity equals $340,000, how would its debt-to-equity ratio change if it reported the unconditional purchase obligations in the balance sheet? (Ignore discounting.)

a. It would increase by 0.32
b. It would increase by 0.50
c. It would decrease by 0.51
d. It would decrease by 0.32

Answer: b
Rationale:
Total liabilities = $540,000 – 340,000 = $200,000
Current debt-to-equity ratio: $200,000 / $340,000 = 0.59
Total Unconditional Purchase Obligations = 87.6 + 79.2 + 4.5 + 0.5 = $171,800
Debt-to-equity ratio (with off-balance-sheet obligations added) =
($200,000 + $171,800) / $340,000 = 1.09
1.09 – 0.59 = 0.50

7. Lawson Company leases a machine under a capital lease. The asset is recorded at $225,000 and has an economic life of 8 years. The lease term is 5 years. The asset is expected to have a market value of $75,000 at the end of 5 years and a market value of $45,000 at the end of 8 years. The lease term provides for a transfer of ownership to the Lawson at the end of the lease.

Based on this information, what amount should Lawson record for depreciation expense in the first year of the lease (assuming straight-line depreciation is used)?

a. $45,000
b. $30,000
c. $28,125
d. $22,500

Answer: d
Rationale: ($225,000 – $45,000) / 8 = $22,500

8. Which of the following lease-related items would be recorded by a company who leases a machine if the lease is to be accounted for as an operating lease?

a. Lease liability
b. Interest expense
c. Depreciation
d. Rent expense

Answer: d
Rationale: A lessee accounts for an operating lease by debiting Rent Expense and crediting Cash.

9. On January 1, 2016, Andrews Corporation signed a ten-year capital lease for machinery. The lease called for Andrews to make annual payments of $100,000 at the end of each year for ten years. The machine has an economic life of 15 years and title for the machine would pass to Andrews at the end of the lease. The lease payments were determined to have a present value of $671,008.

If the lease has an effective interest rate of 8%, how much interest expense should Andrews record for 2016?

a. $80,000
b. $ 8,000
c. $53,681
d. $32,899

Answer: c
Rationale: $671,008 x 8% = $53,681

10. The following information is given for two leases entered into by Hamilton Company:

<u>Lease 1:</u>

- The present value of the lease payments is 75.5% of the asset's fair market value.
- No transfer of ownership

<u>Lease 2:</u>

- Lease term is equal to 90% of the economic life
- No bargain purchase option

Based on this information, what kind of leases are these?

	Lease 1	**Lease 2**
a.	Operating	Capital
b.	Operating	Operating
c.	Capital	Capital
d.	Capital	Operating

Answer: a

Rationale: Lease 1 does not meet any of the four criteria and is an operating lease. Lease 2 is a capital lease because the lease is at least 75% of the economic life of the asset.