

**Module 10 – Financial Accounting for MBAs, 6<sup>th</sup> Edition by Easton, Wild, Halsey & McNally**

**Solutions to Practice Quiz**

LO: 1

1. Answer: c

Present value of Continental Airlines' operating lease payments:

Year (\$ millions)	Operating Lease Payment	Discount Factor (i=0.07)	Present Value
1.....	1,003	0.93458	\$ 937
2.....	966	0.87344	844
3.....	955	0.81630	780
4.....	910	0.76290	694
5.....	924	0.71299	659
>5.....	6,310	5.38929*	<u>3,550**</u>
Remaining life .....	6.829 years***		\$7,464

\* Present value of annuity factor for 7 years @ 7%

\*\*  $\$924 \times 5.38929 \times 0.71299 = \$3,550$

\*\*\*  $\$6,310 \div \$924/\text{year} = 6.829$  years, rounded to 7 years

(Alternate solution using present value formula or financial calculator:

Present value of annuity factor for 6.829 years @ 7% = 5.28577

$\$924 \times 5.28577 \times 0.71299 = \$3,482$ . Total present value = \$7,396)

LO: 2

2. Answer: d

American Express reports \$112 million in pension expense for 2005. The footnote also reports the component parts of the total expense.

LO: 2

3. Answer: a

The funded status is \$(205), which is the PBO less the market value of the plan assets (\$815 PBO - \$610 Plan assets). The negative amount indicates that the plan is underfunded as of 2005. YUM!'s balance sheet will show a liability for this amount.

LO: 1

4. Answer: a

The present value of the operating leases is computed as follows:

Year (\$ millions)	Operating Lease Payment	Discount Factor (i=0.07)	Present Value
1.....	\$45.6	0.93458	\$ 42.6
2.....	33.5	0.87344	29.3
3.....	26.9	0.81630	22.0
4.....	20.2	0.76290	15.4
5.....	15.7	0.71299	11.2
>5.....	37.3	1.80802*	<u>20.2**</u>
Remaining life .....	2.376*** years		\$140.7

\* Present value of annuity factor for 2 years @ 7%

\*\*  $\$15.7 \times 1.80802 \times 0.71299 = \$20.2$

\*\*\*  $\$37.3 \div \$15.7/\text{year} = 2.376$  years, rounded to 2 years

(Alternate solution using present value formula or financial calculator:

Present value of annuity factor for 2.376 years @ 7% = 2.12144

$\$15.7 \times 2.12144 \times 0.71299 = \$23.7$ . Total present value = \$144.2)

LO: 1

5. Answer: b

According to Verizon's lease footnote, it has both capital and operating leases. Only the capital leases are reported on-balance-sheet in the amount of \$112 million (\$17 million in current liabilities and \$95 million as long-term liabilities). However, this is not Verizon's total lease obligation. Verizon also has sizeable leases that it has classified as operating. In fact, the minimum lease payments under operating leases are over 27 times that for capital leases--\$4,497 million vis-à-vis \$166 million! These operating leases are not reported on-balance-sheet.

LO: 2

6. Answer: d

During fiscal 2005, retirees received payments of \$2,856 million for U.S. pension plans and \$1,355 million for non-U.S. pension plans, totaling \$4,211 million. These payments came from the pension plan assets and not from Ford's operating cash flows.

LO: 2

7. Answer: b

In 2005, Xerox recorded an “actual” return on pension investments of \$933 million (which increases the pension investment account). There is no income effect from the actual return on the health care plan assets. The expected return (not the actual return) of \$622 million on the pension investments impacts Xerox’s profitability in 2005. Pension expense is reduced by this amount. Since the health care plan is not funded, there is no expected return offset for this plan.

LO: 2

8. Answer: c

Verizon reports pension income of \$366 million, resulting primarily from the overfunded nature of its pension plan. It reports an expense of \$2,104 million relating to its health care plan.

LO: 1

9. Answer: a

Capitalization of Abercrombie & Fitch’s operating leases would make the following adjustments to its income statement:

1. Remove rent expense of \$187,674,000
2. Add depreciation expense of \$1,016,713,000(see below)/ 8 years = \$127,089,000.
3. Add interest expense of \$1,016,713,000(see below) × 7% = \$71,170,000.

The net effect is to reduce income before taxes by \$10,585,000.

Year (\$ 000s)	Operating Lease Payment	Discount Factor (i=0.07)	Present Value
1.....	\$187,674	0.93458	\$ 175,396
2.....	187,397	0.87344	163,680
3.....	178,595	0.81630	145,787
4.....	169,856	0.76290	129,583
5.....	155,670	0.71299	110,991
>5.....	538,635	2.62432* x 0.71299	<u>291,276**</u>
Remaining life .....	3.460*** years		\$1,016,713

\* Present value of an annuity for 3 years at 7%

\*\* \$155,670 x 2.62432 x 0.71299 = \$291,276

\*\*\*\$538,635 ÷ \$155,670 per year = 3.46 years, rounded to 3 years.

(Alternate solution using present value formula or financial calculator:

Present value of annuity factor for 3.46 years at 7% = 2.98166;

\$155,670 x 2.98166 x 0.71299 = \$330,938; Total present value = \$1,056,375

LO: 2

10. Answer: c

Benefits paid to retirees is not a component of net pension expense.