

Solutions to Practice Quiz

Chapter 9 – Debt Financing: Bonds, Notes, and Leases

Multiple Choice

Identify the answer that BEST completes the statement or answers the question.

1. Pfizer issued 20-year bonds with a maturity value of \$200 million. Which of the following statements is *true* if the bonds were issued at a premium?
 - a. The yield rate of interest exceeded the coupon rate
 - b. The cash rate of interest exceeded the coupon rate
 - c. The yield rate of interest was less than the coupon rate
 - d. The yield rate of interest was greater than the rate on equivalent risk-rated bonds

Answer: c

2. The Claremont Company issued \$60,000 of 6% bonds on January 1 at a discount of \$4,214. Interest expense reported during the year totaled \$3,905, while amortization amounted to \$305.

How much is the book value of the bonds on December 31?

- a. \$55,786
- b. \$55,481
- c. \$56,091
- d. \$63,909

Answer: c

Rationale: $(\$60,000 - \$4,214 + \$305)$

3. Smith & Sons issued \$900,000 of 8%, 10-year bonds at par on July 1. The bonds pay interest semiannually.

How much cash did the company receive upon issuance?

- a. \$898,600
- b. \$828,000
- c. \$900,000
- d. More information is needed to calculate

Answer: c

4. On January 1, the Pomona Company issued \$1,000,000 of 4%, 5-year bonds when the market rate of interest was 6%. The bonds pay interest semiannually on June 30 and December 31.

How much are the proceeds that the company will receive from the bond issue? Use the time value of money tables to solve.

- a. \$1,000,000
- b. \$ 914,600
- c. \$1,014,600
- d. \$ 944,344

Answer: b

Rationale: $(\$1,000,000 \times 0.744) + (\$20,000 \times 8.530)$

5. On June 30, Keck Corporation leased equipment and treated the lease agreement as an operating lease when in fact the lease should have been accounted for as a capital lease.

What effects will this error have on Keck's liabilities and net income for the year ending December 31?

- a. Liabilities overstated; net income understated
- b. Liabilities overstated; net income overstated
- c. Liabilities understated; net income overstated
- d. Liabilities understated; net income understated

Answer: c

6. The following information relates to an equipment lease with an inception date of January 1:

- Fair value of equipment at lease inception, \$150,000
- Lease term, 5 years
- Economic life of property, 6 years
- Implicit interest rate, 8%
- Annual lease payment due on December 31, \$33,000

The equipment reverts back to the lessor at the end of the lease term.

How much is recorded as the lease liability on the lease inception date? Use the time value of money tables to solve.

- a. \$150,000
- b. \$131,769
- c. \$165,000
- d. \$152,559

Answer: b

Rationale: $(\$33,000 \times 3.993)$

7. Pomona Enterprises issued \$100,000 of 5-year, zero-coupon notes on January 1 when the market yield was 3% per period. The bond agreement stated that compounding was semiannual. The issue price of the notes was \$65,220.

How much interest will the company report on its income statement during the first year?

- a. \$3,600
- b. \$2,756
- c. \$3,111
- d. \$3,972

Answer: d

Rationale:

$$\begin{array}{rcl} (\$65,220 \times 3\%) & = & \$1,956.60 \\ + (\$65,220 + \$1,956.60) \times 3\% & = & \underline{2,015.30} \\ & & \$3,971.90 \end{array}$$

8. On April 1, Stowe Co. issued \$1,000,000 in 8%, 10-year bonds payable when the market interest rate on similar risk-rated bonds was 9%. The bonds pay interest on April 1 and October 1.

What were the proceeds from the bond issue?

- a. \$1,000,000
- b. Greater than \$1,000,000
- c. Less than \$1,000,000
- d. Such a bond could not be issued

Answer: c

9. Diego Drums issued \$100,000 of 5-year, zero-coupon debenture bonds on January 1 when the market yield was 6%. The bond agreement stated that compounding was semiannual.

How much are the proceeds of the bond issue using the time value of money tables?

- a. \$80,000
- b. \$74,400
- c. \$50,160
- d. \$84,800

Answer: b

Rationale: $(\$100,000 \times 0.744)$

10. Which statement is *true* as it relates to callable bonds?
- a. The bond investor has the right to exchange the bonds for stock
 - b. The issuing company can pay off the bonds before maturity
 - c. The bond investor can request that the bonds be repaid prior to the maturity date
 - d. The bonds are considered 'junior' to the claims of secured creditors

Answer: b